

## **Common Practices in Setting Expenditure Ceilings within National Budgets**

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Developing a National Budget has always entailed a complex set of negotiations between national Government priorities, line ministry priorities, and a national funding envelope. In many instances, countries have struggled to control spending by Ministries, Departments, or Agencies. There have been several innovations to bring greater fiscal discipline to National Budgets. One recent innovation has been the development of aggregate and line ministry Expenditure Ceilings.

Governments usually adopt Expenditure Ceilings to send strong signals within and outside of Government on the fiscal space available to implement policies and to influence behaviors in Line Ministries, Agencies, and Departments.

Overall, Expenditure Ceilings at the National and Line Ministry levels are widely recognized to have several benefits:

- Strengthening fiscal discipline and expenditure efficiency at the National Level
- Improving the strategic allocation of public resources
- Establishing a baseline for future improvements

This note explains how to introduce a medium term horizon into a Government’s budgeting process, including the key steps involved. It provides guidance on setting aggregate and line ministry ceilings, reviewing experiences from countries with extensive experience of ceilings (e.g., Finland, the Netherlands, Sweden, South Korea, Indonesia, Brazil, Australia, and Canada, among others), as well as those that have more recently adopted them. There is no one “right” way to set Expenditure Ceilings. Countries tailor Expenditure Ceilings to meet their specific needs, budget challenges, and capacity constraints.

This note proposes an iterative approach – starting from annual ceilings and gradually moving toward a medium-term expenditure framework – allowing for procedural, institutional, and organizational learning and adaptation along the way.

### **I. Defining National and Line Ministry Expenditure Ceilings**

A National or Line Ministry Expenditure Ceiling can be defined as the allocation of a fixed amount of funding for a fixed period of time (e.g., 3 years). A Government or Ministry is then free to allocate expenditure within that ceiling without needing to seek the authorization of the Ministry of Finance.

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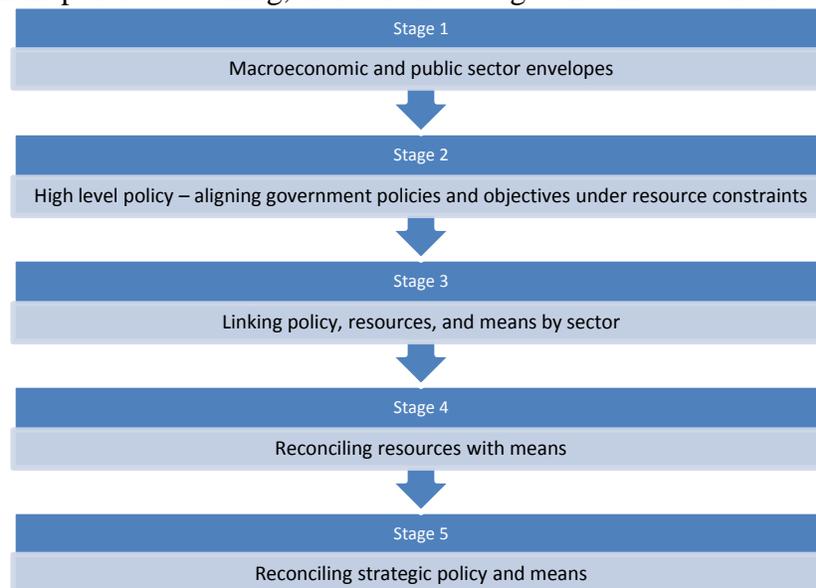
Expenditure ceilings have usually been introduced where countries have faced certain challenges in their budgeting process. For example, a lack of fiscal discipline (both from a technical and political level), poor processes for determining budget priorities, incremental and annual budgeting that makes longer term planning challenging, and a lack of budget ‘space’ for new policies and programs.

At a National level, ceilings indicate the fiscal stance of government and commitment to fiscal discipline. At a line ministry level, ceilings (if set in a conservative framework) are a realistic resource envelope for sectors to plan. They represent both a minimum level that Ministries can expect to receive – offering some certainty that improves planning and administration – as well as a maximum level, requiring Ministries to plan realistically, and look for savings and efficiency gains within the ceiling to finance new policies.

Countries tailor ceilings to meet their specific requirements, budget challenges, and capacity constraints. Some ‘variables’ that differ between countries include which expenditure categories to include, how comprehensive the ceiling should be (in other words, the types of expenditures covered by the ceiling), how to reconcile the impact of inflation on ceilings, the duration of the ceiling, and policy priorities - all of which reflect their political, administrative, economic, fiscal conditions, as well as level of public financial management capacity.

## **II. Stages to set a National or Line Ministry Expenditure Ceiling**

In order to set an Expenditure Ceiling, there are five stages that most countries follow:



### *Stage 1: Macroeconomic and public sector envelope*

The decisions on what to include or exclude in the aggregate ceilings will be driven by several factors, for example, the time horizon selected, the capacity of government agencies or ministries to analyze discretionary and mandatory spending, the political context, and economic stability. At a general level, the main parameters to consider when developing an estimate of the aggregate or “global” fiscal policy envelope/ceiling are:

#### *A. Comprehensiveness/Coverage*

The degree to which the ceiling covers all expenditure categories. Generally, the aggregate ceiling will always include discretionary spending. On the other hand, the inclusion of entitlement spending (also referred to as “mandatory” spending) usually only occurs under medium term ceilings. Key expenditure categories to consider include:

- **Interest Payments**

In general, interest payment on government debt is one of the few expenditure categories which is normally not included in the aggregate ceiling, but is always deducted from the aggregate available resources.

- **Non-cyclical Entitlements** (e.g. legislated benefits such as government pensions)

An annual limit on expenditure for entitlements is not a viable option and as such should be done under a medium-term ceiling. A number of countries do include non-cyclical entitlements under medium-term ceilings, though the practical difficulties of including them under the ceiling must be recognized and addressed.

- **Cyclically Sensitive Entitlements** (e.g. unemployment benefits)

As with non-cyclical entitlements, the decision for the inclusion or exclusion of this type of expenditure is relevant for medium-term ceilings. In general, the inclusion/exclusion will depend on the sensitivity of government expenditure to cyclical variations, the effectiveness of countercyclical monetary policy, and a country’s economic stability.

- **Investment Expenditure**

Investment expenditures are generally included in the ceiling.<sup>1</sup>

#### *B. Inflation Adjustments*

Whether to set ceiling in real vs. nominal terms. Distortions caused by inflation arise as a result of forecasting errors. The appropriate way for making inflationary adjustment depends on the nature, level, and volatility of inflation. In Finland and the Netherlands, four-year ceilings are determined in real terms, and converted into nominal terms just

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<sup>1</sup> For a comprehensive discussion of each of these categories and the advantages and disadvantages of including/excluding them from the aggregate ceilings, please see IMF Working Paper, “Expenditure Ceilings- A Survey” by Gosta Ljungman (2008) available from: <http://www.imf.org/external/pubs/ft/wp/2008/wp08282.pdf> Note that in general, as the number of expenditure exceptions increases, monitoring of compliance with the ceiling quickly becomes complex and the benefit of not subjecting an expenditure category to the ceiling should be weighed against the loss of clarity.

before annual budget preparation. In Sweden, three-year ceilings are set in nominal terms.

*C. Planning Reserve*

Given the natural uncertainties in medium-term expenditure development, planned expenditure (the “ceiling”) should be set at a lower level than the best estimate of available resources for spending. This difference is referred to both as the “planning reserve” or a “contingency margin.” Its function is to absorb unforeseen increases in expenditure. The amount of this reserve needed depends on the construction of the ceiling. A highly comprehensive ceiling will generally require a larger reserve, as will multi-annual ceilings set in nominal terms. For example, if ceilings are set for three years, the third year contingency reserve should be larger to accommodate greater uncertainty. The size of the reserve depends on what type of forecasting errors the government can handle without having to cut expenditure. Even within a single-year framework there can be significant fiscal risks that need to be managed within the expenditure ceilings set. Two planning reserve categories could be considered. One would be to guard against revenue shortfalls and increases in entitlement spending i.e. to manage the risk of adverse economic outcomes. The other category would be to manage the risk of unforeseen events that create significant pressure on individual discretionary program spending where the magnitude of the pressure would make it unrealistic for those ministries impacted to manage within allocated funds i.e. within the set expenditure ceiling. Historical data on actual versus forecasted/budgeted revenue and expenditure aggregates would provide average deviations and a basis for setting the size of the reserve.

*D. Time Horizon*

The main questions here are how many years the ceiling should apply and whether to have a fixed or rolling ceiling? A fixed ceiling stays constant over the relevant time horizon, while a rolling ceiling means that a new annual ceiling is added every year. The latter allows for more discretion in the medium term, but the former helps to keep some of the politics at bay. Considerations include election cycles, planning horizons, and the inevitable increase in uncertainty in the macroeconomic and fiscal forecasts as the time horizon lengthens.<sup>2</sup>

*E. Legal Status*

Another aspect to consider is the legislative status of the ceiling – will it have a legal basis or take the form of a political commitment? In general, aggregate and sector/ministry ceilings take the form of a political commitment (e.g. endorsed by the Cabinet) made in good faith, though there are some exceptions.

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<sup>2</sup> For a much more detailed discussion on each of these points, please see: see IMF Working Paper, “Expenditure Ceilings- A Survey” by Gosta Ljungman (2008) available from:  
<http://www.imf.org/external/pubs/ft/wp/2008/wp08282.pdf>

Table 1 presents the cases of aggregate ceiling construction in Finland, the Netherlands, and Sweden in terms of comprehensiveness, adjustment for inflation, the planning reserve, and time horizon.

**Table 1: Aggregate ceilings in Finland, the Netherlands, and Sweden**

	Comprehensiveness					Inflation adjustment	Flexibility instruments	Time horizon
	Interest expenditure	Non-cyclical entitlements	Cyclical expenditure	Earmarked revenue	Investments			
<b>Finland</b>	Excluded	Partly excluded	Partly excluded	EU funds, lottery revenue	Rule for revenue from the sale of government property	Real ceiling converted with a government expenditure deflator	Possibility to carry over an ex post budget margin	Four-year fixed ceiling for the government term
<b>The Netherlands</b>	Excluded	Included	Included	Some non-tax revenue excluded	FES-fund	Real ceiling converted with national income deflator	Small contingency margin	Four-year fixed ceiling for the government term
<b>Sweden</b>	Excluded	Included	Included	User fees	Internal loans	Nominal ceiling	Contingency margin	Three-year rolling ceiling

Source: IMF Working Paper, “Expenditure Ceilings- A Survey” by Gosta Ljungman (2008)

*Pulling it all together* – At an aggregate level, ceilings indicate the fiscal stance of government and commitment to a fiscal policy. The methods for calculating the ceiling vary significantly among countries and are rarely published. Annex 3 illustrates the process within Thailand. The underpinning calculations require defining the macro economic projections, determining the main parameters for the ceiling (comprehensiveness, inflation, planning reserve, time horizon), estimates of public revenues, and planning and setting expenditure and debt levels. In Finland, the aggregate spending limit (ceilings) are set to support the achievement of targets of the Government Program and continuation of fiscal policy that safeguards stable economic growth within the national election cycle.<sup>3</sup>

Box 2 identifies a number of good practices from around the world for estimating and assuring the integrity of macroeconomic variables, budget assumptions, and fiscal policy.

**Box 2: Good practices in estimating macroeconomic variables**

There are a number of good practices that countries have adopted to improve the accuracy and conservative posture of their macroeconomic estimates. These include:

- Comparison with private or other forecasts (e.g. Central Bank) during forecast development;
- Vetting forecasts through academic or non-government fora or panels;
- Early release of forecasts to Parliament and the public;
- Technical rules (publically announced) for making the forecasts more conservative;
- Economic updates prior to budget enactment that allow modifications to the budget

<sup>3</sup> Decision on Central Government Spending Limits in 2007-2011. Government of Finland, March 23, 2006

proposals to fit emerging trends;

- Inclusion in the budget of a table comparing the key economic variables of the government forecast with several reputable private or public forecasts with explanations for significant variation for median forecasts;
- Having multiple government forecasts that could be the basis of budget development;
- Reserves set aside during budget formulation to account for some variation in forecasts after budget passage;
- Mid-fiscal year economic updates combined with required proposals to bring the budget into line with emerging trends during the fiscal year;
- Formal procedures for passing supplemental budgets during the fiscal year;
- Subsequent annual budgets which include a comparison of prior year budget forecasts with actual economic variables to assess the quality of estimates.<sup>4</sup>

***Stage 2: High level policy – aligning government policies and objectives under resource constraints***

With conservative revenue estimates in hand, a government might consider preparing a fiscal policy paper (also referred to as a Budget Strategy Paper, Budget Allocation Strategy (Thailand), or Fiscal and Economic Update (Canada)) for presentation. This document would bring together the results of the modeling and forecasting exercises into an understandable report of trends and policy implications for senior government officials (and possibly the public). The paper would explore the implications of monetary and fiscal policy for economic growth and trends in fiscal policy, deficits, and debt projections, as well as broad options for changing policies.<sup>5</sup> The paper might also include a sensitivity table, showing what happens to the aggregates when economic variables change. This would serve as a useful vehicle for educating senior policy officials of basic economic issues and linkages between government policies and economic/fiscal/other outcomes.

The fiscal policy paper would be presented to senior officials for discussion, with the objective of obtaining an executive decision on overall government revenue, expenditure, and deficit policy or framework. The focus of the discussion should be on the policies for revenues and expenditures, the path over the budget and subsequent years to attain government objectives, and should generally not turn to discussing the economic forecasts themselves. At this stage, the government-wide public sector pay policy might also be clarified with wage bill negotiations

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<sup>4</sup> Korean Development Institute & the World Bank, “Reforming the Public Expenditure Management System: Medium Term Expenditure Framework, Performance Management and Fiscal Transparency.” (2004:3)

<sup>5</sup> For examples of such papers and how they are structured, see the Budget Strategy Papers required by the EU’s pre-accession economic programs which outline the appropriate medium-term policy framework, including public finance objectives and structural reform priorities. Available from:  
[http://ec.europa.eu/economy\\_finance/international/enlargement/pre-accession\\_prog/index\\_en.htm](http://ec.europa.eu/economy_finance/international/enlargement/pre-accession_prog/index_en.htm) .

starting shortly thereafter.<sup>6</sup> Sweden combines discussion on the fiscal policy, expenditure envelope, and sector ceilings into one two-day Cabinet retreat, after which the approved levels are sent to Parliament for ratification. In all there are 27 sectoral ceilings sent to the Parliament.

In some countries, Cabinet approves the aggregate ceiling as well as the sector/ministry ceilings. Annex 3 contains an illustration of Thailand’s Budget Calendar and key points at which Cabinet is involved. Once approved by Cabinet, these indicative sector/ministry ceilings are transmitted to Ministries, usually within the annual budget call circular. In Parliamentary systems, Cabinet sanctions can be important for compliance, as it represents a collective Government decision, which each Cabinet member is bound to follow.

### ***Stage 3: Linking policy, resources, and means by sector/ministry***

Top-down budgeting refers to the assignment of spending ceilings to ministries and agencies before they prepare annual budget requests. Once the ceilings are set, line ministries formulate their budget proposals to fit within the ceilings.

Setting indicative sectoral and ministerial ceilings aims to facilitate policy prioritization and improve resource allocation in the budget, and to promote more responsible budget proposals of line ministries. Within the ceilings, line ministries are given much more flexibility in deciding how to allocate resources to meet policy objectives. Whereas line ministries may have prepared budget proposals based on what they wanted, in the new orientation they are required to match their proposals within pre-determined limits. Before seeking new funds for new initiatives, Ministries, Departments, and Agencies (MDAs) are expected to reallocate within their ceiling.

A good starting point for setting the indicative ceilings for sectors and ministries is the prior year’s budget, adjusted for known modifications in Government priorities and policies, improved spending estimates, major revisions in revenues and expenditure targets, and so on. In setting the indicative ceilings for sectors and ministries the basic steps are:

**Step 1:** Take the prior year’s<sup>7</sup> actual spending (to capture the full-year costs of continuing activities/programs)

- + Annualize full- year cost of policies adopted mid-year in prior year
- Annualize full-year savings of terminated programs

**Step 2:** Adjust for:

- +/- known modifications in enacted/adopted Government priorities and policies (to capture enacted new or expanding activities/programs),
- +/- personnel costs,<sup>8</sup>

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<sup>6</sup>A sound information base on staffing and pay is needed to ensure that discussions on the topic of the public sector wage bill address policy differences rather than factual challenges.

<sup>7</sup> If the budget being worked on is  $t=0$ , then the prior year’s actual spending would be  $t=-2$ . There is no outturn data for  $t=-1$  when you are preparing the budget for  $t=0$ , although there will be some part year spending.

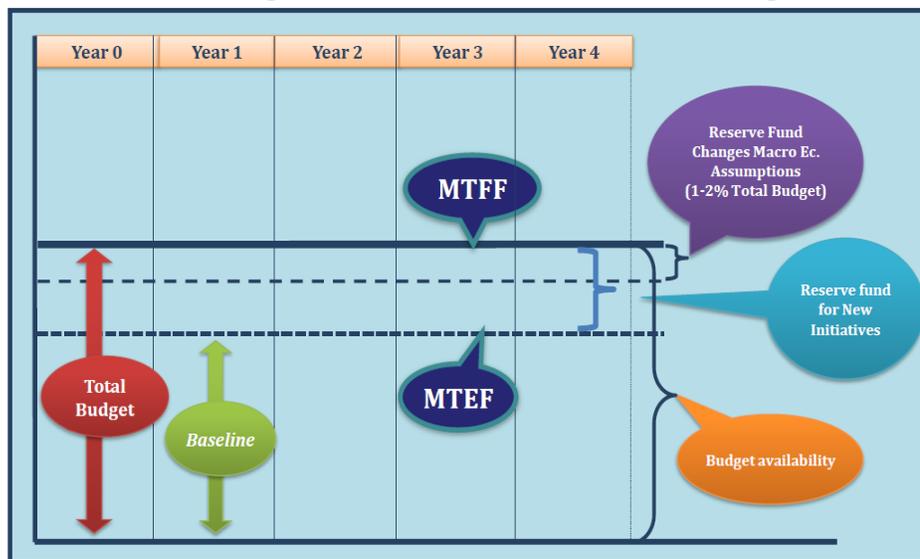
<sup>8</sup> The changes to the personnel costs here will reflect the sector implications of the government wide public sector pay policy agreed to at the start of the process.

- +/- debt, principal and interest
- + continuing capital projects,
- + new or expanding capital projects,
- completed/discontinued capital projects,
- + inflation estimates and other changes in the per-person cost of providing programs/services,
- +/- estimates of changes in the number of people utilizing benefits/services due to population growth and other factors.

Countries such as Brazil, Australia, Canada, and the US begin with baseline (or forward) estimates that are drawn from previously approved policies. In these countries, the ceilings and subsequent budget action represent marginal changes in policy, as measured against a baseline (referred to in the US as the “current services” baseline). The underlying assumptions in calculating the baselines are clear and published in budget guidance, call circulars, or handbooks. On the other hand, in South Korea, spending ceilings are supposed to derive from a full policy review – effectively a form of an attempt of “zero base budgeting.” This requires a substantial planning & policy analysis capacity. The Annexes include detailed descriptions of the ceiling development process in Brazil, Canada, Thailand, and the development of the current services baseline in the United States.

In order to find room for new policy initiatives, some countries reduce sector ceiling allocations by a specific amount to create a central planning reserve that is used to fund new initiatives after spending requests are received. Figure 1 illustrates this approach in Indonesia with the baseline set below the total budget for 4 years - the difference is dedicated for new initiatives.

**Figure 1: Indonesia’s Four Year Ceilings**



**Stage 4: Reconciling resources with means**

Once line Ministries receive their sector/ministry level allocations based on the aggregate resource envelope, the expectation is that each Ministry would take the resource ceiling as given, and allocate spending among its activities and programs to attain its objectives. Often, there is a review process so that this ceiling has legitimacy. In some cases it may involve bilateral meetings with the Ministry of Finance prior to the submission deadlines.

Ministries will need to consider guiding policies and laws, program priorities relative to objectives, assess various modalities (or means) to meet their objectives, and evaluate/assess the ‘production function.’ They will also need to construct realistic staffing cost estimates under various scenarios. The UK Budget 2010 Policy Costing methodology provides some guidance on how to determine the impact of various budget policy decisions related to taxes, benefits, and entitlements on the overall revenue and expenditure framework.<sup>9</sup>

Ministries may have begun to develop their budgets prior to receiving the Call Circular, and such early budget development can assure that ministry budgets are carefully developed. Ministries may have undertaken their own strategic planning exercise, or undertaken a special review of the effectiveness or continued usefulness of policies, programs, and projects. These reviews and plans should be undertaken, either as part of the annual budget cycle (with sufficient time allotted to this stage), or prior to it and then fed into the resource allocation decisions during the budget process.

An important issue to consider is the extent to which other Ministries have the policy and program analysis skills to undertake the reviews of activities and laws, assess their effectiveness

<sup>9</sup> [http://www.hm-treasury.gov.uk/d/junebudget\\_costings.pdf](http://www.hm-treasury.gov.uk/d/junebudget_costings.pdf)

and cost, and develop options for the responsible Minister. At the end of the stage, the Ministries will submit their budget requests to the Ministry of Finance. The format of the requests will vary by country, but it is recommended that in addition to the tables of numbers, there is text explaining the policies contained in the proposals, changes in policy from prior years, significant reallocation decisions, and new objectives.

### ***Stage 5: Reconciling strategic policy and means***

This final stage will take on a very different structure depending on the budget process. In the US, after decisions are taken, they are passed to the Departments who then have the right to appeal the decisions – once the appeals process is settled, Departments must revise requests to be in alignment with the President’s policy. A primary role for the Ministry of Finance in this stage is resolving any loose ends in the decision process, finalizing or refining numbers and policies to assure consistency. A further Ministry of Finance role in many countries is the development of a communications strategy and material to clearly explain decisions, elaborate the rationale for choices taken, and explaining the directions for budget policy. Once the budget has been approved, many countries also have a process for revising the budget in-year to accommodate changes to existing and new policies. In Sweden, supplementary estimates are presented to the Parliament twice during the fiscal year in connection with the Spring Financial Bill and the normal Budget Bill. Any proposal for new spending must be accommodated within the global and usually the relevant expenditure ceiling. In other words, it must be accompanied by a proposal for reductions in other areas. The number and volume of new proposals is quite limited.<sup>10</sup> In the United States, during the fiscal year, scorekeeping is also used for new legislation. Since the Office of Management and Budget must clear all legislation before transmittal to Congress, no uncosted or unfunded legislation is transmitted from the executive. All proposals must fit within the ceilings.

### **III. Change Management**

Initiating and sustaining the process of setting and adhering to expenditure ceilings, as well as increasing its effectiveness over time, requires not only a series of political and technical decisions, but also requires changes in behavior in both the budget agency and line agencies, and between different levels of government. This change is best driven from within government, and it requires strong leadership and commitment from the budget agency and the Minister of Finance to push through the changes and ensure a credible ceiling development process.

Such change also requires patience, as it takes years to build a fully successful process. At the start, there will be a need for a strong commitment from the Cabinet to ‘promise’ the envelope, and clear (and early) communication to all actors who will be involved in the process (including ministries) on their new roles and responsibilities. Table 2 presents key changes in roles that accompany the development of ceilings.

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<sup>10</sup> Korean Development Institute & the World Bank, “Reforming the Public Expenditure Management System: Medium Term Expenditure Framework, Performance Management and Fiscal Transparency.” (2004: 67).

**Table 2: Changing Roles of Line and Budget Departments**

<b>Cabinet</b>	<b>Budget Department (MoF?)</b>	<b>Line Ministry</b>
<ul style="list-style-type: none"> <li>• Prepared to use the budget to discipline policy decisions</li> <li>• Discusses budgetary decisions in the context of policy objectives</li> <li>• Able to stick to decisions on budget ceilings</li> <li>• Hold ministers to account for performance</li> </ul>	<ul style="list-style-type: none"> <li>• Predictable budget policy and process</li> <li>• Deliver realistic, conservative fiscal projections</li> <li>• Deliver predictable ceilings and funding</li> <li>• Transparent process for reallocating funds between sectors</li> <li>• Be prepared to leave budget decisions to line agencies</li> </ul>	<ul style="list-style-type: none"> <li>• Be prepared to set out clearly policy objectives in the budget process</li> <li>• Develop sector strategies and plans</li> <li>• Must be prepared to live within budget ceilings one approved</li> <li>• Examine ways to improve efficiency and effectiveness of spending</li> <li>• Report on resource use and performance</li> </ul>

Source: Overseas Development Institute, “Implementing a Medium Term Perspective in Budgeting in the Context of National Poverty Reduction Strategies,” Good Practice Guidance Note.

At the start of the process, how well a Ministry of Finance communicates with stakeholders is critically important to the successful introduction of ceilings. In South Korea, when ceilings were introduced in 2005, the Ministry of Finance encountered heavy pushback because:

- The ceilings were not sufficiently based on consultation within the government or on bilateral discussions with line ministries.
- The ceilings were bereft of policy guidance.
- Without linkage to an ongoing fiscal management process, the ceilings may be interpreted by spending units as floors, thereby generating upward pressure on future budgets.

The initial round of ceilings in South Korea stirred much confusion in spending units.<sup>11</sup> Inevitably, tension will arise from both the way top-down budgeting is implemented and communicated, as well as from natural tensions that emerge from restructuring budget rules and relationships.

The main focus early on should be *changing the processes and rules* – such as the processes surrounding budget drafting and negotiation – rather than focusing on producing highly detailed budget estimates and costing. Engaging the political level at key decision points in the budget cycle in making strategic choices about where and how resources should be prioritized is a critical part of developing an effective process. Political engagement not only gives substance to the ceiling development process, it is also vital for ensuring the credibility of expenditure ceilings. If politicians are unwilling to be constrained either by a hard budget constraint or by agreed priorities then the process can easily be undermined.

<sup>11</sup> Korea Institute of Public Finance & the World Bank, “From Line Item to Program Budgeting: Global Lessons and the Korean Case,” Available from: <http://www1.worldbank.org/publicsector/pe/bookprogrambudget.pdf>



The introduction of aggregate and sector/ministry ceilings into the budget development process will require a series of incremental adjustments. The process by which these ceilings are agreed and formalized will be iterative – in other words, discussions and negotiations will happen throughout the process, resulting in major (e.g. Cabinet approval process) and minor adjustments (e.g. discussions with line Ministries) to the indicative ceilings.

## **Resources**

European Commission. “Pre-accession economic Programmes (PEP).”

[http://ec.europa.eu/economy\\_finance/international/enlargement/pre-accession\\_prog/index\\_en.htm](http://ec.europa.eu/economy_finance/international/enlargement/pre-accession_prog/index_en.htm)

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## **Annex 1: Brazil’s Budget Development Process**

The broad functional steps in the Brazilian budget formulation process are:

- Define the macro-economic projections, estimate public revenues, and plan/set expenditure and debt levels.
- Develop indicative sectoral limits based on analysis of current operating costs, programs, and activities. The ceilings include several subsets of estimates:
  - A. Personnel costs — A detailed personnel registry provides information on wages, new hires, and early retirements. This is a known number.
  - B. Debt — Part of debt service for loans related to each Ministries programs are allocated to each Ministry and part to the Ministry of Finance. The budget office knows all contracts, and knows this number.
  - C. Activities, continuing — The cost of continuing the current programs is estimated by the budget office and refined by the line Ministry. This includes administrative costs in support of personnel (utilities, etc.), plus mandatory activities (health, pensions, etc.)
  - D. Activities, new or expansions — Line Ministries develop these proposals and submit to the Ministry of Planning for review.
  - E. Projects, continuing — Line Ministries estimate the cost of maintaining the economic viability or continuing on-going projects.
  - F. Projects, new or expansions — Line Ministries estimate the cost of expansion of projects or of new projects.
- Within the available resource estimates, subsets a, b, and c are treated as priorities in the annual budget process. Subsets d, e, and f are treated as residual: if resources are available to allocate, they first go to new or expanded activities, then to continuation of projects, and finally to new or expanded projects.
- Note that items d through f are only the marginal cost of the activity or project. The personnel costs and associated overhead costs (running costs) are separately funded in a and c.
- This process assures the basic obligations of the state — debt service, mandatory social benefits, personnel (which are fixed in Brazil) and fixed administrative costs, as well as transfer payments, receive funding first.<sup>12</sup>

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<sup>12</sup> Korean Development Institute & the World Bank, “Reforming the Public Expenditure Management System: Medium Term Expenditure Framework, Performance Management and Fiscal Transparency.” (2004:9).

## **Annex 2: Canada’s Budget Development Process**

There are six principal activity streams to the budget process:

- A. Development of new expenditure policy options
- B. Consultations with private sector economic forecasters
- C. Forecasting revenue
- D. Forecasting the cost of delivering existing programs on a policy status quo basis:
  - a. major statutory programs and debt service charges (i.e. those that are dependent on economic and demographic variables); and
  - b. direct programs (i.e. those for which spending is authorized annually)
- E. Development of new budget measures;
  - a. Prioritizing and narrowing down new policy options – tax and spending
  - b. Identifying and assessing significant and high risk spending pressures from existing programs
- F. Development of expenditure reductions options if needed to increase fiscal flexibility

The first stream (new expenditure policy) is a separate process coordinated by the Privy Council Office in which line departments develop proposals that are presented by their Minister for consideration by policy sub-committees of Cabinet. These sub-committees have no funds to allocate and result only in a series of policy options that are considered in the budget decision-making process.

The budget development process itself consists of a series of iterative interactions between streams 2 to 6 above and starts in earnest with the development and publication (typically in October/November) of a Fiscal and Economic Update that includes a public version of a policy status quo fiscal framework. The process is coordinated by a committee of the permanent heads of the three central budget agencies (Privy Council Office, Department of Finance (DOF) and Treasury Board Secretariat (TBS)), supported by a shadow committee of their senior officials, and is almost exclusively internal to these agencies. With the exception of developing statutory and direct spending forecasts (see below), engagement with officials of line departments is strictly limited and tightly controlled.

The primary instrument of fiscal discipline is the fiscal framework that is developed and regularly updated by DOF and that provides forecasts of revenue and expenditure over five forward years on a policy status quo basis. The forecast annual budgetary balance (surplus or deficit) highlights the degree to which there is flexibility to fund new spending measures and creates a focus on balancing the relative priority of spending measures to respond to government priorities and high risk spending pressures from existing programs against measures that might be required to create or increase fiscal flexibility to deal with them.

Departments are required to provide “Annual Reference Level Update” (ARLU) (also known as a current services baseline) submissions to the TBS as the basis for forecasting policy status quo

spending. However, these are explicitly *not* a vehicle to request additional funding over existing allocations. The exception is with so-called “quasi-statutory” activities where a high proportion of individual program spending is subject to factors outside a department’s control (e.g. significant fluctuations in inmate population in prisons). The practice for some time for all programs has been *not* to provide compensation for inflation although an allowance for inflation is included in multi-year capital allocations. TBS’s ARLU review results in a determinative input to DOF’s Fiscal Framework and allocation of funds to departments for three forward-years within which they must plan their operations. Allocations for the first year provide the basis for the Main Estimates and the related Appropriation Bill.

Final budget decisions are made by the Minister of Finance and the Prime Minister typically with no involvement of Cabinet or its sub-committees. The Budget typically provides complete fiscal framework numbers for only two forward years although there has been some recent departure from that practice driven by political budget communication strategy that requires the support of numbers further into the future. The target budgetary balance for the first year of the Budget has emerged as the primary performance indicator on which the government’s credibility is judged in Parliament and by the media. A variety of both explicit and implicit prudence factors have been included in the Budget fiscal framework in order to manage this credibility risk.

The federal government does not establish overall legally-binding spending ceilings although the direct program spending component (i.e. excluding statutory spending) is tightly and legally controlled by means of program votes in the annual appropriation legislation and by means of allotment controls within individual votes that can be established by the Treasury Board. Although these control points can be increased through supplementary estimates, such decisions are made within the same process as for the annual budget with an updated fiscal framework and an unchanged budgetary balance providing the discipline.

### **Annex 3: Thailand’s Budget Development Process**

The budget planning process starts with the four core economic agencies (the Bureau of the Budget (BOB), the Ministry of Finance, the Bank of Thailand, and the National Economic and Social Development Board (NESDB)) agreeing on key macroeconomic parameters, aggregate revenue projection, public debt forecasts, and annual corresponding budget envelope with three years of forward projections. Macroeconomic assumptions include economic growth, inflation, and unemployment rates, which are used for revenue projections. The expenditure envelope is limited by fiscal rules at 125 percent of forecast revenues.<sup>13</sup>

Subsequently the BOB and NESDB prepare an annual Budget Allocation Strategy which sets out the strategic targets, key performance indicators at the macro level, and a budget allocation guideline together with the budget calendar. The Budget Allocation Strategy is approved by the Cabinet. The Bureau of the Budget then requests budget submissions from all budget agencies.

Once the Budget Allocation Strategy is approved by the Cabinet, the Bureau of the Budget commences preparing the top-down medium term expenditure framework and the bottom up medium term expenditure framework.

***The top-down Medium Term Budget Framework:*** The Bureau of the Budget takes the current year budget and adjusts the estimates for inflation, change in key goods and services prices, salary adjustments, debt service projections, and other statutory obligations to arrive at the baseline ceilings for agencies and a corresponding overall projection of the next year budget. The difference between the top-down baseline budget projection and the overall budget envelope agreed between the core economic agencies represents the fiscal space available for new policy initiatives.

***The bottom-up Medium Term Expenditure Framework:*** The Bureau of the Budget aggregates all the budget requests from ministries and agencies, adjusts the budget requests in discussion with respective agencies to ensure that these are consistent with the approved Government Administrative Plan and corresponding Ministerial Operating Plans, and prepares the bottom-up Medium Term Expenditure Framework (MTEF). The MTEF is based on needs to fulfill the government administrative plan and the 5 year National Development Plan.

The fiscal space available from the top-down medium term budget framework is always not enough to meet the financial needs from the bottom-up medium term expenditure framework. Therefore the Bureau of the Budget in discussion with respective agencies allocates the available fiscal space to priority programs and presents the budget to the Cabinet for consideration and subsequently to the Parliament for approval. The allocation of fiscal space to priority programs is

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<sup>13</sup> Per the Public Debt Management Act (2005), the proposed budget deficit (excluding ‘on-budget’ principal repayments) cannot exceed 20 percent of expenditures. Because the expenditure envelope is equal to the deficit plus projected revenues, it is therefore limited to 125 percent of projected revenues.

mostly a political bargaining process which is referred to as the ‘black box’.<sup>14</sup> Figure 2 illustrates the budget formulation process in Thailand.

Figure 2: Thailand’s Budget Calendar (next page)

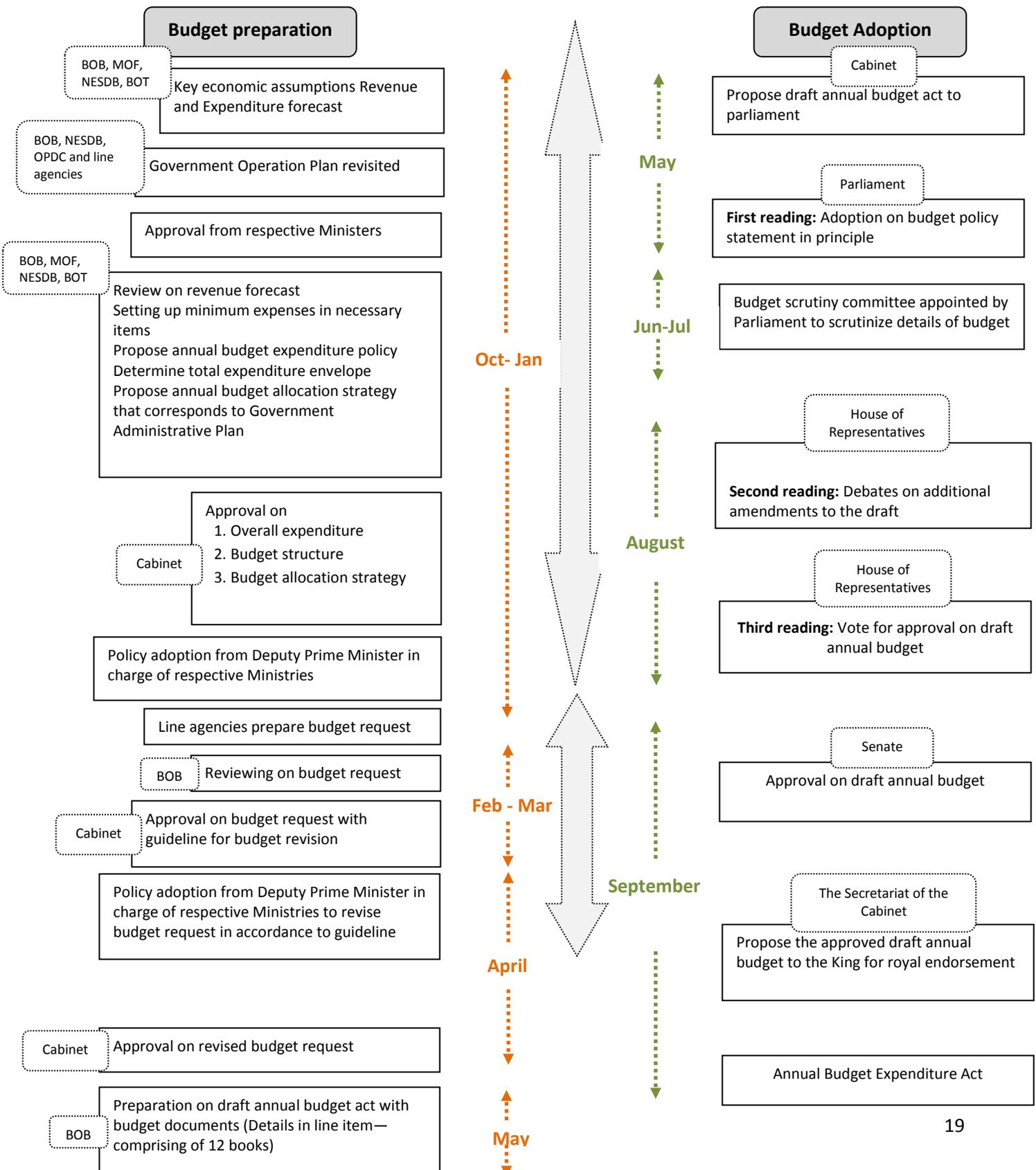
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<sup>14</sup> Thailand Public Finance Management Review 2011 (adapted by Shabih Mohib)

# GET Note: Setting Expenditure Ceilings within National Budgets

## "Recently Asked Questions" Series

### January 2013



## **Annex 4: Current Service Baseline Development in the United States**

Since the mid-1970s, the US federal government has requested agencies to prepare their “current services” baseline forward estimates each year. The preparation of these estimates is detailed in the 1990 Budget Enforcement Act and detailed in Office of Management and Budget’s Call Circular A-11. The guidelines on how to prepare these forward estimates has evolved over time since its introduction. The current services baseline refers to a projection of **current-year** levels of new budget authority, outlays, revenues, and the surplus or deficit into the budget year and the out years based on laws enacted through the applicable date. It represents the amount that would occur if existing budget policies were left unchanged. The baseline reflects a set of ex-ante assumptions for different types of expenditures. The assumptions for calculating the forward estimates of various types of expenditures/appropriations categories are published in the A-11 call circular. Examples are drawn for the following three categories to illustrate the assumptions underpinning current services baseline development – with more detailed information provided in the footnote references:

- A. *Direct Spending & Receipts*: Laws providing or creating direct spending and receipts are assumed to operate in the manner specified in those laws for each such year and funding for entitlement authority is assumed to be adequate to make all payments required by those laws. Exception: No program with estimated current-year outlays greater than \$50 million shall be assumed to expire in the budget year or outyears.
- B. *Discretionary Appropriations*: Assumptions to be used in the calculation of baseline are set for the following categories: inflation of current-year appropriations, expiring housing contracts, social insurance administrative expenses, pay annualizations and offset to pay absorption, and inflators. (The inflator used to adjust budgetary resources relating to personnel shall be the percent by which the average of the Bureau of Labor Statistics Employment Cost Index for that fiscal year differs from such index for the current year. The inflator used to adjust all other budgetary resources shall be the percent by which the average of the estimated gross national product fixed-weight price index for that fiscal year differs from the average of such estimated index for the current year.)
- C. *Current-Year Appropriations*: If, for any account, a continuing appropriation is in effect for less than the entire current year, then the current-year amount shall be assumed to equal the amount that would be available if that continuing appropriation covered the entire fiscal year. If law permits the transfer of budget authority among budget accounts in the current year, the current-year level for an account shall reflect transfers accomplished by the submission of, or assumed for the current year in, the President's original budget for the budget year.<sup>15</sup>

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<sup>15</sup> Adapted from the Budget Enforcement Act of 1990 `SEC. 257. OMB A-11 Call Circulars:  
(2011) [http://www.whitehouse.gov/omb/circulars/a11/current\\_year/a11\\_toc](http://www.whitehouse.gov/omb/circulars/a11/current_year/a11_toc)  
(2008) [http://georgewbush-whitehouse.archives.gov/omb/circulars/a11/current\\_year/a11\\_toc.html](http://georgewbush-whitehouse.archives.gov/omb/circulars/a11/current_year/a11_toc.html)  
(2001) <http://www.cio.gov/Documents/ACF45C1.pdf> (1999) <http://clinton2.nara.gov/ombcirculars/a11/99toc.html>