

BREAK-OUT SESSIONS ON KEY BUDGET FORMULATION ISSUES

Improving macro forecasting and setting realistic budget ceilings

Introduction

Even though an ECA country has experienced steady economic growth over the last few years, domestic revenue has been lower than forecast, resulting in spending cuts (needed to meet fiscal targets agreed with the international community). Line ministries have begun to publicly criticize the MoF for not giving them the promised funds approved in the budget. Line ministries are also openly ignoring the budget preparation process, arguing that the time they take to develop budget proposals is wasted because the MoF makes random cuts during the fiscal year, undermining any planning.

The Minister of Finance is frustrated by this situation, because he thought the ‘forecasting’ problem was dealt with. He had hired a PhD in economics several years ago to make macro forecasting more accurate, and set up a specialist forecasting unit (which does not communicate very much with the Budget Department because of its high degree of specialization). He had also introduced ‘ceilings’ in budget circulars to limit budget requests from line ministries and bring more reliability to the budget.

Determined to make budgeting more meaningful and restore line ministry respect, the Minister sent a delegation to various countries with reliable budgets. The goal was to identify lessons on improving macro forecasting and ceiling development—to foster budget reliability and respect. The delegation made the following observations:

1. Forecasting is integral to budgeting—and involves more than ‘good’ forecasts

Good budgets start with good macro-economic forecasts and credible expenditure ceilings. Realistic estimates of resource availability lay a strong foundation for effective and predictable resource allocation and efficient public spending. ‘Good’ forecasts are only effective when they are *owned* by the budget department, however, which has the responsibility for developing the budget -- even though the act of forecasting itself may rely on borrowed technical skills from outsiders. Countries with more reliable budgets relied on research institutes, private sector entities, specialist forecasting departments or the international community for full scale macro-forecast modeling but the budget departments always made the final call on the numbers they would use.

In this process, the best budget departments identified the final numbers with reference to multiple forecast scenarios and used a ‘planning reserve’ in ceiling preparation that mitigated for forecasting error (and generally assured that forecasts were always conservative and realistic). In some cases the budget department was required to identify resource expectations related to high, medium and low growth cases and was mandated to select the low case scenario. The delegation learned that this reduced the risk of large scale revision later on, thus adding credibility to budget ceilings and to the budget itself.

2. Conservative policy frameworks guide setting overall resource envelopes

The delegation also found that governments with more reliable budgets embedded the entire forecasting practice in a conservative and publicly endorsed fiscal policy framework. These governments introduced multi-year policy frameworks requiring maintenance of the overall fiscal balance over the economic cycle. These frameworks allowed yearly fiscal surplus and deficit situations and future domestic and foreign

borrowing – but only to finance capital investment. These frameworks, adopted as law in the most disciplined governments, provided an unambiguous mechanism to determine resource availability in budgets, which assisted in maintaining fiscal sustainability.

3. There are ‘good practices’ in setting budget ceilings

The delegation noted that forecasts were actively used in setting budget ceilings—for the entire budget and for sectors and ministries. The ceilings were more effective in actually binding budget users’ requests and facilitating budget reliability where top-down and bottom-up approaches were balanced to arrive at final allocations. In the best cases, ceilings were set through a consultative process that involved political and technical leaders. In one case the Council of Ministers (CoM), assisted by experts from the MoF and from various line ministries, determined the overall resource envelope and sectoral ceilings. A two day retreat was organized for all CoM members to discuss national and sectoral priorities and agree on sectoral allocations for the next 3 years. It was a closed meeting and intensive but candid discussion among ministers was common. For the retreat, MoF prepared several analyses on national priorities and their fiscal implications. It was said that the sectoral ceilings made through this consultative process dramatically reduced the repetitive negotiation process between MoF and line ministries that used to take up so much energy from both sides.

In the better cases, the ceilings were used to limit line ministries—who gained from having less intrusive MoF engagement on spending decisions under the ceilings! In these cases MoF checks whether major programs are in line with sectoral priorities identified in sector strategy papers only. This has saved substantial resource and time from the MoF side and shifted the focus of discussion into more policy oriented dialogue. However, the lack of capacity in some line ministries in budgeting still warrants close monitoring of budget proposals prepared by those ministries.

The delegation noted that the political structure within executive and legislative governments affects how resource can be allocated among sectors. CoM-type discussions described above are fairly binding in a Parliamentary system, but in a Presidential system the structure of discussions need to reflect the relationship structures between the President, Prime Minister and Cabinet members.

Questions for discussion:

The Minister has found these observations interesting but is also aware that changing the budget process is a complex and risky undertaking. He would therefore like to seek more advice, and is asking your group for thoughts on the following:

1. The delegation implies that having a forecasting function is not sufficient if one wants better budget reliability. Do you agree with this and, if so, what ‘more’ is needed for effective forecasting and setting budget ceilings?
2. If you agree that strong forecasts are vital for predictable budgeting, what steps could be taken to make the forecasting function more integral to the budget process?
3. If you agree that a fiscal policy framework is necessary for effective budgeting, what should this ‘policy framework’ look like (what goals, rules, etc. would it introduce)?
4. If you agree that forecasts are only valuable if they are translated into meaningful budget ceilings, what practical steps can you offer the Minister to set these ceilings?