



FISCAL AFFAIRS

Why and How to Prepare Expenditure Baselines?

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Outline

- I. Definition and International Examples
- II. Benefits and Limitations
- III. Methodology and Specific Issues
- IV. Institutional Requirements

Definition and International Examples

Definition

Concept

- Baselines are estimates of future expenditure on the assumption that current policies remain unchanged

Basic Assumption

- Even if policies remain unchanged, the cost of delivering these policies can change
 - Price and volume can change
 - Policies may be at different stages of implementation
 - E.g. capex; pension reform; implementation of savings measures on social transfers or operating expenditures following a spending review

Usual approach

- Multi-year
 - But baselines do not represent future spending allocations nor the most likely budgetary outcomes (expenditure forecasts). They only reflect spending dynamics if no new, discretionary decision were taken over the next few years.
- Bottom up
 - But that does not mean that baselines are necessarily prepared at the most detailed level (e.g. at detailed policy level, or at detailed activity level).

Some Examples of Uses of Baselines around the World

Country	Main objective(s)	Who prepares baselines ?	Level of baselines ?	Frequency
Australia	Identify fiscal space, facilitate budget discussions and set multi-year ministerial ceilings	Line ministries	Overall budget (baselines prepared at the level of programs)	4 years
France	Facilitate budget discussions and review of policies, identify fiscal space	MoF and line ministries	State budget (baselines prepared at the level of <i>missions</i> – policy areas – and programs)	3 years
Madagascar	Facilitate budget discussions	MoF	Budget	3 years
Senegal	Facilitate budget discussions	MoF	Budget	3 years
South Africa	Facilitate budget discussions	Treasury ; line ministries	Budget	3 years
United States	Transparency on spending trends	Congressional Budget Office	Federal spending (prepared at the level of subaccounts)	11 years
European Union	Fiscal surveillance	Member States under the guidance of the Commission	State budget	3 years
Poland	Identify fiscal space	Line ministries	State budget (baselines prepared at ministry level)	3 years
Peru	Increase allocative efficiency	MoF	State budget	3 years
Kenya	Facilitate budget discussions	Treasury	Specific line ministries	Annual

Benefits and Limitations

Benefits

- **Provide early indications of spending pressures and their drivers.**

“Baselines give an early indication on how resources may have to be reallocated and policies change to addresses future imbalances.”
- **Help in the identification of fiscal space at macro-fiscal level.**

“provide an assessment of the fiscal space available to implement new policies, or the extent to which corrective actions are needed when fiscal savings are required.”
- **Simplify budget negotiations by focusing discussions on new policies.**

“moving away from the minutiae of line-by-line review of spending ministries’ budget bids”
- **Allow the reassessment of continuing past policies.**

“Avoid rolling over a policy or program on the basis of outdated cost estimates”
- **When published, serve as a tool in the public debate on the fiscal sustainability of public policies.**

“can stimulate public discussion on the cost of policy inaction in some areas such as health and pension spending”

Dangers

...in relying too mechanically on baselines in budgeting

- **Incremental budgeting & insufficient scrutiny of existing spending**

Mitigation measure : Spending reviews to periodically assess the quality of existing spending

- **Baselines becoming future entitlements**

Mitigation measures :

- An effective top-down approach to budgeting & a strong Ministry of Finance

- A strategic use of baselines, e.g. on wages to avoid endangering future wage negotiations

- A better reflection of real spending needs, e.g. adopt a very restrictive approach for capex to avoid persistent underfunding of opex and maintenance”

Methodology and Specific Issues

A Step-by-step Guide to Preparing Baselines

Understanding the budget

Knowing where and on what the various administrative units are spending is essential to

- a) **Make strategic choices.** These include (i) choosing a preferred level of disaggregation (e.g. main spending units, programs) (ii) choosing the costing approach and tools to use (iii) other decisions such as the level of effort to apply in the determination of baselines
- b) **Set the current base.** The base provides the starting point of a baseline projection.
- c) **Adjust the base** by (i) **identifying and removing past one-offs** from base. These costs will not be incurred in coming years (e.g. the cost of elections held in the base year) and (ii) **including the effect of past policies that are yet to fully mature in base year.** Examples of such policies include an IT modernization program or a wage reform which began midway in the base year.

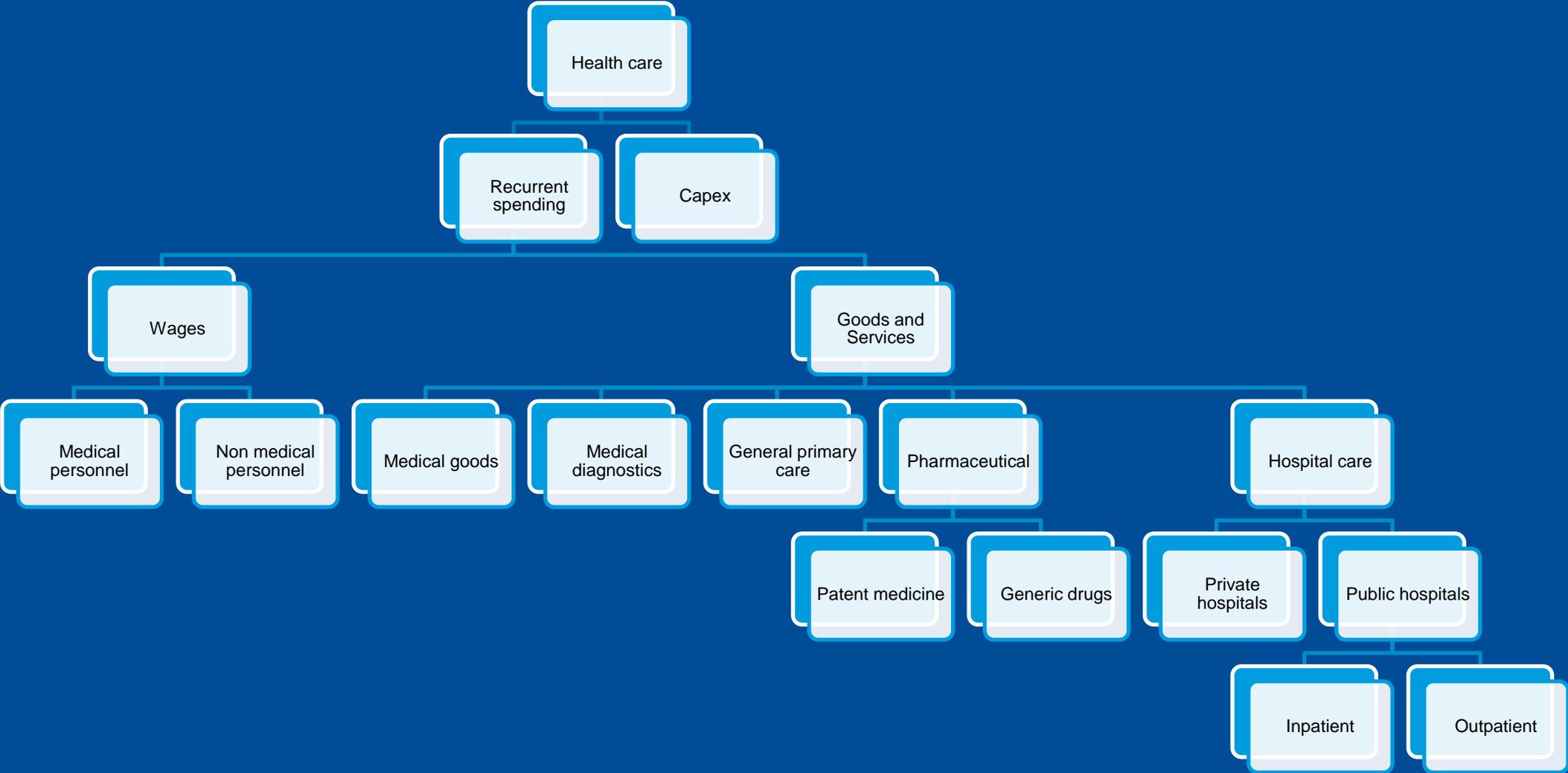
Understanding and applying medium-term cost drivers

- a) **Identify price and volume cost drivers.** This should be done for each level of baseline projection
- b) **Link these cost drivers to macroeconomic and demographic variables** (e.g. consumer price index – CPI – or population growth)
- c) Adjust base spending by the price and volume parameters

Aggregating to get the overall baseline projections for each ministry

Transfers across budget organizations within the Ministry should be netted out to provide a consolidated baseline projection for each ministry

Strategic Choice: Choosing the Level of Disaggregation



Strategic Choice: Choosing the Base

Base	Advantage	Disadvantage
Current year's budget	No need to reopen recent budget discussions	Budget may be aspirational, so this will need to be corrected to take into account information on the interim execution of the current year
Last year's realization	Reflects actual execution	Line Ministries and Agencies (LMAs) will need to justify again new budget funding that was agreed for the current year
Previous years' budget	Avoid difficult-to-identify one-offs in recent years	LMAs will need to justify again new budget funding accrued in recent years
Legal entitlements only	Suitable for demand-driven programs for which recent spending has been volatile	Legal entitlement may not adequately reflect current level of funding

Adjusting the Cost Base

Clean the base with one offs

E.g. Elections, census collections, and IT infrastructure upgrades.

Adjust for policy implementation

E.g. Wage increase that took effect half-way in last year; pension reform which is being implemented over a number of years

Adjust for cyclical factors and crisis response

E.g. Preparing the baseline in the aftermath of a crisis as was the case in 2021 with COVID-19 : need to identify COVID-19 measures that will trail off and those that will persist

Applying Cost Drivers

The default approach: PxQ

- Decompose spending alongside its economic components (wages and services, good and services, etc.); and sub-components (e.g. basic wage vs. other allocations) and identify each price and volume drivers

Other less used approaches:

- Trend extrapolation
- Analogous estimation
- Lump sum or fixed amount costing

Examples of price and volume drivers

Economic classification	Price	Volume
Wages and salaries	Negotiated wage increase; wage drift (reflecting promotions and increments, new staff replacing higher paid staff retiringC)	Projected recruitment and separation
Social contributions	Contribution rate; wage increase	Projected recruitment and separation
Goods and services	Macro variables (inflation; oil prices); specific component of the CPI (utilities, food), other price specific price parameters (e.g. pharmaceuticals)	Volume of goods and services (quantities of medicine; number of vehicles; number of square meters of office space)
Subsidies	Inflation; price specific parameters	Estimates of demand in volume
Grants	Grant formula; inflation	Estimates of demand in volume

Specific Issues in Preparing Baselines

Wages and Payroll Expenditure

- Follow PxQ but account for the wage drift (see forthcoming HTN - Chadi/Bender)
- Be aware of the sensitivities
 - Setting ministerial ceilings using wage baselines can compromise wage negotiations
 - Solutions:
 - a central contingency allocation
 - (Australia) Only award minimum legal requirement

Interest Spending

- Interaction between interest forecasting and financing needs (debt-interest loop) (see forthcoming HTN - Balibek/Hurcan)

CAPEX

- Distinction between major and minor capex. Which threshold?
- Major capex should trail off; minor capex can be assumed to continue
- CAPEX baselines determine opex and maintenance baselines
- How to avoid persistent underfunding of opex and maintenance? Use depreciation, but needs accrual accounting

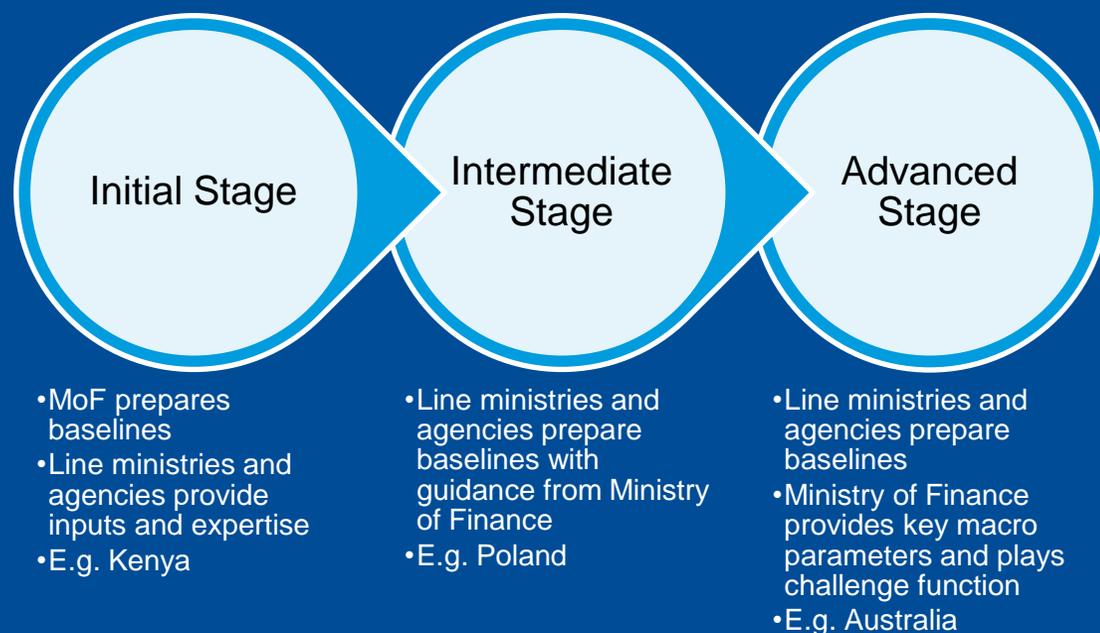
Welfare spending

- Example:.. Need to understand target population; eligibility criteria; external environment; and behavioral factors
- Further complexity: interactions across programs (e.g. changes in eligibility for unemployment benefits can affect the baseline for disability payments)
- Need in-depth knowledge and access to administrative and survey data. Best leave it to specialized agencies if they have the capacity

Institutional Requirements

The Distribution of Roles (MOF and LMAs)

Stages of maturity in baseline preparation



Lessons:

- Irrespective of the stages, strong guidance of MOF
- Progressing across stages: MOF plays a guidance and challenge function, leaving LMAs preparing baselines
- Even at initial stage, LMs need to be on-board:
 - For their buy-in
 - For their sectoral expertise

Guidance and challenge by MOF

- **Budget Department**
 - Guidance on methodology to ensure consistency across LMs and programs
 - Challenge baseline submissions by LMs: require having own internal baselines
 - Be aware of LM strategies to get access to more resources:
 - When expenditure ceilings are set early on, LMs can underestimate their baselines to get their new policies through
 - When ceilings are not set early on, LMs can inflate their baselines
- **Macro-Fiscal Department**
 - Provide updated macro-fiscal forecasts, and time forecasting rounds to coincide with the main milestones in the budget process
 - Be ready to provide customized parameters
 - Build capacity in budget department, and line ministries

Key Enablers

- Good budget classification
 - One that maps funding with spending areas/programs
 - One that is integrated with the accounting classification
- Strong top-down approach to budgeting necessary to avoid the pitfalls of an approach excessively centered on baselines

Supporting Reforms

- Spending reviews are a necessary complement as they enable to question baseline spending
- A fully functional Medium-Term Budget Framework helps maximize the usefulness and impact of baselines – multi-year baselines as a major step towards constructing a realistic and well-rounded multi-year budget

Conclusions

- The concept of baselines is a major and powerful analytical tool from a budget preparation standpoint
- Applying this concept of baseline is not as straightforward as it may intuitively appear
 - Need to have a clear definition
 - Methodology
 - And be aware of specific issues
- Introducing baselines
 - A staged approach: a strong role for the Ministry of Finance
 - Need for supportive institutions to maximize the benefits of baselines

Thank you