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REPUBLIC OF POLAND

TECHNICAL ASSISTANCE REPORT—DEVELOPING A MEDIUM-TERM BUDGET FRAMEWORK

June 2017

This Technical Assistance Paper on the Republic of Poland was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed in February 2017.

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FISCAL AFFAIRS DEPARTMENT

Republic of Poland

Developing a Medium-Term Budget Framework

Carolina Renteria, Richard Allen, Jason Harris, Duncan Last, and Fazeer Sheik Rahim

Technical Assistance Report | March 2017

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F I S C A L   A F F A I R S   D E P A R T M E N T

Republic of Poland
Developing a Medium-Term Budget Framework

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GLOSSARY

CoM	Council of Ministers
CP	Convergence Programme
EC	European Commission
EDP	Excessive Deficit Procedure
EU	European Union
FAD	Fiscal Affairs Department
FCL	Flexible Credit Line
FE	Forward Estimates
IMF	International Monetary Fund
IPSAS	International Public Sector Accounting Standards
GFSM	Government Finance Statistics Manual
LM	Line Ministries
MoD	Ministry of Development
MoF	Ministry of Finance
MTFF	Medium-Term Fiscal Framework
MTBF	Medium-Term Budget Framework
MTO	Medium-Term Objective
MYSFP	Multi-Year State Financial Plan
NBP	National Bank of Poland
NDS	National Development Strategy
NIK	Supreme Audit Office
OECD	Organization for Economic Cooperation and Development
PFA	Public Finance Act
PFM	Public Financial Management
TA	Technical Assistance
SB	State Budget
SER	Stabilizing Expenditure Rule
RIA	Regulatory Impact Assessment
WB	World Bank
ZUS	Social Security Institution

PREFACE

The mission took place from January 25 to February 6, 2017. It met with senior officials of the Ministry of Finance, including Hanna Majszczyk, Undersecretary of State; Leszek Skiba, Undersecretary of State; Aneta Cieloch Director, Budget Zone Financing Department; Anna Napiorkowska Director, State Budget Department; Tomasz Robaczyński, Director, Paying Authority Department; Katarzyna Szarkowska Director, Expenditure Policy Department; Joanna Bęza-Bojanowska, Deputy Director, Macroeconomic Policy Department; Joanna Stachura, Deputy Director, Expenditure Policy Department; Marek Szczerbak, Deputy Director, Public Debt Department; Barbara Brodowska-Maczka, Counsellor to the Minister, Economy Financing Department; Karolina Burzynska Head of Unit, Local Government Finances Department; and Bartosz Staszewski, Head of Unit, Spending Review Methodology and Budget in Performance, Expenditure Policy Department.

In addition, the mission had meetings with

- Ministry of Development: Marcin Sobczyński, Deputy Director, Department of Development Budget; and Stanisław Sudak, Deputy Director, Department of Development Strategy;
- Ministry of Infrastructure and Construction: Jarosław Waszkiewicz, Director of the Public Roads Department, Adam Orzechowski and Ewa Szczepańska, Director and Deputy Director of the Budgetary Department; and Michał Perliński, Head of Unit, Public Roads Department;
- Supreme Audit Office (NIK): Stanislaw Jarosz, Director, Budget and Finance Department;
- National Bank of Poland (NBP): Tomasz Jedrzejowicz, Head of Public Finance Bureau, Economic Institute;
- Chancellery of the Sejm: Dr Zofia Szpringer and Prof. Kamilla Marchewka-Bartkowiak, Bureau of Research;
- Social Security Institution (ZUS): Pawel Jaroszek, Board Member; Hanna Zalewska, Director, Statistics and Actuarial Forecasting Department; and Radoslaw Socha, Deputy Director, Funds Management Department;
- European Commission: Tomasz Gibas, Advisor; and
- Office of the World Bank in Warsaw: Iwona Warzecha, Leszek Kąsek and Ryszard Malarski.

The mission made presentations on Medium-Term Budget Frameworks and Forward Expenditure Estimates Techniques, including international best practices and an assessment for Poland, which was attended by senior staff of the MoF, the NIK, the NBP, the Chancellery of the Sejm, and ZUS.

The mission would like to express its appreciation for the hospitality and courtesy extended by the authorities. The mission is thankful to Bartosz Staszewski and Olga Krasicka-Wezykowska for their support in coordinating the mission meetings with the authorities and the IMF resident representative in Warsaw, Bas B. Bakker and his staff for logistical and other assistance.

EXECUTIVE SUMMARY

The Polish government has committed to a budget reform strategy that is intended to modernize, strengthen, and lift the horizon of policy-making into the medium term. The reform was introduced by the Minister of Finance, and approved by the Council of Ministers (CoM) in July 2016. The first step in the new process will take place in March 2017 with a meeting of the CoM. At this meeting, the macroeconomic and fiscal projections to be included in Poland's Multi-Year State Financial Plan (MYSFP) will be compared to spending envelopes, and policy priorities for the coming budget will be determined. This meeting will also launch the process of preparing Poland's first medium-term budget framework (MTBF) for the period 2018–20.

The budget reform strategy covers six areas: (i) implementation of an MTBF; (ii) integration of annual and multi-annual planning processes, and modifications to the budget calendar; (iii) redefinition of the role of the CoM, line ministries, and the Ministry of Finance (MoF) in the budget process; (iv) unification of the traditional budget classification and the performance-based classification, built around 20 broad policy areas; (v) improvement in accounting and financial reporting systems; and (vi) institutionalization of spending reviews.

The authorities' highest priorities are to introduce an MTBF, integrated with the annual budget and to achieve its medium-term objective (MTO) of a structural deficit of 1 percent of GDP by 2021 (Section I). The government has committed to an annual fiscal consolidation equivalent to ¼ percent of GDP starting 2018, but additional measures will be required to attain the MTO. Additionally, Poland is subject to the EU rule that requires the annual deficit not to exceed 3 percent of GDP. As requested by the authorities, the present report focuses on aspects of the reform that relate to the establishment of an MTBF, but discusses other relevant areas.

While the government's strategy for reforming the budgetary system is comprehensive, it is complex and ambitious (Section II). If the strategy is to be implemented within a three-year period, it will require careful sequencing and management. The mission proposes the creation of a High-Level Committee of the MoF, chaired by the Minister or co-chaired by the Deputy Ministers to prepare a detailed, realistic, and prioritized road map for implementing the reform. This road map should describe and sequence the different actions and activities that need to take place, and how they will be coordinated with each upcoming budget cycle. It should also define which departments within the MoF will be responsible for implementing each component of the strategy, and for supervising and managing its execution.

Many of the prerequisites for establishing an MTBF have already been satisfied in Poland (Section III). The annual budget has a high degree of credibility, macroeconomic projections are generally accurate, and fiscal rules on debt, expenditure, and the deficit provide sufficient guidance to fiscal policy in the medium term.

However, some weaknesses remain that should be addressed either in parallel or as part of the MTBF reform. Many spending decisions are taken outside the budget process, and the current budget classification, in addition to being complex and outdated, does not align policy decisions with spending areas. The single-stage budget decision-making process only allows the CoM to set priorities at a late stage in the budget cycle. Within the MoF, there is poor coordination of information and decision making on fiscal and budgetary issues, resistance to change, missed opportunities for cross learning, and lack of ownership of the reforms.

The design of the MTBF should be carefully considered to meet the government's fiscal objectives while operating within current capabilities (Section IV). There is no single ideal model to follow, but instead a set of choices to be made that will instill discipline in the budget process, create legitimacy, ensure compliance, and build credibility. Key questions include: how should a framework of medium-term expenditure commitment be designed and on what basis? How should the multi-year prioritization process be organized? What control mechanisms should be employed to enforce multi-annual spending commitments? What accountability mechanisms should be used to establish credibility? The report makes recommendations that fit the Polish context in each of these areas.

Underlying the MTBF will be a set of tools that needs to be developed, both within the MoF and the broader public service (Section V). Many of the foundations for these tools are in place, but will require considerable work and refinement to be effective:

- *Forward estimates*. An MTBF should be anchored in the stabilizing expenditure rule (SER) and be based on a well-defined, bottom-up expenditure forecast for each ministry on a no-policy-change basis. A good system of forward estimates, which in Poland's case should be based on broad spending areas rather than traditional "budget parts," is the first essential step in implementing an MTBF. The report provides detailed guidance on the application and use of forward estimates.
- *Costing of new policy proposals*. Medium-term cost estimates should be prepared for all new policy proposals, as well as changes to existing policies, including alterations to eligibility criteria or assistance rates of existing transfers or social security programs.
- *Spending reviews*. Poland has already put in place a framework of spending reviews, but their impact in identifying savings or reallocation options has been limited. To increase the effectiveness of the reviews, they should be given clear targets for achieving savings, be fully integrated with the budget process, and be staffed by representatives from the MoF's budget departments, line ministries, and possibly external experts.

Table 1 provides a summary of the report's main recommendations. They are divided into three time periods:

- the *immediate term*, defined by the 8 weeks until the March 2017 meeting of the CoM;
- the *next 8 months*, until the preparation and approval of the budget for 2018; and
- the *next 18 months and beyond*, during which a broader range of issues relating to the implementation of the MTBF and other reforms needs to be considered.

Table 1. Poland: Summary of Recommendations

Issue	First 8 weeks	Next 8 months	Next 18 months and beyond	Responsibility*
MANAGEMENT OF PFM REFORM STRATEGY				
Effective management of PFM Reforms	2.1 Establish a MoF High-Level Committee, chaired by the Minister or Deputy Ministers, to oversee the design and implementation of the PFM reform strategy.	2.2 Prepare a detailed, realistic and prioritized road map of PFM reforms; define roles and responsibilities of the key actors; set key deliverables and performance targets; monitor results; and extend the implementation timetable to more than three years.		Minister, Deputy Ministers, PW
PREREQUISITES FOR IMPLEMENTING A MTBF				
Coordination of fiscal and budgetary issues within the MoF	3.1 The proposed MoF High-Level Committee should also oversee the preparation of the MYSFP and the annual budget (see Recommendation 2.1)	3.2 Define roles and responsibilities in the MoF for implementing MTBF and for broader budget reform.		Minister
Revenue forecasting		3.3 Carry out assessment of forecasting errors and identify solutions by using more disaggregated data and better modeling techniques.		PM
Modernizing the budget classification			3.4 Implement CoM's decision to create a unified budget classification based on policy areas and programs.	PW, BP, PM, DR
Revision of Public Finance Act			3.5 Prepare and adopt changes to the legal framework to formalize decisions of the CoM.	PW, BP, DR, DP, PM, PR
DESIGN CHOICES FOR AN MTBF				
Multi-year commitment mechanism	4.1 Clarify that the MTBF is based on an aggregate binding commitment consistent with the SER, with lower-level indicative spending area/budget part allocations over the medium term based on forward estimates.	4.2 Finalize spending areas for setting MTBF spending ceilings and implement in stages over three budget cycles.	4.3 Adopt a phased approach to introducing multi-year ministerial ceilings. 2018-20 MTBF: three-year estimates by parts, first year ceiling. 2019-21: three-year estimates aggregating by spending area. 2020-22 MTBF: binding ceiling for first year budget and estimates for outer two years by spending area.	PW, BP
Multi-year prioritization mechanism		4.4. Strengthen the role of the CoM in expenditure prioritization through a sub-committee charged with reviewing and clearing all new policies. 4.5 Design and implement a more strategic expenditure prioritization process earlier in the budget cycle, focused on improved scrutiny of baseline and new policies, that feeds into the MTBF and Convergence Program.		BP, FG, FS, PW PW
Control of multi-year commitments and carryovers	4.6 Define a framework for setting planning margins in the MTBF, using a risk averse approach to begin with.	4.7. Strengthen the arrangements for multi-year commitment controls and carryovers to better underpin the new MTBF framework.		BP

Table 1. Poland: Summary of Recommendations [Concluded]

Issue	First 8 weeks	Next 8 months	Next 18 months and beyond	Responsibility*
Accountability mechanisms, including fiscal responsibility statements		4.8. Establish a framework for reconciling between forecast vintages, starting with macro forecasts, expanding to MTBF aggregates. 4.9. Consider introducing fiscal responsibility statements for line ministries and budget holders.		PM, BP BP
TOOLS UNDERPINNING THE MEDIUM-TERM BUDGET				
Methodology for calculating forward estimates	5.1 Define a template to produce 2018-2020 forward estimates for budget teams. Include conceptual model; basis upon which estimates will be built, and definition of "No-Policy Change". 5.2 The Expenditure Policy Department and Macroeconomic Policy Department should work together to verify and assess the first initial bottom-up forward spending estimates.	5.3 Set up a process for agreeing forward estimate baseline models with line agencies. 5.4 Extend the use of Regulatory Impact Assessments to all new policy decisions considered through the budget process	5.5 Continue to refine and improve forward estimates, reconciling each estimate to the previous round by identifying changes due to parameters, policy decisions, and technical adjustments.	BP, PW PW, PM, BP
Tracking of investment projects	5.6 Split State Budget investment expenditure between major projects and minor projects and capital purchases; seek 3-year spending profiles of major projects from implementing agencies and define which investments shall be included within the no-policy-change baseline.	5.9 Develop an investment project tracking system for large projects financed through the State budget, mirroring that used for EU funds.		FG, BP
Fiscal impact of public service wages	5.7 Maintain projection assumption of flat nominal wage bill; simulate options and implications of alternative wage growth.	6.0 Develop a proposal for improving the projection of the wage bill in the forward estimates to be approved by the CoM.		FS, PW, PM
Transfers to other units	5.8 Categorize, forecast and consolidate transfers to other entities in the general government based on existing models.			PM, BP
Spending reviews	6.1 Spending Review Steering Committee expanded and tasked with conducting spending reviews	6.2 Establish clear top-down targets for expenditure savings to be achieved through spending reviews	6.3 Strengthen spending reviews by linking recommendations to the budget, including budget and line agency officers, and identifying savings/reallocation to meet targets.	PW, BP, FG, FS

* Key: PR = Legal; PW = Expenditure Policy; PM = Macroeconomic Policy; BP = State Budget; FG = Economy Financing; FS = Budget Zone Financing; DP = Public Debt; DR = Accounting and Auditing Departments.

Numbers correspond to the number of the recommendation in the report.

I. INTRODUCTION

1. **The Polish economy has performed well in recent years but its fiscal stance has turned procyclical.** The general government budget target of 2.9 percent of GDP in 2017 is close to the EU's Excessive Deficit Procedure (EDP) limit of 3 percent of GDP and represents a relaxation of about 0.5 percent of GDP in structural terms. New spending commitments are likely to raise the fiscal deficit in 2017 compared to previous years. In this regard, the announcement of new measures such as the reduction in the retirement age and the increase in income tax allowances will increase fiscal pressures in both 2017 and over the medium term. Over the longer term, an increasing old-age dependency ratio is likely to require further substantial fiscal outlays. Under the January 2017 Flexible Credit Line (FCL) arrangement, the authorities were committed to start fiscal consolidation from 2018 with at least a ¼ percent of GDP adjustment per year while ensuring that the deficit does not exceed the EDP limit of 3 percent of GDP in 2017. Further in the April 2017 Convergence Program Update, the authorities presented their latest fiscal targets, aiming to improve headline deficit to 1.2 percent of GDP by 2020 and hit the MTO of one percent of GDP structural deficit by 2021. This target would be achieved by avoiding new spending measures that cannot be financed by additional revenues or expenditure cuts, rationalizing spending, and reducing the tax gap by strengthening the tax collection process, a reform that is already underway. However, it is likely that additional measures will be required to attain the MTO.

2. **Against this background, the IMF's Executive Board recently approved a new two-year €8.24 billion Flexible Credit Line (FCL) arrangement with Poland.**[1] The arrangement is a successor to the previous FCL, but with a reduced level of access. The authorities intend to treat the arrangement as insurance against external shocks, supplementing Poland's flexible exchange rate and strong reserve buffers. The reduced level of access signals the authorities' intention to fully exit from the arrangement once external risks subside. Poland's eligibility for the FCL is based on credible assurances that the policy framework is strong. Having an MTBF would signal that Poland is committed to maintain the strength of their framework, which is particularly important to reassure the international community in face of recent slippages.

3. **Reforms to the budget process could play an important role in facilitating the fiscal adjustments that are likely to be required in 2018 and subsequent years.** For example, budgeting is essentially annual, with only a limited focus on the medium-term perspective. The connection between the fiscal projections prepared for the European Commission (EC) under the Convergence Programme and the annual budget is weak. In addition, the performance perspective has not been fully developed, both because performance information is not

[1] IMF, December 28, 2016, *Republic of Poland: Arrangement under the Flexible Credit Line and Cancellation of the Current Agreement*. A press release announcing the decision was issued on January 13, 2017.

systematically taken into account in budget decisions, and because budgeting is not integrated with the strategic planning coordinated by the Ministry of Development (MoD).[2]

II. PFM REFORM: PAST, PRESENT, AND FUTURE

A. Past Reforms

4. **The authorities have previously received external advice on strengthening key aspects of their budgetary procedures, including medium-term fiscal and budgetary frameworks.** This advice includes two previous reports from the Fiscal Affairs Department (FAD) of the IMF in 2008 and 2010,[3] together with recent reports from the OECD,[4] and the World Bank.[5] The government has made progress in implementing some of the earlier recommendations by FAD and others on fiscal and budgetary reform, but many gaps remain (Table 2). The endorsement by the CoM the *Assumptions to Budget System Reform* paper in July 2016 effectively means that the reforms associated to revision of PFM Act, presentation of the budget strategy reform to the CoM and implementation of forward estimates were approved and the process initiated.

5. **Some of the fiscal and budgetary reforms implemented by the government arise from Poland's obligations as a member of the European Union (EU).** In particular, the government has prepared each year since 2004, most recently in April 2017,[6] the EU's Convergence Programme (since 2011 as part of a Multi-Year State Financial Plan, MYSFP). Poland must also comply with Council Directive 2011/85/EU on *Requirements for Budgetary Frameworks of the Member States*. The Commission has issued generally favorable opinions on the government's performance under the Convergence Programme, and other legislation on fiscal and budgetary matters.[7] Further, the EC Delegation in Poland informed the mission that Poland

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[2] The recent decision by the government to bring both the MoF and the MoD under Minister Mateusz Morawiecki creates a possibility to improve the coordination of budgeting and planning.

[3] R. Allen et al. June 2008, *Developing a Multiannual Fiscal Framework*, June 2008; and M. Kumar, et. al., *Strengthening the Fiscal Framework*, June 2010.

[4] I. Hawkesworth, et. al., *Performance Budgeting in Poland: an OECD Review*, OECD Journal on Budgeting, Vol. 2011/1.

[5] World Bank, *Poland: Selected Budget Reform Issues*, December 2016.

[6] Most recently, *Republic of Poland: Convergence Programme: 2017 Update*, April 2017.

[7] An exception is Poland's failure to establish a fiscal council, thought this is not required in the case of non-Eurozone countries.

was in broad compliance with Directive 2011/85/EU, including the part related to setting the budget within a medium-term fiscal framework.[8]

Table 2. Progress Made by Poland in Implementing Fiscal and Budgetary Reforms

Recommendation	Actions taken
Implement permanent fiscal rules	Achieved. Stabilizing expenditure rule introduced in 2013 and implemented in 2015
Introduce a Fiscal Responsibility Law	Partly achieved through amendments to Public Finance Act since 2010
Initiate a budget reform process	Achieved. CoM approved MoF proposals in the Assumptions to Budget System Reform paper, July 2016
Establish a Fiscal Council	Not achieved
Comprehensively review the Public Finance Act to incorporate reforms in the budget process	Not achieved – initiated
Budget strategy paper presented to the CoM at beginning of the budget process	Not achieved – initiated.
Build and implement expenditure forward estimates model	Not achieved, no systematic framework yet in place – initiated.
Synchronize preparation of the MYSFP and annual budget	Initiated. First step in building a top-down decision making process will be taken in March 2017, but process needs to be formalized
Implement a performance-based budget system	Partly achieved. Performance data are not integrated with decision making on the annual budget, nor with budget execution
Establish a spending review committee in the MoF, and initiate first reviews	Partly achieved, but few reviews initiated to date, and limited progress made in implementing savings identified

Source: Mission assessment, based on recommendations in FAD reports of 2008 and 2010 referred to above.
Key: Green = achieved; yellow = partially achieved; red = not achieved.

B. Present and Future Reforms

6. **The government recently embarked on a broad and ambitious program of reforming the budgetary system.** In July 2016, the CoM approved a six-point plan ("Assumptions to Budget System Reforms") for budgetary reform, based on a proposal submitted by the MoF. The components of this plan are as follows:

- **Implementation of an MTBF.** The mechanisms for managing public expenditure and fiscal space will be based on the MTBF, the first year of which would comprise the annual budget law.
- **Integration of annual and multi-annual planning processes, modifications to budget calendar and budget formulation process.** The integration of the annual budget process with the MYSFP should be completed. The Convergence Programme should begin to play the role of a medium-term fiscal framework that specifies major fiscal objectives, key

[8] Article 20 of the Directive states that "planning of annual budget legislation should be based on multiannual fiscal planning stemming from the medium-term budgetary framework." Article 21 adds that the "medium-term budgetary framework should contain, inter alia, projections of each major expenditure and revenue item for the budget year and beyond, based on unchanged policies." The Directive, however, gives considerable latitude to Member States on how to interpret these provisions in the national context, and how to implement them.

assumptions of budgetary policy, including the availability of fiscal space, and the establishment of expenditure priorities.

- **Redefinition of the role of the CoM, its members and the Minister of Finance in the budget process.** The CoM would intervene earlier in the budget process, deciding on expenditure priorities and the indicative allocation of expenditure ceilings, based on the overall limit set by the Stabilizing Expenditure Rule (SER). The Minister of Finance would be responsible for budget policy and frameworks, for leading the budget process and negotiations to ensure the sustainability of public finance, and for efficient management of public spending. Line Ministers would be responsible for expenditure policy in specific areas within the approved ceilings, and accountable for efficient implementation of government priorities and objectives in their respective policy areas.
- **Elimination of the existing dual classification and the introduction of a new state budget structure and uniform performance-based classification.** The new classification would aggregate the traditional budgetary "parts" into broad spending areas.
- **Improved data collection for budget and financial reporting.** Financial reporting systems would be systematized and standardized, based on uniform and consistent public sector accounting rules, supported by upgrades of IT systems.
- **Institutionalization of spending reviews and other instruments into the budget process.** This reform would give spending reviews a permanent and supportive role in the budget process.

7. The government is about to take the next step in implementing the budgetary reform plan agreed by ministers in July 2016. The MoF is currently preparing for a CoM meeting, scheduled to take place in March 2017, at which spending projections for the three-year period 2018 to 2020, on a no-policy-change basis ("baseline" spending estimates), will be presented to ministers. As discussed later in this report, this meeting essentially brings forward the budget calendar by more than one quarter, and provides an opportunity for the Minister of Finance to discuss with his colleagues the direction and stance of fiscal policy, spending priorities, and options for making savings or initiating new policy proposals at a time when significant fiscal adjustment is likely to be required.

8. The scope and complexity of the proposed reform cannot be overstated, and it will require careful and committed management. Even though the reform is comprehensive and well thought out, it is complex, and the implementation calendar is ambitious. It will need to be carefully prioritized and sequenced. Strong leadership will be required from the MoF, together with sensitive handling of change management issues within and outside the Ministry.

C. Recommendations

Immediate - First 8 weeks

2.1 Establish a MoF High-Level Committee, chaired by the Minister or the two Deputy Ministers (Expenditure and Budget), and including representatives of all relevant departments to oversee the design and implementation of the PFM reform strategy. The same Committee would also oversee the preparation of the MYSFP and the annual budget.

Short Term - Next 8 months

2.2 The proposed MoF High-Level Committee should prepare a detailed, realistic, and prioritized implementation road map of PFM reforms that lists and sequences the different activities that need to take place; coordinates proposed changes with upcoming budget cycles; defines the role and responsibilities of the key actors in the reform; sets key deliverables and targets; monitors results; and extends the implementation timetable to more than three years.

III. PREREQUISITES FOR IMPLEMENTING AN MTBF

9. **This section assesses the extent to which Poland has achieved the prerequisites for implementing an MTBF.** In particular, it examines the credibility of the current annual budget, the quality of macroeconomic forecasts, the robustness of the fiscal framework, the comprehensiveness and unity of the annual budget process, and the robustness of underlying institutional arrangements. These prerequisites have been devised by FAD from the analysis of the performance of several advanced countries in adopting MTBFs.[9]

A. A Credible Annual Budget

10. **The annual budget provides the foundation for making revenue and expenditure projections for the medium-term.** If the preparation of the annual budget is of poor quality or the execution of the budget deviates significantly from what was approved, spending estimates in the initial year will be off-track, leading to even larger deviations in the outer years. Without a credible annual budget, the medium-term projections of spending cannot serve as a basis for decision making, nor will they support medium and long term fiscal goals. An annual budget is credible when actual expenditure adheres closely to the approved budget. At an aggregate level, this credibility derives from the ability of the MoF to resist expenditure pressures and stay within

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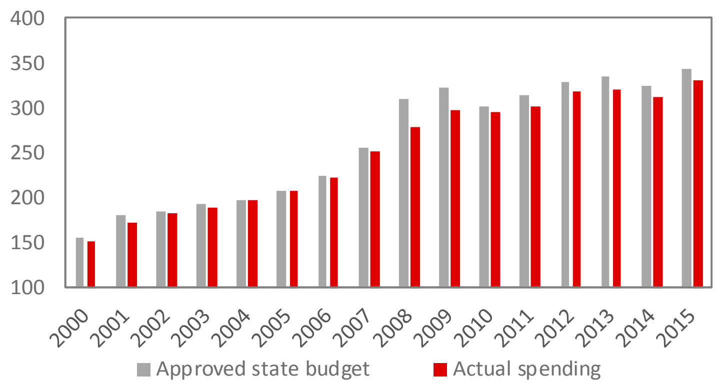
[9] J. Harris, R. Hughes, G. Ljungman, and C. Sateriale, 2013, "*Medium-Term Budget Frameworks in Advanced Economies: Objectives, Design, and Performance,*" in M. Cangiano, T. Curristine, and M. Lazare (eds.), Public Financial Management and its Emerging Infrastructure, IMF: Washington D.C.

the overall budget envelope.[10] At a disaggregated (spending ministry or agency) level, it derives from a coherent budget allocation process and firm control over its execution.

11. The Polish budget is highly credible, with no overspending in past years and few transfers between budget parts, and has delivered a successful consolidation in recent years. Since 2000 the proposed budget has been underspent by an average of 3.4 percent, or by only 2.4 percent if the financial crisis is excluded (Figure 1). The Public Finance Act (PFA) does not permit transfers to be made across budget parts, resulting in the actual spending by budgetary parts corresponding closely to the initial appropriations. Exemptions are earmarked reserves that top up the budget allocations, two notable cases being the transfers to the 16 regions of Poland – voivods - and rural development spending (see Figure 2).[11] The annual budget process has been effective in delivering on the government's fiscal policy objectives, with a successful fiscal consolidation of 2.3 percent of GDP since 2004, all while increasing capital spending (Figure 3).

Figure 1. Poland: Expenditure - Budget vs. Actual
(2000-15, PLN billions)

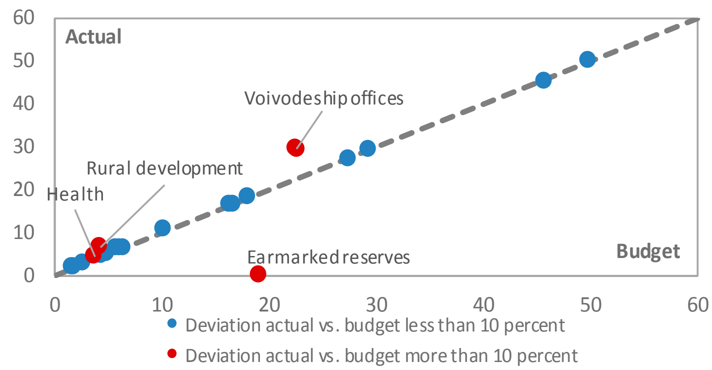


Source: Ministry of Finance

[10] The Public Finance Act sets a legal obligation not to exceed the budget spending envelope and deficit limit, unless the budget law is revised.

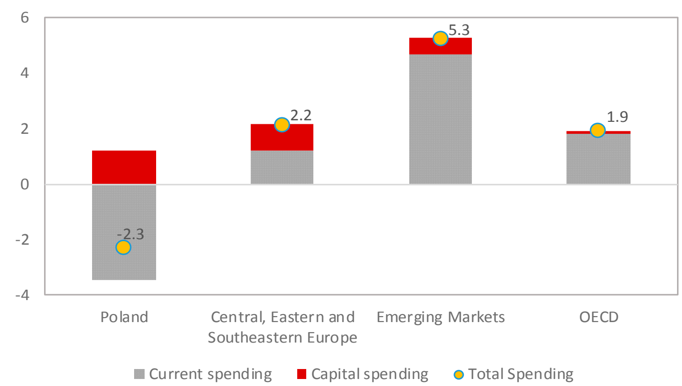
[11] This particular arrangement exists because transfers between budgetary parts are not permitted by the PFA. When the budget is being prepared, the level of spending by specific voivods and rural development projects is not known, although the overall envelope is already determined. An earmarked reserve is therefore created to cater for the spending when needed.

Figure 2. Poland: Expenditure by Main Parts
(Average 2010-15, PLN billions)



Source: Ministry of Finance

Figure 3. Changes in Spending (2004–15)
(in percent of GDP)



Source: IMF Expenditure Assessment Tool

B. Prudent Medium-Term Macroeconomic Forecasts

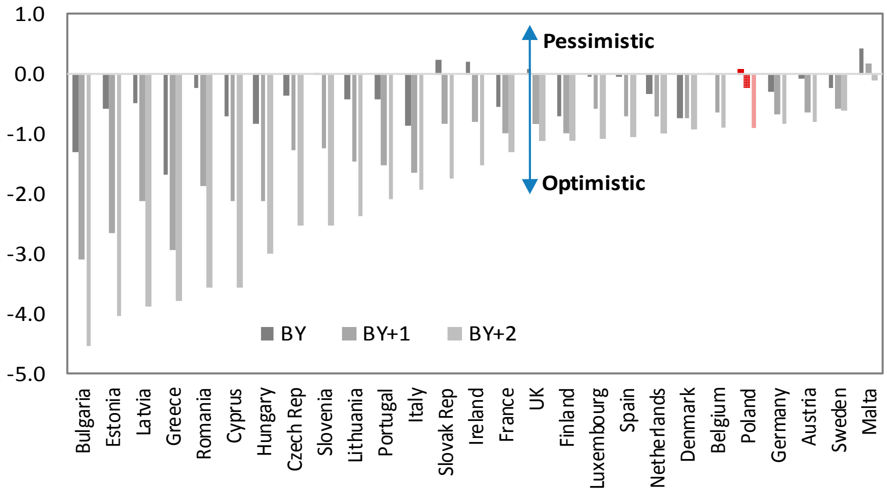
12. The credibility of medium-term fiscal projections depends critically on the underlying macroeconomic assumptions on which they are based. Most budget items have economic and demographic determinants: direct taxes are affected by the level of and changes in disposable income, indirect taxes by income and employment, retirement pensions by demographic factors and wages, wages by the inflation rate, and investment spending by the inflation rate and labor costs. Forecast accuracy can be improved and potential biases reduced if independent checks and validation mechanisms are built into the process.[12]

13. Over the past 15 years, macroeconomic forecasts in Poland have been accurate for the budget year, with some limited optimistic bias for the outer years. For the budget year,

[12] For example, through the fiscal councils that have now been adopted by most EU Member States according to EU law. Other mechanisms include the German Council of Economic Experts which provides the authorities with advice on macroeconomic developments and forecasts.

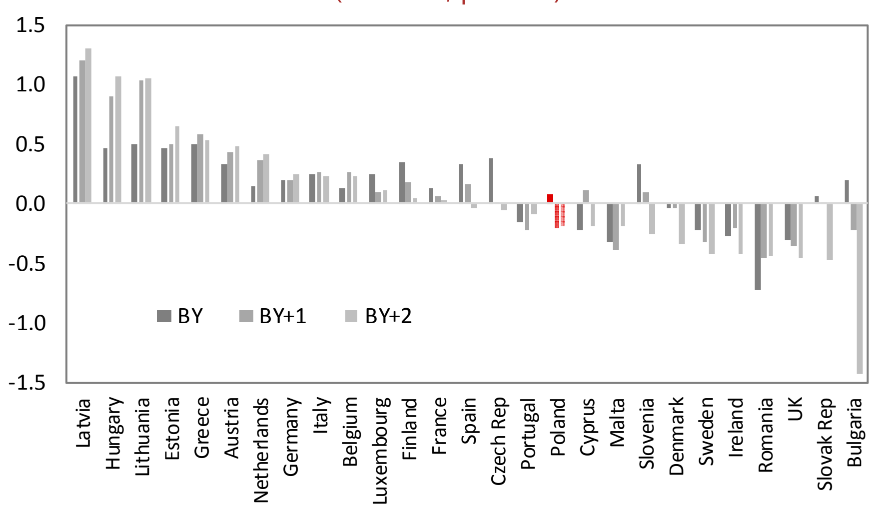
Poland has one of the most accurate real GDP and inflation forecast records in the EU region (Figures 4 and 5), but, for the outer years, forecasts of both these indicators have underperformed. This implies an overall optimistic bias in the forecasts of nominal GDP in the outer years, which is the main basis for preparing medium-term fiscal forecasts. However, this bias remains low in comparison with peers.

Figure 4. Average Real GDP Forecast Errors
(2000–15, percent)



Source: Poland convergence programmes; BY = Budget Year

Figure 5. Average Inflation Forecast Errors
(2000–15, percent)



Source: Poland convergence programmes; BY = Budget Year

C. A Stable Medium-Term Fiscal Framework

14. A stable medium-term fiscal framework is underpinned by fiscal objectives and rules that provide an anchor for medium-term spending, and by robust revenue projections. While many countries have adopted fiscal rules in recent years, not all rules are consistent with an MTBF. In this respect, good fiscal rules are those that are clear, can be translated into precise medium-term aggregate ceilings, allow fiscal policy to be counter-cyclical, and ensure the sustainability of public finances.[13] The accuracy of medium-term revenue projections depends on the quality of macroeconomic forecasts, good knowledge of tax elasticities, and the predictability of discretionary revenue measures.

15. Poland's fiscal framework is guided by several fiscal rules that collectively provide sufficient guidance on short-term and medium-term fiscal policy. The Constitution imposes an upper limit on the stock of debt (based on a Polish definition) of 60 percent of GDP, while the PFA sets strict limits on local government borrowing. A stabilizing expenditure rule (SER), introduced in 2013 and in place since 2015, limits the rate at which general government expenditure can grow (see Box 1). Poland is subject to the EU rule that requires the annual deficit not to exceed 3 percent of GDP.[14] The government has set itself a medium-term objective of reaching a structural deficit of 1 percent of GDP by 2021.

Box 1. The Stabilizing Expenditure Rule (SER)

The Stabilizing Expenditure Rule (SER) was adopted in 2013, and came into force with the 2015 budget. The original formula kept the growth of nominal general government expenditure below the combined medium-term growth rates of real GDP, inflation expectations for the given year, and past inflation errors. This rule also contained a correction mechanism which required the government to reduce expenditure growth when: (i) the debt or the deficit exceeded thresholds specified in the PFA, or (ii) the cumulated difference between the general government nominal balance and the "medium-term objective" (MTO) exceeded six percent of GDP. It also contained a counter-cyclical dimension: in "bad" times (real GDP growth less than 2 percent), there was no expenditure correction when the fiscal balance deviated from the MTO.

In December 2015, two amendments were made to the SER which could potentially weaken its effectiveness. First, inflation expectations and past inflation errors have been replaced by an inflation target (currently 2.5 percent) set by the National Bank of Poland. Thus, expenditure is now allowed to grow in line with the inflation target, irrespective of actual inflation. Second, expenditure is allowed to grow in the case of one-off revenue that exceeds 0.03 percent of GDP. As a result, temporary revenue increases can lead to a permanent increase in the level of expenditure.

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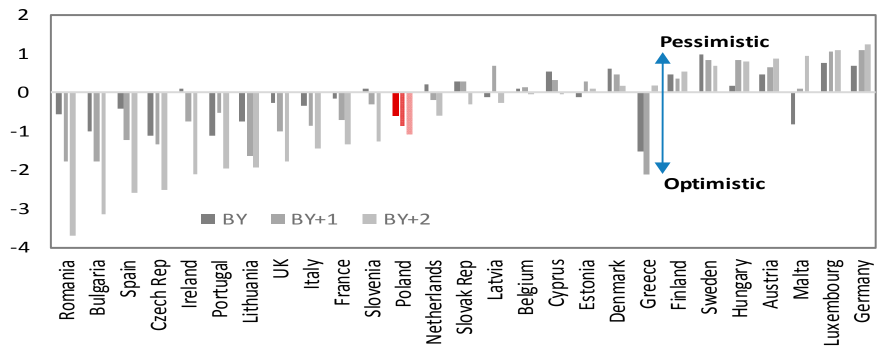
[13] IMF, Fiscal Affairs Department, "*Fiscal Rules—Anchoring Expectations for Sustainable Public Finances*," December 2009.

[14] The expenditure and deficit rules are consistent with each other in the following sense: if the expenditure ceiling set by the expenditure rule requires a deficit in excess of 3 percent of GDP, spending must be reduced to meet the deficit rule.

16. Revenue forecasts have tended to be over-optimistic and this does not appear to be primarily linked with macroeconomic forecasting errors. On average, revenue as a ratio of GDP was 0.6 percentage point lower than forecast for the budget year and close to 1 percentage point lower for the outer years (Figure 6). This bias has translated into fiscal deficits that are higher than projected. However, macroeconomic and revenue forecast errors have not been correlated in recent years and the revenue errors have been much larger (Figure 7).[15] Thus, it is possible that inaccurate revenue forecasts may primarily result from weak forecasting techniques, structural changes in the economy, and/or frequent changes in tax policy. Further work is needed to determine the root causes of these errors and possible solutions.

Figure 6. Average Revenue Forecast Errors

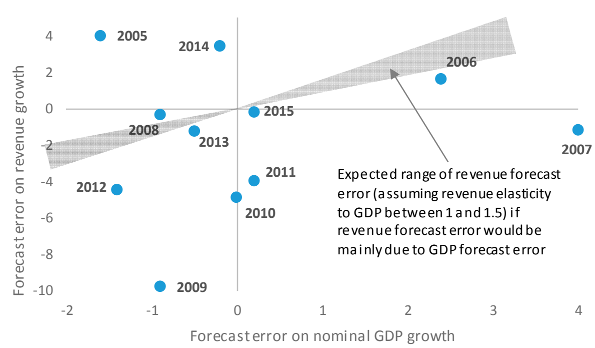
(2000–15, percent)



Source: Poland convergence programmes

Figure 7. Poland: Budget Forecast Errors on Nominal GDP and Revenue Growth

(Percent forecast error for t+1)



Source: Poland convergence programmes and IMF staff calculations

[15] Although for some taxes the elasticity can be negative, the overall elasticity of taxes to GDP is positive in Poland (as shown in "New and Updated Budgetary Sensitivities for the EU Budgetary Surveillance," EU Commission, 2005. Note that more recent studies have not fundamentally changed this parameter). A positive elasticity should result in revenue forecast errors being positively correlated with macroeconomic forecast errors, if the former were being driven by the latter.

D. A Unified and Comprehensive Budget Process

Unity

17. The annual budget process is highly fragmented. In order to incorporate the full medium-term fiscal impact of existing and planned policy initiatives in an MTBF, it is important that all major expenditure decisions are costed and made collectively during the budget process. In Poland, many decisions are made outside of the budget, including decisions related to the financing of the EU structural fund program, the social security funds, and transfers to local government, which are ruled by separate laws, with little discretion.

Comprehensiveness

18. The annual budget presented to the legislature provides a comprehensive view of central government activity but the existing budget classification makes it difficult to identify spending areas. A unified budget, under a well-formulated classification structure, is key if a MTBF is to serve as a mechanism for expenditure prioritization. The information published with the Budget Act covers all central government spending and about 55 percent of general government spending. Despite the sufficient coverage, the complexity of the classification system does not allow for the clear identification of budget allocation by spending areas (e.g. education and health) on which policy decisions are to be made (see Box 2).

Box 2. Budget Classification in Poland

The current system of budget classification in Poland is highly complex and does not allow the identification of spending undertaken in the various policy areas.

There are two systems of classification. The traditional system, used by the Parliament to authorize and control expenditure, is based on a system of **budgetary parts**. There are 84 budgetary parts - some relate to spending areas (e.g., education and health), others cover budgetary units (e.g., courts), transfers to extra-budgetary funds (e.g., social security), transfers to voivods, and reserves (general and earmarked).

There is no clear mapping between budgetary parts and line ministries or spending areas. Line ministries may be budgetary holders of multiple parts (e.g., the Ministry of Agriculture and Rural Development hold parts "Agriculture" and "Rural Development"), while spending areas may cut across different parts (e.g. the policy area of education is covered by parts on "Education", "Higher Education", and "Voivods").

The budget classification consists of "**sections,**" "**chapters,**" and "**paragraphs.**" Although sections were intended to be based on the functions of government (e.g., provision of primary health care) broken down into specific chapters, in practice they comprise a mixture of functions and organizations. Paragraphs represent the economic dimension of classification. The Parliament authorizes and control expenditure at the level of budget parts, subdivided into sections and chapters and group of paragraphs (grants, transfers to natural persons, current expenditures of budget units, investment, servicing the public debt, EU own resources, and co-financing of EU projects).

In addition, alongside the traditional budget classification, a programmatic classification was introduced in 2009 which requires budget holders to develop their multi-year financial plans along the lines of functions, tasks, subtasks and activities. Performance information is presented mainly as an annex to the budget, but is not used in decision-making by budget holders or the MoF.

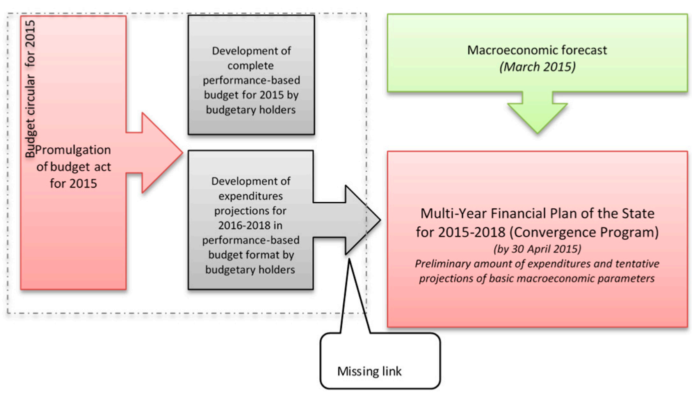
E. Clear and Effective Institutional Arrangements

Link between Multi-Year State Financial Plan and the annual budget

19. The preparation of macroeconomic and fiscal projections for the Multi-Year State Financial Plan (MYSFP) is largely disconnected from the budget preparation process. The MYSFP, including an update of Poland's Convergence Programme which is finalized in April each year before being submitted to the European Commission. This update is prepared by the Macroeconomic Policy Department using macroeconomic assumptions developed in March, State Budget revenue forecasts, State Budget expenditure forecasts derived from the SER (calculated by the Expenditure Policy Department), and information provided by major general government units (collected by the Macroeconomic Policy Department). However, it does not contain medium-term expenditure projections by budgetary parts. This is because the projections provided by line ministries during the previous budgetary exercise are not used in this process, since the figures are not current, and are prepared using the programmatic classification. Thus, there is currently a disconnect between the two processes illustrated in the lower half of Figure 8.

20. While the annual budget and the MYSFP are based on broadly consistent macroeconomic projections, they are largely independent exercises with separate timetables. The annual budget cycle starts in May, and is managed by the budget departments[16] (through a series of stages defined by the PFA and summarized in Figure 9). Given the absence of disaggregated projections in the MYSFP, the annual budget is conducted as an independent exercise, although they both use the same macroeconomic forecasts. Under the arrangements approved by the CoM in 2016, the two sets of processes would be integrated.

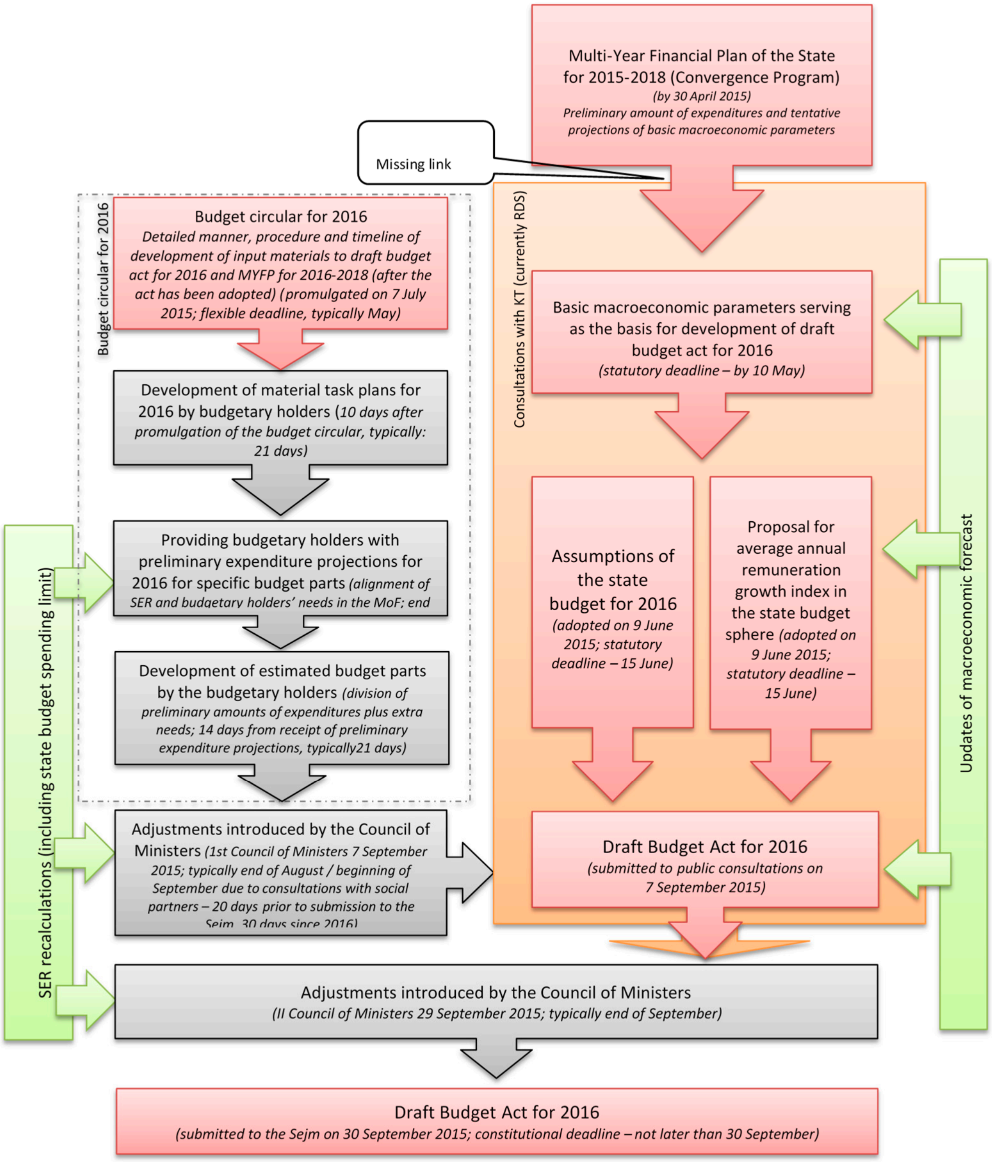
Figure 8. Poland: The Preparation of the MYSFP



Source: Assumptions on Budget Reform, Ministry of Finance, July 2016

[16] There are four budget departments in the MoF: the State Budget Department, the Economy Financing Department, the Budget Zone Financing Department, and the Paying Authority Department. The first of these departments is responsible for overall coordination and management of the budget process, the second and third for managing the budgets of specific ministries and agencies, and the fourth for managing EU-financed expenditure.

Figure 9. Poland: The Preparation of the Annual Budget



Source: MoF, *Assumptions on Budget Reform*, July 2016

Internal coordination within MoF

21. Arrangements for coordinating work on fiscal and budgetary issues within the MoF are not effective. A silo culture prevails within the Ministry of Finance: The Macroeconomic Policy Department, responsible for macroeconomic analysis and forecasting, and the Expenditure Policy Department, responsible for doing analytical work and reforms to the budget process and methodologies, are supervised by one Under-Secretary; while the budget departments, responsible for the annual budget, are supervised by another Under-Secretary. Communications between the departments on the preparation of the MYSFP and the annual budget are weak, and limited to essential business only. This arrangement creates issues around the ownership, leadership, realism, and implementation of reform initiatives. Other EU Member States have developed stronger mechanisms for exchanging information and coordinating the process of internal decision making on fiscal policy and budgetary issues (Annex 1). Moreover, in most other EU Member States, the budget department would be responsible for developing and proposing reforms in these areas.

Role of the Council of Ministers

22. In Poland, the budget process as currently defined in the PFA, comprises only a single stage, thus limiting the role of the CoM in setting spending priorities. By contrast, in most other EU Member States, as well as in many other countries, there exists a two-stage budget process[17] in which decisions about spending priorities and budgetary ceilings are made initially, followed by a second-stage when the detailed annual budget is prepared. The situation in Poland is exacerbated by a budget classification based on budget parts that does not allow either clear identification of spending areas, or the accountability of ministers and other budget holders for spending in these areas. The reforms initiated by the CoM in 2016 should reinforce the role of the CoM, by introducing a first stage to the budget process in which strategic decisions are taken about budget priorities and spending ceilings.

Role of Parliament

23. The legislative process for approving the budget is orderly and the legislature makes only limited changes to it. According to Art. 221(1) of the Constitution, Parliament cannot amend the draft budget if it would lead to a "budget deficit exceeding the level provided in the draft budget." In practice, any such amendments also require the approval of the MoF, and tend to be very small, averaging 0.03 percent of the total budget in the last 10 years. In addition, supplementary budgets though permitted by law, are rarely used, and in-year adjustments to the budget ("virement") are relatively small, and confined to chapters and paragraphs of the budget. However, the legislature partly circumvents these restrictions by proposing laws outside of the budget process, which do not undergo sufficient validation of their fiscal impact.

F. Recommendations

24. Poland performs well against some of the preconditions for establishing an MTBF, but in some areas, weaknesses exist and reforms are indispensable (see Table 3).

[17] Sometimes called the "top-down" budget process.

Table 3. Poland: Summary Assessment of the Prerequisites for Implementing an MTBF

MTBF Prerequisite	Assessment	Recommendation
Credibility of annual budget process	A credible budget that delivers spending consolidation and prevents over spending	
Prudent medium-term macroeconomic forecasts	Accurate budget year forecast, with some optimism bias for outer years, but bias is low compared to peers	
Fiscal Rules	Fiscal rules provide sufficient guidance to fiscal policy for the medium term	
Revenue Forecasts	Actual revenue usually below revenue forecasts	3.3
Unified Budget	A fragmented budget with many decisions made outside of the budget process	3.4 and 3.5
Comprehensive Budget	Budget Act covers substantial part of central government activity but budget classification does not allow alignment of policy decisions with spending areas	3.4
Link between MYSFP and the annual budget	Weak link between MYSFP and the annual budget process. Improvement expected under revised budget process for 2018	3.5
Role of the Council of Ministers	One-stage budgeting process that does not give the CoM the opportunity to set priorities at an early stage	3.5
Role of Parliament	Parliament makes limited changes to the proposed budget but some laws with financial implications are approved outside the budget process	4.7
Internal coordination within MoF	Strong silo culture and lack of ownership of reforms	3.1 and 3.2

Immediate - First 8 weeks

3.1. The proposed MoF High-Level Committee, chaired by the Minister or the two Deputy Ministers (Expenditure and Budget) would oversee the preparation of the MYSFP and the annual budget (see also Recommendation 2.1).

Short-term - Next 8 months

3.2. Issue guidelines defining the roles and responsibilities of the various departments of the MoF regarding (i) the preparation of the MYSFP and the annual budget; and (ii) the implementation of the budget reforms already approved by the CoM. These instructions should be prepared and approved by Senior Management of the Ministry.

3.3 Improve the current approach to revenue forecasting by (i) carrying out further diagnostic assessments of forecasting errors (e.g., a forecast reconciliation table that decomposes the sources of past forecast errors into policy changes, structural changes and changes to the economic outlook); and (ii) identifying possible solutions which could include the use of more disaggregated data, and better modeling techniques.

Longer-Term - Next 18 months and beyond

3.4 Implement the decision of the CoM in 2016 to create a unified budget classification based on policy areas and programs; recognizing that this is a complex reform that will take time to be designed and implemented.

3.5 Prepare and adopt changes to the legal framework and budget calendar that are required to formalize the decisions on budget reform taken by the CoM in July 2016. In particular, a revised PFA should be enacted by the end of 2017, so that the new arrangements can be fully implemented in 2018.

IV. DESIGN CHOICES FOR AN MTBF

25. Given the CoM's decision to implement an MTBF in Poland, authorities should consider what form the MTBF will take in practice in order to meet its objectives. There is no single ideal model, but instead a set of choices to be made in order to:[18]

- **Instill discipline**: which will require medium-term expenditure commitments that are well designed;
- **Create buy-in**: which will depend on an effective multi-year prioritization process;
- **Ensure enforcement**: which requires effective control mechanisms to enforce the commitments; and
- **Build credibility**: which will depend on the establishment of appropriate accountability mechanisms.

A. Medium-Term Expenditure Commitment Mechanisms

26. Medium-term expenditure commitment mechanisms aim to ensure that decision-makers remain committed to revenue and expenditures targets beyond the budget year. In practice, medium-term commitment mechanisms are about setting limits on future spending. The design of these limits should address the following questions:

- What should be the *nature* of future years' spending limits – nominal, real, or linked to output?
- What should the *coverage* of the limits be – should some expenditure be excluded from multi-year restrictions?
- At what *level* should those limits be set – aggregate, ministerial, programs or economic category?

[18] See *Medium-Term Budget Frameworks in Advanced Economies* in Cangiano, Curristine and Lazare (2013) for a discussion of pro and cons of these design choices.

- How often should the limits be *revised* to allow for discretionary changes?

27. The coverage and level of commitment limits are important considerations when designing the commitment mechanism. Countries vary widely both in terms of the level at which they set their ceilings and the spending they include (see Annex 2). In general, the more aggregated the limit that is applied, the broader the coverage of the commitment. The more detailed the level of the commitment—e.g., putting in place binding multi-year ministerial ceilings—requires lower coverage, as spending areas that are out of a ministry's direct control, such as interest, pensions and unemployment benefits, need to be excluded from the ceilings. Thus, a country like Sweden, which operates with an aggregate expenditure limit, includes 96 percent of spending within the limit, while a country such as the UK, which sets ministerial ceilings, includes only 59 percent of spending.

Coverage

28. In Poland, the SER caps nearly 90 percent spending at a general government level, and, while spending can be revised from year to year, these variations are anticipated to be relatively small. From a practical point of view, it makes sense to continue with this existing arrangement for setting the aggregate ceiling. This general government aggregate ceiling can then (as it is now) be decomposed between state budget and non-state budget. The latter is treated as largely exogenous and based on existing expenditure forecasts, while the former is the residual amount, which forms the basis for the multi-year state budget expenditure limit.

Level

29. A credible commitment mechanism requires ceilings to be set below the aggregate spending level within the MTBF. A gradual approach to setting these limits could be adopted, one that aims to first improve the quality of budgetary estimates based on existing policies—forward estimates—while establishing a more robust approach for discussing and approving new policies. Forward estimates are already being prepared for non-state budget entities (such as social security, health and local governments), but are not yet being produced for entities within the state budget. The development of these forward estimates would create the basis for eventually setting more reliable and acceptable detailed ceilings within the MTBF (see Section V).

30. The budget process may bring forward the setting of working spending ceilings for each line ministry and budget holder from August to July and eventually to March CoM meetings. Currently these ceilings are adopted by the CoM in an August meeting, late in the budget process, and means that prioritization both across and within the budget parts is done quickly and without sufficient assessment. The budget reform proposal is for these ceilings to be defined in accordance with the overall expenditure limit earlier on in the process, and to be compared with the estimates for each part, in order to identify areas where spending pressures need to be curbed, or offset by additional savings.

Box 3. Ceilings, Limits, Estimates, and Forecasts

Some terms commonly used in medium-term budget frameworks are often used interchangeably, but have specific meanings:

Forward Estimates: These are bottom-up expenditure forecasts for individual parts of the budget (ministry, part or program) that provide the best estimate of future costs of delivering existing policy commitments. Forward estimates can be aggregated to derive the overall forecast of expenditure on a no-policy-change basis, which is commonly described as the baseline expenditure projection.

Ceilings and Limits: These are the maximum levels of expenditure, determined by the MoF or CoM, that will be allowed to occur in the future. Ceilings are commonly used to define maximum spending levels at the level of ministries or budget holders, while limits are more commonly used to define maximum levels of aggregate expenditure (e.g., the maximum level of general government expenditure under the SER). Ceilings may be applied to expenditure in a single year (e.g., the annual budget), or in a multi-year context.

Fiscal Space/Savings Task: This is the difference between the overall imposed expenditure limit and the baseline expenditure projection. When the former exceeds the latter, there is fiscal space for additional spending measures; while if the latter exceeds the former, there is a savings task required in order to bring baseline expenditure within the imposed limit.

Indicative spending amounts: These can be adjusted in the future, due to either parameter variation (changes in economic forecasts underlying the expenditure projections) or to absorb policy changes. This term is usually associated with forward estimates and forecasts, but can often be applied to medium-term ministerial spending allocations that lie below a binding aggregate limit.

Binding spending commitments: These cannot or should not be altered in the future, regardless of policy or parameter changes. Binding commitments (ceilings) may be defined in law, or take the form of a political commitment.

Appropriations: These are the binding legislated maximum amount of spending for individual budget parts that are approved within the budget law, and are only applicable for the annual budget.

31. For the State Budget process, the annual binding ceilings are set at the level of parts, but the MTBF reforms envisage these to be set at the level of some 20 newly created spending areas. Budget parts, of which there are currently 84, are well established and understood by all. The notion of spending areas, however, is new and yet to be widely accepted. To ease the introduction of spending areas, the authorities' proposal is to ensure a one-to-many relationship between spending areas and parts—i.e., one spending area would have one or more parts, but a part would only belong to one spending area. This approach is intended to limit institutional resistance to the introduction of spending areas.

32. The spending areas may prove to be the most effective way of presenting the forward estimates, and to allow for reallocations as part of the budget process. Presenting forward estimates for each of the 84 budget parts would be too overwhelming to be absorbed, while the 20 spending areas make more sense, both in terms of numbers and because they are intended to aggregate budget part spending to a level consistent with ministerial responsibility. This latter feature also makes the spending areas a good way to allocate spending within the budget process, by providing greater discretion of Ministers to manage their entire portfolio.

From forward estimates to ceilings

33. As the MTBF process matures, and the forward estimates become more accurate, the government may consider introducing multi-year ministerial ceilings to assist in reallocating resources to higher priority areas. This will provide a more binding commitment to future spending at lower levels, which would be unwise to enter into initially, as it will be difficult to enforce ceilings based on inaccurate estimates. It should be done in a phased manner.

B. Multi-year Prioritization Mechanisms

34. The credibility of the MTBF requires that it reflects the government's policy priorities and is consistent with the multiyear spending limits. Achieving these dual objectives requires institutional mechanisms that allow competing policies to be prioritized in a manner that takes into account their medium-term budgetary impact. These institutional mechanisms are:

- an integrated medium-term expenditure planning and budgeting process and presentation;
- a clear separation between the cost of maintaining existing policies and the cost of new policy initiatives in budget documents, based on an unambiguous and widely accepted methodology; and
- a forum for discussing and deciding expenditure priorities, based on sufficient information, that is perceived to be comprehensive, politically legitimate, evidence based, and binding.

Integrating planning and budgeting

35. Multi-year prioritization mechanisms vary considerably across countries. These range from coalition agreements established at the start of government mandate (Finland, Netherlands), agreeing medium-term policy directions/changes ahead of the annual budget debate (Sweden), establishing periodic spending reviews (UK, France), and enhancing the scrutiny of all policy changes (Australia).

36. In Poland, prioritization of spending over the medium-term is fragmented both in terms of coverage and decision-making mechanisms. New programs are reviewed and approved throughout the year, strategic development spending is overseen by the Ministry of Development (MoD), and the policy directions set out in the Convergence Programme sent to EC each year are not fully reconciled with the allocations made in the annual budget. There is a Standing (or Permanent) Committee of Under-secretaries reporting to the CoM dealing with budgetary issues, but its role in reviewing spending proposals and deciding on spending priorities on behalf of the CoM is neither formalized nor comprehensive.

37. Development related priorities are coordinated by the Ministry of Development (MoD) and established in the National Development Strategy (NDS).[19] Current objectives include sustainable economic growth, socially and territorially sustainable development, and efficient state and economic institutions. The NDS focuses on six areas—human and social capital, transport, digitalization, energy, environment, and national security—and currently includes some 180 strategic and 10 flagship projects, many using EU funds, some funded by budgets, and others in cooperation with the private sector. It is worth noting that the NDS multi-annual plan classifies over 1,000 billion PLN of state and local budget spending between now and 2020 as "development" (about 55 percent of GDP), much of which is current spending notably in education, defense and other areas identified in the NDS. Given the significance of these spending areas and the use of EU funds, the role of the NDS in guiding multi-year spending prioritization cannot be ignored.

Costing of policy initiatives

38. The authorities have in place a fiscal impact assessment process for new legislation, coordinated by the Chancellery in the PM's Office. According to the Public Finance Act, for all government led legislative changes that effect the expenditure level, a Regulatory Impact Assessment (RIA) which include 10-year forecasts of fiscal impact, has to be prepared. The RIA are scrutinized by the MoF, as part of the public consultation process, establishing binding limits on program spending related to the new legislation, subsequently approved by the Sejm, over the first 10 years of implementation.

39. To be an appropriate tool for MTBF prioritization, this process would need to be broadened to all new policies, not just new legislation, and more closely linked to the budget cycle. At present, new legislative proposals can be initiated throughout the year and are not linked to the budget process. This ex-ante scrutiny excludes legislation initiated in the Sejm[20] although a fiscal impact assessment is made subsequent to the adoption of such legislation. Furthermore, it is not clear whether such proposals are required to be aligned with the National Development Strategy discussed above.

Spending prioritization

40. For the budget year, spending prioritization often only takes place towards the final stages of budget preparation, too late to guide initial budget bids. In the absence of decisions on spending priorities early in the budget cycle, budget bids tend to be well beyond available fiscal space, which leads to difficult budget negotiations with the MoF and intense debates at the August and September CoM meetings each year. Line Ministries complain that the

[19] The NDS is an overarching strategic document closely linked to the budget and EU funds. Other strategies, adopted within the system of development policy management deal with specific sectoral issues.

[20] Approximately 50 percent of the legislation adopted in the first year of the current term of the Sjem.

process forces them to prepare their bids twice, with insufficient time to adequately prepare budgets for decisions that are made at the end of the process.

41. Given the fragmentation of spending prioritization in Poland, institutional arrangements for budget approval and policy prioritization should be strengthened and streamlined. Institutional arrangements for prioritization vary across countries (see Box 4). Given the policy and competitive nature of prioritization, the body that reviews and approves new policies, including changes to existing one, should have the full authority of, and report to the CoM. While the current Standing Committee of Under-secretaries is important for technical reviews of policy proposals, its broad membership may complicate decision-making, especially when it comes to spending cuts.[21]

Box 4. Institutional Decision-Making Options in Expenditure Prioritization

Established around spending reviews – this is the case for instance in the UK, which undertakes efficiency and strategic bottom-up reviews of spending across government that set spending limits for around 60 percent of the budget; the reviews are overseen by the Treasury and reviewed by the Public Expenditure Committee of Cabinet (known as the "Star Chamber"). Other countries such as the Netherlands and France have also established their key prioritization mechanism around spending reviews.

Focused on new policies – this is the case for example in Australia, where a sub-committee of Cabinet (known as the "Razor Gang" because of its role in expenditure rationalization) scrutinizes all new policy proposals, including savings measures, as part of the annual MTBF process. New Zealand operates a similar prioritization process.

Focused on program budgeting – countries with long established and effective program/performance budgeting, e.g., the United States and Canada, undertake prioritization as part of their medium-term review of programs. In the case of the United States, the review process has undergone multiple transformations. South Korea has also developed a system of scoring the performance of programs.

42. Decision-making by the CoM could be streamlined. While the CoM should retain the authority to approve the budget and new policies, the Standing Committee of Under-secretaries could do the detailed work, and provide a recommendation on the final budget package. An example of the type of decisions that should be sought from the Council of Minister's after the March meeting is provided in Box 5.

[21] Another option to explore is the Economic Committee.

Box 5. Example of Potential Decisions from the March 2017 CoM Meeting

- The CoM notes the first indicative forward estimates produced by the MoF.
- The CoM recognizes the implied savings tasks required in order to meet the SER of PLNX billion in 2018, PLNY billion in 2019, and PLNZ billion in 2020, noting that these may be revised.
- The CoM decides on the following increases for minimum wages and pensions to be included in the forward estimates, subject to agreement with the Social Partners.
- The CoM directs the MoF and relevant line ministries to work up savings proposals sufficient to meet the above savings tasks in the following areas:
    - Cross-cutting savings (e.g., efficiency saving from all departmental expenditures)
    - X (e.g., health) [could seek amounts for each of the three years]
    - Y (e.g., transport)
- The CoM directs the Standing Committee of Under-secretaries to assess and provide the CoM with recommendations regarding the savings options at the July 2017 CoM meeting.

C. Control Mechanisms

43. Once the expenditure limits and indicative spending allocations are set, there needs to be a range of controls in place to ensure they will be delivered over a multi-year period. These controls should include:

- At least two updates per year of the medium-term expenditure forecasts to ensure the government knows its fiscal position;
- Allowing sufficient margins between expenditure commitments and expenditure plans to absorb unexpected events without requiring reprioritization of policies;
- Firm controls on ministries' and agencies' ability to enter into multiyear expenditure commitments; and
- Controls over the accumulation, stock, or drawdown of carryovers.

Expenditure projections

44. Medium-term macroeconomic and revenue forecasts are prepared three times a year. The macro forecasts are prepared for the Convergence Programme in April, for the budget circular in June/July, and for the annual budget in August. These forecasts also include the aggregate expenditure ceilings derived from the expenditure rule. These top-down expenditure ceilings are prepared by the Expenditure Policy Department in consultation with the budget departments.

45. More detailed medium-term expenditure estimates are prepared by budget holders in March but are not used for the Convergence Programme. The State Budget Department consolidates these estimates, but given they are essentially bids, they are not used in the bottom-up estimation of aggregate state budget expenditure for the Convergence Programme.

These estimates are not updated during the year. The evolving use of forward estimates is discussed further in Section V.

Reserves and margins

46. Within the budget year, the State Budget Department monitors budget execution and has a record of keeping it on track, despite the absence of a formal budget review process. The Department's ability to control spending is linked to its approval role for any releases of funds from special purpose earmarked reserves (see Figure 2). These reserves, identified in the budget under part 83, ensure that spending reflects actual commitments and allows some discretion to address emerging in-year developments.

47. These earmarked reserves are not part of the general contingency reserve and often end up being fully allocated by year-end. They are used: (a) when details of spending (including loans and EU funds) are unknown at budget preparation; (b) when required by statute; or (c) where distribution between regions cannot be pre-determined, e.g., social payments. The Public Finance Act (Article 140) only caps domestic earmarked reserves at 4 percent of budget reserves for loans and EU funds are not capped.

48. The budget also includes up to 0.2 percent of the budget for general contingencies and a further amount of around 0.5 percent of spending for emergencies and disasters. This is low compared to other countries (see Table 4). Under the MTBF, the general contingency allocation should be increased for outer years to reflect increasing uncertainties regarding the funding of existing policies.

49. The authorities should increase the planning (contingency) margins for new policies. Initially, the margins for years 2 and 3 could be set at higher, more risk-averse levels, and gradually reduced in subsequent MTBFs. Given the expected need to consolidate in the next few years in Poland, a higher planning margin for outer years would be prudent and would convey the message to budget holders that future spending related to current policies will need to be reduced to accommodate the new policy initiatives that are likely to materialize.

50. Under the MTBF the total unallocated expenditure in outer years (contingency plus planning margin) would be set as a percentage of the aggregate spending ceilings. Based on practices in other countries these vary between 1 to 3 percent of spending in year 2, and 3 to 5 percent in year 3. The higher end of these margins would be appropriate for Poland in the next few years, but the most appropriate level should be calculated by the authorities.

Table 4. Contingency Reserves and MTBFs

	Implicit Margins		Explicit Margins		Total Contingency
Country	GDP forecast	Other economic assumptions	Within expenditure estimate	Within budget balance	Percent of total spending
Canada	MoF uses average of indicative forecasts	MoF adds 0.5% to 1.0% to interest rates and runs through model	Contingency reserve of 1.5% to 2.0% of total spending	MoF targets a surplus of 0.1% of GDP despite balance rule	3.5% to 4.0%
United Kingdom	MoF uses GDP forecast 0.25% below trend	7 other economic assumptions explicitly cautious	Reserves and margins equal to 0.75% to 1.0% of total spending	MoF targets average surplus of 0.2% of GDP despite golden rule	2.5% to 3.0%
Sweden	Budget based on central assumptions for GDP and other macro variables[1]		Budget margin within expenditure ceiling rising from 1.5% to 3.0% of total spending	None	1.0% to 3.0%
Netherlands	Deficit target and expenditure ceiling based on cautious economic scenario in which GDP is 0.5% to 1.0% below outturn		Central contingency reserve of 0.1% of total spending	Most recent CA targets structural surplus of 1.0% of GDP	1.1% to 2.0%
Australia	Budget is based on central economic assumptions[1]	Conservative bias in forward estimates of 0.5% to 1.5% of spending	No central contingency reserve	None	0.5% to 1.5%

Source: Annual budget documents.
Note: CA = cyclically adjusted; MoF = Ministry of Finance; MTBF = medium-term budget framework.
[1] "Central" refers to taking the forecast that is neither cautious nor optimistic but refers to the most likely perceived ex ante outcome.

Controls over multi-year contracts

51. Some areas of public expenditure are already subject to multi-year control commitments, notably:

- Multi-year programs approved by the CoM with binding limits, which include an estimate of the total fiscal impact of programs (based on RIAs), as well as performance indicators and expected results. Three-year forecasts are presented in the State Budget documentation (Annex 10) on each program. Such programs represent PLN16.8 billion or 4.35 percent of State Budget spending in 2017, with the stock of pre-committed programs amounted to PLN132 billion as of end-2016.
- Up to 10-year limits on expenditures on specific new government-led initiatives, which may result in an increase in expenditure.
- Multi-year projections of projects co-financed with EU structural funds are presented in Annex 15 of the State Budget documentation for each agreed "investment program", totaling 33.9 and PLN4.7 billion respectively for EU and domestic components. Together these represent 10 percent of State Budget spending, although some PLN15.7 billion of the

PLN 33.9 billion EU funds will be executed directly through the National Road Fund which is outside the State Budget.

52. Approval of these multi-year commitments follow prescribed processes and require an MoF review, but cannot be circumvented. The MoF reviews the multi-year program projections prior to their approval by the CoM, and the MoD in collaboration with the MoF reviews EU funded investment project proposals. Subsequent multi-year contracting which can encumber future budgets is subject to strict control by the MoF. However, particularly in the case of investments, these controls are sometimes considered to be too stringent by budget holders who then circumvent the need for approval by slicing their contracts into annual tranches.[22]

Carryovers

53. The Public Finance Act has a provision for carryovers with approval on a case-by-case basis. Such carryovers must be cleared within three months. There has been uptake of this provision, and most such carryovers are cleared within a short time after year end. Some line ministries avoid this problem through their extra-budgetary funds, which are not subject to carryover restrictions. The generally strict rules related to carryovers have an important impact on expenditure, as budget holders rush to spend before the end of the year so as not to lose future entitlements.[23] There could be a good case for loosening the restrictions on carryovers once the medium-term framework for budgeting is well established. See Annex 3 for country examples.

54. New carryover rules and limits should be carefully designed to avoid unfettered accumulation of carryovers that can undermine budget credibility and the ability to meet fiscal targets. Design considerations for setting suitable carryover limits include:

- **Limiting the *type of appropriations* that can be carried over**: for example, Australia allows full carryover of administrative costs within departments, but requires cabinet approval and re-appropriation for any carryover of program expenditure.
- **Limiting the *accumulation of carryovers* from one year to the next**: for example, France and Sweden allow only three percent of expenditure to be carried over from one year to the next.
- **Limiting the *drawdown of carryovers* in a given budget year**: for example, until 2010, the United Kingdom allowed unlimited accumulation of carryover entitlements by ministries but required treasury approval before those carryovers could be spent in a given budget year.

[22] For further advice on multi-year commitment controls see http://www.imf.org/external/pubs/ft/tnm/2009/tnm0904.pdf.

[23] A discussion of carryovers practices can be found at http://blog-pfm.imf.org/files/carry-over-of-budget-authority.pdf**.**

D. Accountability Mechanisms

55. Ultimately, the credibility of an MTBF depends on the government's ability to demonstrate that it is delivering on what it committed to previously. Demonstrating this consistency between previous multi-year budget plans and current budgetary outturns and forecasts requires a set of accountability mechanisms that ensure:

- for any given financial year, the MTBF projections, the annual budget, and final accounts are presented and costed on a comparable basis;
- governments and line ministries are held to account for any large unjustified deviations from multiyear plans; and
- full reconciliation between vintages of MTBFs that comprehensively and transparently explains changes; with successive vintages of MTB allocations presented side by side with each update to help build credibility.

External scrutiny

56. External scrutiny of Poland's budget assumptions is already being done by the National Bank of Poland and the European Commission. The NBP's Monetary Policy Council provides an independent opinion on the macroeconomic assumptions underlying the budget proposal submitted to the Sejm. The EC comments on the Convergence Programme submitted in April. The IMF also reviews the budget and its underlying assumptions under the FCL as well as its regular surveillance process. The Supreme Audit Office (NIK) undertakes an ex post audit of budget assumptions. The EC has recommended that Poland enhance the external scrutiny of the budget by establishing an independent Fiscal Council.

57. The Sejm's internal analysis of the annual budget proposal is also supported by a well-established and experienced Bureau of Research. In addition to preparing analysis for the various committees, the Bureau of Research also prepares the details of amendments sought, along with their cost implications, and opinions on the Convergence Programme which is assessed in committees.

58. There are currently no rules regarding fiscal responsibility. A fiscal responsibility law is being considered, but this is still some way off. To enhance the accountability of line ministries and other budget holders, some countries (e.g., Croatia)[24] have introduced an obligation for line ministers to sign off on a fiscal responsibility statement at the time the budget is finalized, which effectively holds the minister concerned accountable for the accuracy of his/her budget proposal.

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[24] Fiscal responsibility statements are required in Croatia's Fiscal Responsibility Act. See Croatia's Convergence Programme for 2014-16 (http://ec.europa.eu/europe2020/pdf/csr2014/cp2014_croatia_en.pdf).

Introduction of a similar arrangement in Poland may encourage line ministries and budget holders to enhance the quality of their budget submissions.

Reconciliation

59. There is no reconciliation between vintages of forecasts of either macro or expenditure projections. Forecast reconciliation is important to underpin the credibility of the MTBF. Reconciliation tables should explain the inevitable differences between year 2 and 3 of the previous MTBF and year 1 and 2 of the current MTBF. These differences can be due to various factors as described in Table 5. A typical reconciliation table is shown in Table 6.

Table 5. Factors Affecting Changes in Projections between MTBF Vintages

Factor	Explanation	Examples
Macro-economic	Revisions to macroeconomic parameters	GDP, inflation, exchange rate
Other Parameters	Revisions to operational parameters	Prices of goods, volumes of claimants
Accounting Adjustments	Revisions in accounting treatment	Reclassifying expenditure between ministries
Policy Measures	Discretionary additions or cuts to ceilings	New investment, efficiency savings
Carryovers	Net drawdown or accumulation of carryovers	As authorized by the Council of Ministers
Over/Under Spending	Operational overruns or underspends	Claims on reserve, unauthorized overspending

Table 6. Illustrative MTBF Reconciliation Table

	2018	2019	2020	2021	2022
2018 Budget	**Budget year**	**BY+1**	**BY+2**		
Forward Estimate	100	110	120		
Reconciliation in terms of:					
- Price variation	-5	-6	-8		
- Volume variation	3	4	6		
- Policy adjustment	0	5	3		
- Technical Adjustment	2	2	2		
Total Variation	**0**	**5**	**3**		
2019 Budget	**Estimated Actual**	**Budget year**	**BY+1**	**BY+2**	
Forward Estimate	100	115	123	130	
Reconciliation in terms of:					
- Price variation		2	13	15	
- Volume variation		-2	-2	-3	
- Policy adjustment		0	-11	-12	
- Technical Adjustment		-3	-2	-1	
Total Variation		**-3**	**-2**	**-1**	
		Estimated Actual	**Budget year**	**BY+1**	**BY+2**
2020 Budget		112	121	129	139

Recommendations

60. A summary of the recommendations for the design of multi-year commitment, prioritization, control and accountability mechanisms is set out below. More detail has been provided in the previous sections.

Multi-Year Commitment Mechanism[25]

Immediate - First 8 weeks

4.1 Clarify that the MTBF is based on an aggregate binding commitment consistent with the SER, with lower level indicative spending area/budget part allocations over the medium term based on forward estimates.

Short-term - Next 8 months

4.2 Finalize spending areas definition for setting MTBF spending ceilings and implement in stages over three budget cycles.

Longer-term - Next 18 months and beyond

4.3 Adopt a phased approach, as recommended below, to introducing multi-year ministerial ceilings to assist in reallocating resources to higher priority areas.

- **For the 2018 budget**: ***at the March CoM,*** approve 3-year estimates by Parts based on current policy of State Budget spending, in line with general government spending forecasts within the expenditure rule; ***at the July CoM***, include in the budget circular indicative ceilings by Parts for the budget year based on an update of the estimates prepared in March; ***at the August CoM***, set binding ceilings by Parts for the budget year and require budget holders to update their outer year estimates based on latest macro projections; ***at the September CoM***, approve the budget and the revised MTBF for delivery to the Sejm.
- **For the 2019 budget**: ***at the March CoM***, approve 3-year estimates by Parts, showing an aggregation by proposed spending areas; ***remainder as before***.
- **For the 2020 budget**: ***at the March CoM***, approve indicative ceilings for the budget year and estimates for two outer years by spending areas; ***at the July CoM***, approve binding ceilings by spending areas for the budget year; ***no August CoM.***

[25] See Section V for methodological tools.

Multi-year prioritization mechanism[26]

Short-term - Next 8 months

4.4 Strengthen the role of the CoM in expenditure prioritization through a sub-committee charged with reviewing and clearing all new policies.

4.5 Design and implement a more strategic expenditure prioritization process earlier in the budget cycle, focused on improved scrutiny of baseline and new policies, that feeds into the MTBF and Convergence Program.

Control mechanisms

Immediate - First 8 weeks

4.6 Define a framework for setting planning margins in the MTBF, using a risk averse approach to begin with.

Short-term - Next 8 months

4.7 Strengthen the arrangements for multi-year commitment controls and carryovers to better underpin the new MTBF framework.

Accountability mechanisms

Short-term - Next 8 months

4.8 Establish a framework for reconciling between forecast vintages, starting with macro forecasts, expanding to MTBF aggregates.

4.9 Consider introducing fiscal responsibility statements for line ministries and budget holders.

V. TOOLS UNDERPINNING THE MEDIUM-TERM BUDGET

A. Forward Estimates

Concept of forward estimates[27]

61. A medium-term budget should be based on a well-defined, bottom-up expenditure forecast for each ministry on a no-policy change basis, commonly described as forward estimates or baseline projections. This should be the basis of the expenditure projections and

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[26] Section V provides recommendations on spending reviews.

[27] This section builds upon the 2008 FAD Technical Assistance Report: Developing a Multi-Annual Fiscal Framework, where the concept and benefits of forward estimates are laid out in more detail, as well as the recent December 2016 World Bank Report.

budget bids prepared by ministries, and should be the best estimate of the cost of continuing all existing policies at current levels of service delivery over the next three years. Initially, these estimates should be prepared by the MoF's budget department, in consultation with the line ministries.

62. The forward estimates inform the setting of ministerial expenditure allocations over the medium term. Rather than holding baseline spending allocations unchanged from the last year's budget, forward estimates account for any one-off factors that won't be continued into the future, as well as identifying spending dynamics outside of ministries' control, which if not recognized would make an unchanged allocation unrealistic. For instance, if there was a growing number of school-age children, maintaining the spending allocation of the Ministry of Education fixed (even in real terms) at the level of the last budget would ignore the growing spending pressure from more students in school, and entail a reduction in spending per student. Similarly, if the number of students was decreasing, such an allocation would result in greater spending per student, an unconscious spending increase that uses finite resources that might alternatively be better used in higher priority areas.

63. Spending allocations will not necessarily be set in line with the forward estimates – they are not an entitlement for future budgets, a point to be made clear to all line agencies. For instance, a forward estimate may indicate that there are sharply growing spending pressures in one area of the budget (for instance in the transport sector, due to sharply rising fuel prices). The government may well consider such an increase unacceptable, and set the spending allocation below the forward estimate forecast, requiring the ministry to identify savings.[28] But the use of forward estimates will define just how large a savings decision will be necessary to bring the spending into line with the spending allocation, rather than simply ignoring the pressure to the budget.

64. The benefits of forward estimates are threefold:

- They link annual budgets to medium-term fiscal forecasts, providing better informed and more accurate assessment of overall fiscal space or fiscal savings required in future years.
- They identify early on any spending pressures and dynamics, which strengthens the basis for making new policy, and informs on spending areas where policy changes may be necessary.
- They provide a starting point for next year's budget, based upon agreed models and spending projections automatically adjusted for exogenous inputs like inflation, wages and exchange rates. This simplifies budget negotiations considerably, releasing staff previously involved in discussing the minutiae of line agencies budgets to instead focus on developing new policy and evaluating the quality of existing policy.

[28] Alternatively, new revenue measures, or savings from other agencies could be identified.

65. The forward estimates process will take a number of years to mature. Initially, the forward estimates can be thought of as rough forecasts that will likely contain mistakes, gaps and inconsistencies. Only through ongoing reassessment, interaction with line agencies and continual improvements will the forward estimates become more precise.

The government's approach

66. The Government already effectively prepares forward estimates for half of the general government sector as part of the Convergence Programme document. Forecasts for social security spending are prepared by the Social Security Institution (ZUS) based on MoFs macroeconomic assumptions. Forecasts for spending local government and special funds (such as the National Road Fund and National Health Fund) are prepared by the Macroeconomic Policy Department. The Convergence Programme forecasts for the State Budget sector are more rudimentary, with little linkage to the budget, though some bottom-up information is used in preparing it.

67. The State Budget is still prepared on an annual basis, with no link to the medium-term estimates presented in the Multi-Year State Financial Plan.[29] This lack of coherence between the two documents and processes is a major cause for concern within the government, but also with external partners such as the EC and IMF. A key aim of these reforms is to link the two processes over both the budget and the medium term.

68. As a first step in the implementation of the MTBF, the MoF's budget departments are preparing baseline forward estimates for three years ahead within the State Budget. The first version of these estimates are expected to be produced by early March, and used to inform the March CoM meeting and to determine the amount of fiscal space available, or more likely, the savings that need to be generated. The CoM will be asked at the March meeting to proceed with identifying savings options to be worked up as part of the budget process, (Section IV, Box 4 provides a guide to the decisions which should be sought from this CoM).

69. Preparing forward estimates will pose a challenge to the budget departments. The departments have limited experience in expenditure forecasting, and there are a range of conceptual, modelling and practical issues that will likely need to be addressed over the immediate period. These include:

- Providing budget teams with a basic methodology for preparing forward estimates, and defining the concept of no policy change;
- Specific technical issues that will arise in dealing with areas such as investments, the wage bill and transfers to other agencies;

[29] The MYSFP is prepared in conjunction with the Convergence Programme.

- Verification of this first round of estimates, as well as issues relating to improving and updating the estimates in future rounds; and
- Developing other supporting tools, such as new policy proposals and spending reviews to strengthen the medium-term budgeting process.

Basic methodology for preparing forward estimates

70. Producing expenditure forecasts or forward estimates at the disaggregated level involves several steps. These are focused on understanding the existing budget; understanding and applying the medium-term cost drivers; and aggregating the forward estimates and summarizing the overall sources of variations. Each of these steps need to be identified, analyzed and ideally have the methodology agreed between the MoF and the line ministries, as the forward estimates form the basis of future budget allocations. Annex 4 includes a detailed process for producing forward estimates.

Defining no-policy-change estimates and a new policy approval process

71. The preparation of a baseline expenditure estimate requires an explicit understanding of what constitutes existing policy. The State Budget Department, working with Expenditure Policy Department should define the "No Policy Change" baseline, for example:

> *The level of spending that will continue to occur over the next three years in the absence of any new or amended laws, decisions by the CoM or approvals by the Minister of Finance.*

This definition would include all of the *fixed* spending within the budget (75 percent of spending) plus *semi-fixed* spending such as the wage bill and any other contractual or policy commitments that currently receive funding (a further 12 percent). Earmarked reserves for ongoing social benefit programs would also be included within the no-policy-change baseline. The remaining 13 percent of *flexible* spending would only be included within the baseline if explicit commitment to the spending has previously been made, in order to avoid overstating the fixity of future budget allocations.

72. There is no perfect definition of existing policy, and while it is relatively clear where the majority of spending falls, there are always difficult and continuous border disputes, even in the most mature systems. These should be anticipated, particularly early on in the process when existing spending is being assessed from scratch, and a clear process for deciding where it falls should be put in place. This should be where disputes between budget teams and line agencies are elevated to a senior MoF official or Under-Secretary, who will be the ultimate arbiter. This is usually kept within the civil service, and not elevated to the political level, as it is a technical decision.

73. In order to smooth the process, all new policy decisions should be clear and explicit about what is and what is not ongoing spending. This should be defined within the policy costing in the RIA as well as the cabinet/legal or budget decision that provides authority for the new spending to go ahead.

Level on which to form estimates

74. Despite the somewhat confused and fragmented current budget classification structure (see Section III D), it can nevertheless form an effective base of forward estimates. The traditional classification is a mix of functional, organizational and economic classifications, as is the parallel but largely unutilized programmatic structure of the budget. While programmatic structures are often used to prepare estimates internationally, the deeply unpopular and low use of programs in Poland argue against using them in this first round.

75. For now, the 84 budget "parts" are therefore the most promising basis for preparing forward estimates. These broadly correspond to single spending areas, upon which expenditure projections can be developed. The focus should be on the largest areas, some of which also have the simplest basis upon which to forecast baseline expenditures:

- **Social Insurance** (PLN54 billion): The projected deficit of the social insurance fund, based on ZUS's scrutinized forecasts consistent with the MoF's macroeconomic and demographic projections.
- **Transfers and subventions to Local Government** (PLN53 billion): Transfers are based on a revenue-sharing formula under which local governments receive a percentage of personal and corporate income tax. Subventions are principally related to education spending by local governments, with weak link to the revenue sharing rule.
- **Regional Governors (Voivods)** (PLN39 billion): This is a more challenging area as the actual amount of spending (mostly on family, new child benefits) usually exceeds the budgeted amount by around 30 percent, as earmarked reserves are distributed over the course of the year.
- **Social benefit expenditures**: should be projected based on target population and CPI/wage parameters.
- **Miscellaneous spending**: should either be excluded from the baseline, or held constant as a share of GDP, depending on its nature.
- **National Defense** (PLN35 billion): Initially just using the stated policy intent of funding equivalent to 2 percent of GDP (initial exercise), but in the future based on bottom-up estimates of spending by military agency to ensure that spending estimates are in line with the 2 percent of GDP target.
- **Debt Servicing** (PLN32 billion): provided directly by the Public Debt Department.
- **Earmarked Reserve** (PLN22 billion): More challenging and will require further internal discussion.

- **Internal Affairs** (PLN20 billion): Split between spending areas for police and others.

76. **Most of the estimates can be prepared based on the entire part's expenditure, though some, such as internal affairs, may need to be further disaggregated.** To avoid over-complication (at least initially) disaggregation should be done only if there are radically different types of spending within the part. The estimate forecasts can then be split between departmental expenses forecast on an economic basis (wages and salaries, goods and services) for delivery agencies and public administration overheads; and administered by program area for entitlements (pensions, unemployment and family benefits) and transfers (to local governments, other government agencies – see Box 6). Some parts will include both departmental and administered expenses, which need to be separately estimated.

77. **The budget reform intention is to further aggregate the parts into 'Spending Areas' as defined in the "Assumptions to Budget System Reforms" paper.** This will take the 84 budget parts, and aggregate them to 20 spending areas, broadly organized around Ministerial portfolios. This is a sensible move, as in purely practical terms 20 spending projections will be an easier and simpler basis for the CoM to understand and assess the estimates. However, this will be a new concept, and will therefore need to be carefully undertaken and explained. The aggregation process should be a joint product of the State Budget and Expenditure Policy Departments. Spending areas will need to be explained to the CoM and answers to likely questions prepared—for example, can spending be shifted from one part to another within the same spending area?

Box 6. Administered Programs versus Agency Overheads

In defining forward estimates, it can be useful to delineate between the costs associated with Departmental and Administered expenses:

- Departmental expenses are those associated with day-to-day operations and program support activities of the agencies. They include agency overheads, salaries, property rental and goods and services expenditure used to manage administered programs.
- Administered expenses are the costs of delivering programs on behalf of the government, such as benefit payments and transfers to local government. These are usually defined in law, with the amount not subject to any discretion of the delivering agency. For instance: unemployment benefits will simply be the aggregate cost of number of eligible unemployed multiplied by the defined benefit. Education expenditure is also treated as an administered program, as costs are often associated with per capita funding formulas that are well defined.

Within forward estimates, these are usually separately estimated and then aggregated. Not all parts will necessarily have both types: parts that are purely administered expenses, such as transfers to local government will not include any departmental expenses; conversely, purely policy departments, such as the MoF will often only have departmental expenses without any administered programs.

Investment spending

78. **Investment spending, especially infrastructure, carries a number of particular challenges that will need to be overcome while preparing forward estimates.** These include

the multi-annual nature of decisions, unspecified annual profiles and frequent re-profiling, changes in costs and delays in implementing. The challenges also include the question over what precisely constitutes the existing policy that should be included within the baseline. Capital expenditure estimates will also tend to trail off in the outer years, as existing projects are completed, leaving room for new projects to be identified and funded as new policy proposals.

79. In addition to the capital cost of projects, associated operating and maintenance costs should be included within the relevant parts of the forward estimates. These should be identified at the point of capital project approval, and should be treated as existing policy for those that are already approved.

80. While investment expenditure linked to external (mainly EU) funding is already prepared on a multi-annual basis, internally funded capital spending will need to be brought into new forward estimates. The majority of projects within the Polish budget are funded through a combination of EU funds and co-financing, and are already approved, managed and reported in a multi-annual framework presented in an appendix to the budget. However, there remains around PLN20 billion (one percent of GDP) of internally financed capital spending that is managed through the State Budget. However, while the overall cost of these projects are known, there is no breakdown beyond the current annual year.

81. For the immediate process of developing forward estimates, these investments should be split into two categories: major projects and minor projects/capital purchases. The former should include the top ten or twenty projects, which in many cases will make up the vast majority of investment expenditure. The exact delineation between major and minor should be on the basis of a de minimis level upon which minor projects fall below – potentially somewhere in the order of PLN2 billion. To create an annual estimate profile:

- **For the major projects:** request annual profiles of the project expenditure from the relevant agency, and confirm the basis upon which the project has been approved. These can then be aggregated and included within the estimates as administered expenses.
- **For the minor projects/capital purchases:** as a rule of thumb, treat the current level of spending as the baseline, and hold this steady, either in nominal, real or share of agencies' expenditure, particularly where these minor investments are made up of durable good purchases (cars, ICT equipment etc.) that can be treated as departmental expenditure.

82. The Economy Financing Department should set up an investment project tracking system, mirroring or using the existing system for EU funded projects. This should be updated through each forecasting round to account for newly approved projects, and any re-profiling of existing projects. Gradually the threshold for including projects can be reduced, thus increasing the coverage of the tracking system.

Wages and salaries

83. The treatment of compensation of employees of civil servants can be a tricky issue in developing forward estimates. Wages make up a large share of expenditure, but their future direction is not always certain. Choosing to keep the nominal wage bill flat over the three-year period will usually lead to a systemic understatement of expenditure within the forward estimates (which then results in an overstatement of fiscal space/underestimate of the savings task). On the other hand, including information on future wage changes can also tip the government's hand in negotiations with public sector unions.

84. Initially, the proposed approach of holding the wage bill flat in nominal terms within the forward estimates, but providing wage alternative options to the CoM as a lever to adjust expenditure levels is workable. This is particularly the case in the current environment where wage costs have reportedly been held fixed for a number of years already. However, this is unlikely to be sustainable in the longer term.

85. The method usually deployed to address this issue is a standard wage and employment growth index that is linked to the macro parameters. This is applied uniformly to all civil service employment expenditures, and can take the form of an average of inflation and minimum/average wage growth. This is then treated as the baseline (though not an entitlement), with any deviation from that treated as a policy change. This process could be developed and agreed upon by the CoM over the coming eight-month budget process.

Transfers to other units

86. Transfers to other units make up 54 percent of the State Budget, the main transfers being for social security and local government. This is a complicating factor in preparing forward estimates, and means that consistency between estimates across units and sectors of government are important. These transfers will need to be separately identified and consolidated when bringing together the State Budget with the other sectors of the General Government to compare to the overall spending ceilings. Transfers usually take one of three forms:

- **Formula driven transfers**: often in the form of grants to local governments, where specified formula based transfers can be directly related to macroeconomic or revenue forecast parameters. Initially, the forward estimates can be based on the existing models used by the Macroeconomic Policy Department for forecasting certain sectors of general government.
- **Gap filling transfers:** in some areas, particularly social security, the government is responsible for ensuring that sufficient funds are available for the entity to fund legislated payments. In this case, reliable forecasts of the entities' finances (revenues, expenditures and deficits plus use of reserves) are required over the forward estimate period. The State Budget Department will be able to use the projections produced by ZUS, and scrutinized by Macroeconomic Policy Department, while the defense expenditure, which could initially be allowed for within the 2 percent of GDP ceiling, should be further refined in the future.

- **Fixed transfers:** some transfers are for fixed amounts, and often provided for specific purposes to other agencies. While the fixed nature makes them easy to forecast, there may be greater uncertainty here on whether they should be included as part of the no-policy-change baseline. Inevitably, these will need to be assessed on a case by case basis, informed by the nature of the payment and the basis on which the payments are made—are they discretionary, or fixed by law, or some multi-year agreement between levels of government/agencies? Initially, these payments should be identified, ranked by size and the largest ones assessed to determine if they should fall in the baseline, with the smaller and more numerous payments assumed to remain within. Over the next eight months of the year, the smaller payments can also be assessed.

Verifying and improving the forward estimates

87. This will be the first attempt at preparing forward estimates by the budget departments of the MoF, and suitable wariness over the accuracy should be maintained. The first few attempts will not be particularly accurate, and subsequent expenditure forecasting rounds may lead to significant changes as new information comes to light, the forward estimates models are refined and line agencies provide more useful inputs. As time progresses and forecasts become actuals (as will occur in March 2018) forecast errors should be assessed and analyzed, in order to learn from the errors and apply corrections to the models.

88. In the initial period, there are a number of cross checks that should be done to verify and test the accuracy of the forward estimates:

- From a top-down aggregate spending level, once the estimates are prepared and aggregated into an estimate of State Budget expenditure, they can be compared to the latest top-down State Budget expenditure forecasts from the Macroeconomic Policy Department and relevant budget departments by Expenditure Policy Department.
- The estimate of State Budget expenditure should be compared to the main macro parameters for plausibility: what does it imply for government expenditure as a share of GDP and in real terms; what is happening to the components—is there a large shift between capital expenditure and current spending; what is overall wage growth doing—is it consistent with the government's policy, where are the large spending increases and decreases? These are tests of plausibility, without any hard answers on whether they are correct.
- The estimates can be examined to identify any big shifts of expenditure, and determine whether they are intentional or a result of oversight. What is the share of expenditure that is anticipated to expire due to the fact there are no government decisions (so the flexible share of spending becomes greater in the outer years)? Is this realistic, or should some of that expiring spending be reconsidered to be ongoing policy?
- At each Part level, the forward estimates forecast can be compared to the multi-annual financial plans (effectively program bids) that agencies are due to provide in early February.

While these bids are historically very optimistic (often comprising wish lists for new spending from line agencies), they do provide a cross check, and from large differences between the two, the MoF can anticipate and prepare for potential challenges that might come from line agencies.

- It may also prove useful to prepare backward looking analysis of ministries' past multi-year program bids: what have been the average annual increase built into the bids? Have they always been unrealistic, and if so, did the agency survive without receiving their requested amounts? Additionally, an analysis and comparison appropriations and execution in previous years would be relevant.

89. While this is the first attempt at forward estimates by the budget departments, there is much longer experience of doing such expenditure forecasting within the MoF. The Macroeconomic Policy Department has been producing expenditure forecasts for almost a decade, and has built up expertise in preparing them. This expertise should be drawn on by the budget departments, and staff from the Macroeconomic Policy Department could work with the teams from the budget departments over the next 8 weeks in preparing the initial set, as well as undertaking the plausibility checks once they are complete.

Updating forward estimates

90. A key part of doing forward estimates is rolling them forward in the next forecasting round, and steps taken early on will make that process much easier. In the immediate process, the budget departments should seek to:

- Identify the key parameters, which will evolve as the macro forecasts change. Set the models up so that they can be updated easily, and the impact of those changes recorded as parameter changes.
- Recognize that the models will initially be overly simplistic, and will likely be refined over time. Set in place a clear process where improvements in the models are scrutinized, vetted and improved. While often considered minor, a change in estimate models can result in significant changes in resource allocation, so rigorous testing is essential. These technical improvements in forward estimate models should be approved by both the MoF and line agencies.

91. The process of updating forward estimates in future expenditure forecast rounds can be done in five steps:

- Rolling estimates over, so that T+1 become the budget year, with a new T+2 year added. The timing of this step is usually done at the beginning of the budget process, so that each Budget shows a new T+2 year. This will involve an adjustment to the previous budget year, as estimates become actuals, potentially changing the base of the forward estimates.

- Updating the budget year estimates for execution actuals. These should be based on actual outturns, once the budget year is complete, or on updated forecasts taking account of any changes that have occurred over the course of the year so far if the estimate update is occurring mid-year. In some cases, this may change the base upon which the out-year expenditure estimates are built upon, so it is important that once-off deviations between budget appropriation and budget year forecast are excluded.
- Updating the macroeconomic parameters received from the Macroeconomic Policy Department. These should be entered into the forward estimates models, and the variation in spending levels compared to the previous forecasting round recorded as the effect of parameter changes.
- Inclusion of new policy decisions that have been taken since the previous forecasting rounds. These should be consistent with the costings provided as part of the RIA, and only done if policy approval has been explicitly provided through either a decision of the CoM, or through agreement by the MoF and line agencies as part of the budget process. These new policies will henceforth be included within the baseline.
- Technical updates to the forward estimates models, with their impact on overall expenditure recorded. These technical updates can be undertaken between forecasting rounds, and should be agreed between line agencies and the MoF.

92. Each step of this process should be recorded, and provided in a reconciliation table explaining the variations in expenditure level between the two forecasts (Section IV, Table 6). This is an important element of scrutiny, accountability and assurance that all policy decisions are reflected in both the budget and medium-term expenditure forecasts. Many countries provide a table of policy changes that are included within the budget documentation.

B. New Policy Proposals

Concept of new policy proposals within the forward estimates framework

93. The preparation of medium-term expenditure costing for all measures and policy proposals is a key element of MTBFs. They require analysis over the longer-term impacts of policies, and their use acts as a discipline for decision makers from agreeing to policies without acknowledging costs that may grow significantly over time, leading to unsustainable fiscal policies. They also demonstrate the impact of policy changes against the baseline expenditure projections, in order to meet the fiscal rules. Once all new policy proposals are aggregated, the MoF will be able to calculate the available fiscal space, which will serve as a guide to line ministries in prioritizing their spending requests.

94. Costing should be prepared for all new policy proposals both occurring within and outside of the budget approval process. In addition to new policies, they should also be prepared for changes to existing policies; and alterations to eligibility criteria or assistance rates of existing transfer or social security programs.

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95. Policy costing should provide financial costing of new policies over the three-year period as well as a range of other information. They should identify different components of expenditure (for example wages and salaries and capital expenditure) as well as revenue impacts (for instance due to tax expenditures, or increased own revenues). If the cost of the policy is likely to be significantly different in the years beyond the medium-term, for instance if the measure is not likely to commence within the medium-term period, there should also be a statement about the financial impact of the measure over the longer term.

96. New policy proposals should carry additional information to the medium-term costing in order for the policy to be assessed. This information should include the objectives of the policy, addressing the problem it is being introduced to solve; the expected impact of the policy; distributional impacts on different groups/income levels; any necessary legal or institutional changes; and impacts on other layers of government. For investment projects, the result of cost benefit analyses should be provided. Currently, RIAs also provide useful information on new policy proposals.

97. The preparation of costing should be undertaken on a similar basis as the baseline expenditure forecasts outlined above (See Box 7 for an example). This serves to ensure consistency between costing, but also aids the inclusion of new measures into the baseline projection for the next forecasting round. In most cases, the methodology should be based on a basic price multiplied by quantity approach, with an allowance built in for both factors to vary over time according to well identified parameters. In cases where fixed cash costing is provided, it will still be necessary to ensure that the amount provided is sufficient for the designated purpose. Costing should consider behavioral impacts of the new costing—for instance a first home buyers allowance would have a direct impact of increasing the number of first home buyers entering the market. These behavioral impacts should be identified, and the assumptions specified clearly.

Box 7. A Medium-Term Costing Process: Airport Security

Consider for illustrative purposes the cost of new process for passenger screening at airports.[1/]

The first step is to determine the number of airports affected that do not have the requisite screening process in place. Then determine the price and installation cost of each screening equipment required for each step of the process (explosive detection system for baggage, explosive trace detectors and walkthrough metal detectors for passengers, X-ray machines for passenger carry-on baggage).

The second step is assessing the cost of operating the equipment. This includes the costs of employees with the technical expertise to operate the process (based on the number and type of employees, their salary rates and the length of time required), consultative forums between the administering agency and the airports (including travel costs, meeting expenses, etc.), as well as the cost of ongoing audit and compliance activities (the number of officers, salary rates, the number of visits and the length of time required to undertake these activities).

Finally, the time profile of the expenses would need to be defined. Such a program would have a well-defined upfront capital expenditure based on the first step, as well as depreciation/replacement costs over the medium-term. The ongoing operational costs which will change over time, due to parameter variations in input costs (e.g., salary rates). The volume of screening activities can be expected to increase over time as passenger numbers increase, requiring increased numbers of operational staff.

The total cost profile over the medium-term should take account of all of these costs, with each major cost center being separately identified, understood and verified by Ministry of Finance officials. The key parameters for each element of the costing should be identified and incorporated in the costing, so that changes in parameters can flow through to the policy costing once it is incorporated into the baseline estimate in the future.

1/ Adapted from an example in *Charter of Budget Honesty: Policy Costing Guidelines*, Issued by the Secretaries to the Treasury and Department of Finance and Regulation, Canberra, Australia 2012 http://www.treasury.gov.au/PublicationsAndMedia/Publications/2012/charter-of-budget-honesty

C. Spending Reviews

Role of spending reviews in the forward estimates process

98. **One of the key benefits of forward estimates: shifting the focus to new policy rather than negotiating every line of the annual budget each year, is also one of its weaknesses.** By treating spending within the baseline as automatically continuing, it can lead to an issue of incrementalism, and insufficient scrutiny of existing spending. This is a key concern raised by the State Budget Department in moving to a multi-year budget framework, though the issue is just as present in an incremental annual budget process.

99. **To counter this, countries use spending reviews to periodically assess the quality of existing spending.** These are done in range of ways: some try and do comprehensive spending reviews (UK and France), where all spending is assessed every four or five years; while others focus on one or two spending areas at a time, and roll through the whole of spending over a longer period (Australia, Canada, Korea). The former is highly resource intensive (involving teams of 20 to 30 people over a period of 9 months), while the latter spreads those resources over

longer periods. Both approaches have proven successful, but the one approach that does not work is trying to do comprehensive spending reviews annually – zero based budgeting – as this translates into a continuous overly-resource intensive cycle that wearies both reviewers and line agencies.

Existing elements

100. Poland has a framework of spending reviews already in place, though their success in identifying savings or reallocation options has been limited. The five reviews carried out so far focused on: (i) road programs supported by the National Road Fund; (ii) subsidies for seeds; (iii) supporting low income families; (iv) housing policy; and (v) the flexibility in budgetary expenditure. A methodology has been developed to support these reviews. So far the teams in charge of spending reviews have made limited progress in identifying savings. Hence their impact on current consolidation efforts, one of the objectives of modern spending reviews and an important objective for Poland presently, has been small.

Missing elements

101. An effective spending review process requires several elements that are not currently present in Poland. These include:

- A broad-based staffing of review team.
- Clearly defined saving targets.
- Clearly defined links between spending reviews and the budget process.

102. While spending reviews form an important component of medium-term budget processes, their effectiveness is often overstated and over-relied upon. As a rule of thumb, even successful reviews tend to deliver only around a third to a half of intended savings targets, as savings options are often disputed, overoptimistic and rolled back through the budget process. In the end, while they serve a valuable role, nothing will replace the ongoing rigorous scrutiny of ministerial spending by the Ministry of Finance, with constant questioning over the policy effectiveness of existing spending.

D. Recommendations

Forward estimates methodology

Immediate - First 8 weeks

5.1. Define a standard approach to producing forward estimates for budget teams to use over the next eight weeks, based on the methodology presented in Section VA, specifying:

- The conceptual model.

- The basis upon which estimates will be built (spending areas, parts, sub-parts where necessary, departmental and administered programs).

- A definition of no-policy change, and a process for defining this where it is not clear.

5.2 The Expenditure Policy Department and Macroeconomic Policy Department should work together to verify and assess the first initial bottom-up forward spending estimates.

Short-Term – Next 8 months

5.3 Set up a process for agreeing on forward estimate baseline models with line agencies.

5.4 Extend the use of RIAs to all new policy decisions considered through the budget process.

Longer-Term - Next 18 months and beyond

5.5 Continue to refine and improve forward estimates, while reconciling each estimate to the previous round by identifying changes due to parameter changes, policy decisions and technical adjustments.

Addressing critical technical issues

It is likely that technical issues will arise, they should be addressed by:

Immediate - First 8 weeks

5.6 **Investment projects**: Splitting State Budget investment expenditure between major and minor projects, seeking three-year spending profiles of major projects from implementing agencies and defining which investments shall be included within the no-policy-change baseline.

5.7 **Wages**: Maintaining the current approach of assuming flat nominal wage bill projections, with options and implications of alternative wage growth decisions provided to CoM.

5.8 **Transfers**: Categorizing, forecasting, and consolidating transfers to other entities in the general government based on existing models.

Short-Term – Next 8 months

5.9 **Investment projects:** Develop an investment project tracking system for large projects financed through the State budget, mirroring that used for EU funds.

6.0 **Wages:** Develop a proposal for treating the wage bill in the forward estimates to be approved by the CoM.

Spending Reviews

Immediate - First 8 weeks

6.1 Implementing current regulation and establishing a Spending Review Steering Committee that oversees working groups tasked with conducting spending reviews, with representatives from the MoF (budget departments, expenditure policy department), line ministries and agencies, Chancellery of the Prime Minister and external experts.

Short-Term – Next 8 months

6.2 Establishing clear top-down targets for the expenditure savings to be achieved through each spending review.

Longer-Term - Next 18 months and beyond

6.3 Linking the outputs of the spending review to the budget process, by identifying measures for new spending initiatives and savings for each line of the budget to meet targets.

Annex 1. Coordination Arrangements on Fiscal/Budget Issues in EU Member States

Many EU States have developed robust mechanisms for coordinating the preparation of macro-fiscal projections, updates of the Convergence Programme, preparation of the MTBF and annual budget, and reforms of the budget process. These arrangements include formal mechanisms (e.g., cross-cutting committees of relevant departments) and more informal arrangements for consultation and sharing of information. These arrangements involve a mixture of informal coordination and more formal arrangements. Three examples:

In **France**, the process of preparing the MTBF and annual budget is a joint product of the budget department, the public finance department, and other departments and units of the Trésor (Ministry of Finance). There is an iterative process of preparing the budget ceilings and macro-fiscal projections. The budget department proposes projections of baseline expenditures, and options for generating savings. Several rounds of iteration may be required internally within the Trésor (similar to a budget negotiation with line ministries) to concur on a budget strategy consistent with the macroeconomic projections. Information sharing is good although there are inevitable tensions between the departments that "decide the fiscal position".

In the **Netherlands**, three Directorates General of the MoF are involved in the budget—Treasury, Budget, and Tax Policy. The Central Planning Bureau comprises a fourth silo, focused on macro-fiscal forecasts and strategic policy issues. Coordination takes place through formal working groups, sharing of draft forecasts, and discussion of these forecasts. The Budget and Treasury DGs propose the macro frame for the budget, which is similar to that of the Planning Bureau. The preparation of the draft budget takes place through a Budget Working Group led by a senior advisor of the Budget or Treasury DGs, with drafts being circulated to all relevant directorates, key ministries and the Planning Bureau.

In the **United Kingdom**, macroeconomic forecasting has been outsourced to the Office for Budget Responsibility (OBR, the UK's fiscal council), but HM Treasury (Ministry of Finance) is responsible for the development and implementation of fiscal rules, fiscal policy analysis, and the forecasting of spending and revenue. The budget department of the Treasury coordinates the preparation of the budget in close coordination with other departments and units. During the period in which the budget is being prepared, a committee of senior Treasury staff, together with representatives of the revenue and customs agencies and the Bank of England, chaired by the minister (Chancellor of the Exchequer), meets on a weekly basis to discuss the fiscal projections, and maintains a running "scorecard" of the fiscal impact of potential revenue and expenditure measures to be included in the budget.

In **all three countries**, analysis of possible changes in the budget process, or the budget methodology, are the responsibility of the budget department.

Annex 2. Multi-year Commitments Mechanisms

COUNTRY	COVERAGE				SPECIFITY Binding *Indicative*	TIME HORIZON Years	DISCIPLINE	
	Soc Sec	Debt Interest	Local Gov't	% of CG spending			Rolling or Fixed	Frequency of Update
AGGREGATE EXPENDITURE CEILINGS								
Sweden	Yes	No	T'fers	96%	Total Spending *27 Policy Areas*	3-4	3 -4 fixed	3rd-4th year added each year
Finland	Some	No	No	78%	Total Spending *13 Ministries*	4	4 fixed	Every 4 years
Netherlands	Yes	No	T'fers	80%	4 Sectors *26 Ministries*	4	4 fixed	Every 4 years
FIXED MINISTERIAL PLANS								
United Kingdom	No	No	T'fers	59%	25 Depts	3	3 fixed	Every 3 years
France	No	Yes	No	39%	35 Missions	3	2 fixed + 1 rolling	Every 2 years
Austria	No	Yes	T'fers	75%	32 Sections	4	3 fixed + 1 rolling	Every year
ROLLING PROGRAM ESTIMATES								
Australia	Yes	Yes	T'fers	100%	20 Depts 267 Progs	4	Rolling	Every year

Source: Country authorities and documents

Annex 3. Carryover Practices in Countries with Established MTBFs

	Spending Categories			Carry-over			Carry-back
	Operations	Transfers	Capital	On-flow	Stock	Drawdown	
Australia	Yes	No	Yes	Cabinet approval	Full	Full	No
Austria (2010-)	Yes	Yes	Yes	Full	Full	Full	No
Finland	Some	Some	Some	Full	Expires after 2 yrs	Full	No
France	Yes	No	Yes	Full	Up to 3% of budget	Full	No
Sweden	Some	Yes	Yes	Full	Up to 3% of budget	Full	No
Netherlands	Yes	No	Yes	Full	Up to 1% of budget	Full	MoF approval
UK (1990-2009)	Yes	No	Yes	Full	Full	MoF approval	No
UK (2010-)	MoF Approval			None	None	MoF Approval	No

Annex 4. Basic Methodology for Preparing Forward Estimates

1. **Producing expenditure forecasts or forward estimates at the disaggregated level involves a number of steps.** These are focused on understanding the existing budget; understanding and applying the medium-term cost drivers; and aggregating the forward estimates and summarizing the overall sources of variations.

2. **Each of these steps need to be identified, analyzed and ideally have the methodology agreed between the MoF and the Line Ministry, as the forward estimates form the basis of future budget allocations.**[30] Taking the time to agree on the methodology and inputs at the beginning will simplify future budget negotiations, as the agreed baseline can be approved quickly, leaving more time to focus on the higher value activity of assessing and costing new policy initiatives and proposals, rather than negotiating over existing budget allocations.

3. **In the current situation, the State Budget, Economy Financing and Budget Zone Financing Departments will produce the estimates internally, though a process on agreement with Line Agencies should be put in place following the initial round.** In the absence of agreement with line agencies, the estimates risk not being treated as legitimate and can be unrealistic. Given the indicative nature of the process, this is acceptable initially, however as the process matures, and more weight is given to the estimates in determining budget and medium-term allocations, formal agreement between the MoF and line ministries' will be necessary in order to both improve the quality of the estimates, as well as establish their credibility.

4. **An important factor to remember while first producing forward estimates is that there is the trade-off between complexity and tractability in setting up expenditure forecast models.** The forward estimates are *models* of how expenditure will evolve over the medium term. Thus, they are an approximation of reality; and should not necessarily be thought of as extending the appropriations into the medium term. Thus, they do not need to be prepared at the same level as appropriations. To do so would make the models far too complex, and difficult to both develop and operate. Similarly, the drivers of cost pressures will represent approximations of what drives spending. Taking the time early on to get the right balance between complexity and workability will make the forward estimates far more robust.

[30] This agreement could be done bilaterally, or through the creation of formal estimates committees with membership from both line ministry, relevant budget holder (e.g., ZuS) and MoF, but ultimately headed by a senior MoF official.

Table 1. Major steps in Producing the Forward Estimates

1. Understand the Existing Budget
Identify Current Level of Service Delivery
Separate the Ministry into Major Spending Units, and spending areas within those units
Identify One-off Expenditures
2. Understand and apply medium-term cost drivers
Identify and Apply Price and Volume cost drivers
Link Price and Volume Parameters to macroeconomic and demographic variable
Grow base spending by price and volume parameters
3. Aggregate for the Ministry and Summarize
Aggregate for the spending units then Ministry
Aggregate ministry wide parameter variations

5. **The first step is to understand the current spending base, and allocating it against the key spending areas within each Ministry or Part.** This requires knowing where and what the ministry is spending its money on, and how that is linked to key program outputs. In many ways, the budget "parts" provide a sensible level on which spending can be forecast on, although in some cases where there are multiple policy areas within the one part, such as Internal Affairs, these may need to be further disaggregated.

6. **The second step is to identify the current level of service delivery, or the no-policy change baseline.** One of the important features of forward estimates is to separate the cost of providing existing levels of service, and the cost of introducing new policies. Thus, for education the current level of service delivery can be defined as the cost of maintaining enrolment rates, no matter what happens to the population of school age children. Thus, if the population of children were to increase, no policy change would see the number of students enrolled increase, but the enrolment rate to remain fixed. This is in contrast to an increase in student numbers due to an increase in the enrolment rate, which would be considered a policy change.

7. **The third step is identifying the major spending areas within the spending units.** These are often set up on an economic basis, such as salaries and wages; goods and services; transfers etc. However, at this point, it can be useful to break them up into key elements, so in the case of education, goods and services will be separated into textbooks, food and utilities. Usually there will be an "other" category. As a general rule, this should make up no more than 10 percent of total spending within the unit. Each of these spending areas within the spending unit will be modeled separately.

8. **The fourth step is to identify any one-off expenditures that need to be taken out to adjust the base.** For instance, in education, the triennial PISA Tests Xxx, upgrade in computers and printers may not be expected to occur next year, so the amount allocated for it should be excluded from the expenditure base. Similarly, there may be some one-offs that need to be accounted for specific years over the medium term. Classic examples include elections and census collections.

9. **The fifth step is to identify the *price* parameters that will affect spending.** A number of factors can affect the price of providing services. These factors, such as wages, inflation, specific input factor prices (such as fuel and utilities) need to be identified and analyzed for their relationship with expenditure growth, as changes will not always be one for one.

10. **These parameters need to be linked to the relevant macroeconomic parameter forecasts.** Often the price parameters will simply be linked to the overall inflation forecast. However, in some cases, there will be difference between the forecast of overall inflation and specific price parameters, such as fuel, which will be driven by world oil prices, and will have little relation to overall inflation. Again, the degree of detail here represents a trade-off between complexity and tractability. In general, the rule in setting price parameters should be to keep it as simple as possible, and only use unique parameters if large difference with overall inflation occur.

11. **The sixth step is to identify changes in the volume parameters that drive the cost of providing the services.** A number of factors will affect the amount of services being provided over the medium term. These factors can be due to demographic change (such as the population of school age people in the example above); policy changes, where previously increased capital expenditures require a higher level of maintenance once those projects come on line; and macroeconomic factors, such as a higher unemployment rate that requires a higher level of unemployment benefits. Like the price parameters, these should be defined and linked to macroeconomic and demographic forecasts prepared mainly by ZUS and the Statistical Office (GUS) and projections that can be prepared by the Macroeconomic Policy Department.

12. **The range of macroeconomic and fiscal forecasts provided by the Macroeconomic Policy Department may need to be increased in order to provide the required parameter inputs.** As parameters are identified, this will need to be communicated to the units who prepare the macroeconomic and fiscal forecasts within the central bank and Ministry of Finance, to check that they can be identified, and reach agreement on what basis the forecasts will be made on. For instance, the CPI forecasts may only be prepared for the overall CPI. However, the forward estimates may require parameters for fuel price CPI, so the macro-forecasters may need to develop a methodology for forecasting the lower level CPI series.

13. **The seventh step is to apply the overall price and volume parameters to the base expenditure to yield an expenditure forecast for the spending area.** This is done by multiplying the adjusted base (i.e., accounting for one-off expenditures) by both the overall price and volume parameters. Note that there will be some interaction in the process, as price variations are applied to volume variations.[31]

14. **The final step is to aggregate across spending units and spending areas to yield a forward estimate for the ministry, and then across ministries for the budget as a whole.** The expenditure forecasts for the individual spending areas within a spending unit should be summed, then the spending areas summed in order to give the overall forward estimates for the Ministry. The same is true for the price and volume parameter variations, which can be used to provide a full reconciliation of the changes in the forward estimates (Appendix Table 1).

15. **The estimates models can be prepared using simple excel files, rather than needing to invest in a new IT system, though models will need to be stored and filed carefully.** This will allow flexibility and fluidity, particularly early in the process, as the models are refined and take shape. An aggregation file will be required, with appropriate controls applied. As the process becomes more mature, a basic recording system can be introduced, automatically archiving and recording changes as they are made.

[31] For instance, for a spending base of 100, a 10 percent increase in both price and volume will lead to an expenditure forecast of 121, greater than if price and volumes were applied individually, which would lead to a forecast of 120. This difference is described as the interaction term, and needs to be accounted for when reconciling the change in expenditure between the base and BY+1.

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