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Medium-Term Focus for **Short-Term Problem Solving**

*"You'll never solve intractable short-term problems until you start focusing on the medium term". - **Malcolm Holmes***

An annual approach to national budgeting actually undermines budgetary performance, contributing to fiscal instability and, perhaps even more fundamentally, to resource misallocation and the inefficient and ineffective use of resources." (Holmes 2009). Conversely, a method that uses a system of budgeting with rolling forward estimates of the costs of existing policies, fiscal space estimation, and policy change proposals can strengthen budgetary performance. The big problems facing developing countries that appear immediate and short-term – such as poor budget execution performance or deep and wide corruption – can really only be solved through a medium-term solution.

But the success in implementing Medium-Term Expenditure Frameworks since the turn of the century has not been good. The first approach was the "big bang" approach, which meant lots of resources were used to get macro-fiscal frameworks and complex information managements systems in place. The more recent approach is the very slow and steady method, where basic fiscal forecasting capacity is established first, followed by more advanced macro-fiscal forecasting, followed by more detailed budget strategy and budget ceilings setting processes.

Now there is a new way, which is the original way. It is simple and based on getting better budget preparation processes in place first. In the Cook Islands a Public Expenditure and Financial Accountability (PEFA) compliant medium-term and policy-linked budget preparation system was established quickly and cheaply, simply by following the way the original medium term budgeting system was invented: setting up a good transparent process first, then focusing on improving quality of analytics over time.

The modern medium-term and policy-based budgeting system was invented in the 1970s in Australia. It started with the use of internal medium-term fiscal forecasts of revenues and costs of existing policies. Political events then allowed these internal forecasts to transform into baselines and be published as estimates for annual appropriations – reflected as government promises on fiscal policies. This, then, allowed incremental budgeting to extend from one year to multiple years. This, in turn, allowed the

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prime minster to request only certain departments to bring forward multi-year budget submissions during the annual budget process – those that were required to bring forward new policy proposals in directed areas (and up to a certain value), and those that were required to bring in savings or additional revenues. The medium-term costings prepared by the proposing agency were independently verified by the department of finance as the true costs of implementing the proposed policy, with reasonable assumptions on set up and scale up and capacity to implement. Once the cabinet decided on the proposals, those multi-year estimates were transparently locked-in to the medium term baselines as the funds required for implementation of the agreed policy.

Rolling over of the first forward year estimates formed the baseline for the new budget year. Forward year estimates of the costs of existing policies as they were termed were rolled over to new budget years with differences fully explained in budget papers. It was clear what changes were caused by: i) an estimate variation (e.g. due to differences in estimates of the effects of inflation and key cost drivers like number of beneficiaries); and ii) those as a result of a new policy decision by the government (e.g. a new tax policy or a decision to buy some new fighter jets). Then, every few years, the medium term baselines (forward-year estimates) were checked for accuracy of the true costs of all existing policies of an institution. In development speak, this is akin to costing the sector strategies. In good public finance speak, it is costing of agency (or ministerial portfolio) policies. During that period, the fiscal forecasting methods advanced to more complex macro-fiscal simulation models.

The Cook Islands copied the original approach to establishing a policy-linked and medium-term-based budgeting system. The system developed also happens to be PEFA compliant[1], as revealed here:

i. **A database was established to track three forward-year estimates that became the baselines for budget appropriations** for departments *(PEFA PI12i "A": Forecasts (of costs of existing policies) of fiscal aggregates (on the basis of main categories of economic and functional/sector classification) are prepared for at least three years on a rolling annual basis);*

ii. **The MoF developed a separate but simple medium-term fiscal space modelling tool[2]** that also tracks fiscal pressures and opportunities that can be used to run policy simulations and provide high and low case scenarios for cabinet briefings. *(PEFA PI12i "A": Forecasts (of different fiscal realities) of fiscal aggregates (on the basis of main categories of economic and functional/sector classification) are prepared for at least three years on a rolling annual basis);*

iii. **The president decides which ministries bring forward new policy proposals through budget submissions** and the terms of such submissions, based on advice from the MoF and cabinet discussion *(PEFA PI 11-ii "A" A comprehensive and clear budget circular is issued to MDAs, which reflects ceilings approved by cabinet (or equivalent) prior to the distribution of the circular to MDAs).* The ceilings are not communicated to departments or secretaries to counter problems of institutional politics in PFM – but the effects of the ceilings are (i.e. those ministries that are targeted for a budget increase, and those that targeted for a cut). The ceilings are in fact implicit in the forward estimates that get rolled over into the new budget year – but the ceilings reflect the agreed costs of agreed policies, not some arbitrary basis such as a share of total expenditure.

iv. **Other ministries simply get their first forward-year baseline** adjusted for an estimates variation (e.g. an inflation or agreed cost-driver adjustment). This was crucial as it allowed the budget unit to focus on deeper analysis of only a few new policy proposals, as opposed to reviewing every ministry's budget. Moreover, it stopped the onerous practice of zero-based costing of every budget for every ministry for every new budget year.

v. **All budget submissions require full costing of fiscal impact of new policy proposals over the medium term** – with annual estimates, with costings to be independently verified as accurate by the MoF (*PEFA*

PI12-iii "A": Strategies for sectors representing at least 75% of primary expenditure exist with full costing of recurrent and investment expenditure, broadly consistent with fiscal forecasts. PEFA PI12-iv "A": Investments are consistently selected on the basis of relevant sector strategies and recurrent cost implications in accordance with sector allocations and included in forward budget estimates for the sector);

vi. **Once agreed by cabinet, baselines are adjusted and explained in the budget papers** *(PEFA PI 12-i "A": Links between multi-year and subsequent setting of annual budget ceilings are clear and differences explained);* and

vii. **Pricing (or forward-year estimates) reviews of ministry baselines occur on a rolling basis** against a plan determined by MoF *(PEFA PI12-iii "A": Strategies for sectors representing at least 75% of primary expenditure exist with full costing of recurrent and investment expenditure, broadly consistent with fiscal forecasts).*

Note:

1. PEFA compliance against original PEFA. Compliance with the updated 2016 PEFA also applies.
2. Two forms of fiscal space were reviewed. The original one, which was invented in the 70's, is an over-time-based version. It is the difference between the forward year estimates of revenue and the costs of existing policy. The other version is the Peter Heller approach, which is a point in time version that separates fiscal space in to four dimensions of the primary sources of fiscal space: i) more revenue; ii) more debt; iii) more grants (aid); and iv) becoming more efficient (or cuts to spending).
3. Holmes (2009) Environment Working Paper No 7: Integrating Public Environmental Expenditure within Multi-year Budgetary Frameworks, OECD (http://www.oecd.org/dataoecd/60/6/42898831.pdf)