



## **Medium-Term Budgetary Frameworks: A Key Factor for Effective Public Financial Management and Fiscal Sustainability**

*A Statement*

*by the Network of EU Independent Fiscal Institutions*

The Network of EU Independent Fiscal Institutions (EU IFIs) endorsed the Report "Medium-term budgetary frameworks: A contribution on definitions and identification of good practices" in its meeting held in Rome on the 4<sup>th</sup> of May 2018. The Report was prepared by an ad-hoc Working Group on Medium-term budgetary frameworks (MTBF-WG) set up by the Network with the aim of clarifying the nature of MTBFs and singling out good practices for medium-term frameworks conducive to more effective public financial management and sustainable fiscal policy.

**An MTBF is a mechanism for prioritization and presentation of multi-year expenditure envelopes** and spending-agency resource needs making sure that these are consistent with the medium-term macro-fiscal framework (MTFF). Thus, an MTBF represents a set of interrelated systems, rules, and procedures ensuring that annual budgets are set with a medium-term perspective.

**The expenditure rules underpinning the MTBF should be consistent and strongly interlinked with the MTFF.** This would be coherent with the "top-down" approach on budgeting, i.e. a framework where medium-term macro-fiscal objectives (public debt, budget balances, overall expenditure, usually of the general government) are established before deciding the expenditure envelopes of policy areas or spending agencies or sub-national entities.

**Domestic MTBFs are to some extent disconnected from the MTFF governed by EU fiscal rules.** Practical experience shows that effective domestic MTBFs in EU countries have not been developed on the basis of the EU fiscal rules. In the context of the EU fiscal framework, the Stability Programme (SP) is akin to an (EU) MTFF.

At the same time, **the current EU MTFF might not be conducive to the implementation of effective MTBFs**, *inter alia* because of the instability of targets and the absence of a systematic reconciliation procedure.

**The Proposal by the Commission** for a "Directive laying down provisions for strengthening fiscal responsibility and the medium-term budgetary orientation in the Member States" presented in December 2017 **is a positive development to strengthen a medium-term approach at national level.** This system is based on a medium-term growth path of public expenditure net of discretionary revenue



measures consistent with a medium-term objective for budget balances (as an intermediate target) and with the ultimate objective to ensure public debt sustainability. This proposal could encourage a better link between the EU MTF and domestic MTBFs.

**If the EU surveillance framework remains unchanged, the attention should be focused on two priorities:** a) to support Member States in strengthening instruments towards medium term expenditure planning in budget preparation; b) to enhance the medium-term orientation also for the EU framework, and not only of the domestic ones.

As for the first objective, by the end of 2018 the Commission will review the suitability of the Council Directive 85/2011 on requirements for budgetary frameworks of the Member States. This review is an opportunity to better identify features that would be desirable in domestic decision making for each country to pursue more effective MTBFs. The ultimate aim is to propose further initiatives — not necessarily legislative ones — to promote these features in Member States. IFIs are ready to cooperate with the Commission in this endeavour.

As for the second objective, progress could be made not necessarily by changing EU legislation but by fully implementing the existing one. For example, as already envisaged by the Stability and Growth Pact, Member States could better define and present early on the main expenditure and revenue components of the budget in the short-to-medium term and the main measures needed to reach both the short- and the medium-term objectives.

**Political commitment towards a stronger medium-term orientation of fiscal and budgetary policy is key** for effective MTBFs as well as institutional capacity in implementing medium-term plans. Exporting successful MTBFs' arrangements in different institutional and political contexts, i.e. where reputational cost is low or institutional capacity is not adequate, might be challenging and a more gradual approach would be commendable.

**Political commitment is crucially related to the issue of reputational cost.** In some countries, the cost is high and the government or the parliament generally refrain from changing expenditure plans previously set, at least without thoroughly explaining the reasons for these policy choices. On the institutional side, some prerequisites are important like the ability to carry out reliable economic, revenue and expenditure forecasts or to implement cost-benefit analysis in a medium-term context, areas where IFIs' contribution could be explored.

**There is no single way of establishing an optimal MTBF.** Indeed, MTBFs have different characteristics across countries that do not necessarily imply different degrees of effectiveness. Many differences across existing MTBFs reflect pre-existing institutions, and also the diversity of objectives. Implementation of more effective MTBFs in any single country should take into account the main features



characterising its institutional setting. Also for this reason, country rankings on effective MTBFs are not desirable, especially if they are based on composite quantitative indicators. That said, from a preliminary analysis, some **good practices** in the context of MTBFs can be identified and summarised as follows:

**1. The existence of an operational expenditure rule to establish spending limits in a multi-year setting for each policy area.** We define “operational rule” as a rule that could be easily discussed and established by policymakers, implemented by public managers, and understood by the public at large. One-size-fits-all proposals should be avoided, and the choice of operational variables and targets should be left at the country level.

**2. Reconciliation among different accounting standards, as MTBFs translate macro-fiscal objectives and constraints into broad budget aggregates and detailed expenditure plans.** MTBFs are usually defined on a (national account) accrual basis and often take into consideration the cyclical dimension while budgets are defined on a cash basis or on an accrual basis different from the national account one. Also, classifications are often different. MTBFs would then be equipped with instruments to reconcile these different accounting criteria. In particular, all actors involved, notably Ministries of Finance and National Statistical Institutes, should make public their reconciliation criteria and practices.

**3. Overall stability of expenditure targets over the years and reconciliation procedures in place when these targets are changed.** One of the aims of MTBFs is to provide more stability and predictability of public resources and their allocation. This does not necessarily mean that changes are not possible but, if they are implemented, a full set of explanations would be provided to illustrate origins and causes of these changes so as to “reconcile” the new targets with the old ones.

**4. The establishment of the MTBF at the beginning of each legislative term with no or limited renegotiation afterwards.** If new priorities emerge, MTBFs would help to reconcile them within the existing ones, supporting changes and reshuffles among them.

**5. Establishing in advance, to the greatest possible extent, the "rules of the game" among political and institutional actors in specific circumstances.** For example, rules on revenue windfalls — i.e. revenues on top of those that could be expected from macroeconomic outcomes and “benchmark” tax elasticities — are required. For instance, windfalls would be ‘saved’ to compensate for possible future shortfalls and would not be used to finance new policies. Another example are rules on how to treat expenditure carryovers, i.e. unspent allocations from the previous year. For instance, they would be allowed to be spent in the current year but not to the full extent to avoid unfavourable surprises on expenditure or budget balance targets.



**6. The importance of defining a central MTBF in countries with multilevel expenditure structure, due to the impact that the central government expenditure envelopes have on the budget of subnational governments mainly through transfers.** Indeed, the need for local governments to know in advance the amount of resources they can lean on is essential to put them in a position to implement their own medium-term budgetary planning. Discretionary changes of the grants received from central government on an annual basis would inevitably bias the horizon of local expenditure policies towards the short term.

**7. Finally, a role for IFIs in assessing whether the medium-term orientation of fiscal and budgetary policies is followed through by the government in practice and not only in legislation.** IFIs could also deliver the main technical parameters needed to establish an MTBF or could provide medium-term projections under no policy change. Nevertheless, the final decision on overall targets and allocations would always be left to policymakers. IFIs could finally have a role in the reconciliation process when an MTBF is being revised, and could assess the consistency of medium-term targets across levels of governments.