

The coverage of aggregate expenditure ceilings

by
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Aggregate expenditure ceilings are today a feature of budgeting in many OECD countries. They are typically used either to enforce a trend-based expenditure policy, or to gradually reduce the size of government. With the increased popularity of expenditure rules, aggregate ceilings are also required to give effect to these rules. This article focuses on the key design issue of the coverage of aggregate expenditure ceilings – that is, should they cover the totality of government expenditure, or is it legitimate to exclude certain categories of expenditure? It is suggested that the distinction between “determinate” and “indeterminate” expenditure is crucial to properly answering this question. It is also argued that the appropriate coverage of aggregate expenditure ceilings is different during expenditure planning (budget preparation) and during budget execution.

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1. Introduction

Aggregate expenditure ceilings have become an increasingly widely used budgeting tool. During budget preparation, the early establishment of an expenditure ceiling limits the amount of new spending which is approved, thereby improving fiscal discipline. Clarity about the total amount which can be spent also encourages government to make better choices between alternative expenditure options, thereby improving allocative efficiency. The establishment of an aggregate expenditure ceiling at an early stage of the budget preparation process is the essence of the concept of *top-down budgeting*.

During budget execution, on the other hand, an expenditure ceiling aims to keep total spending in line with plans, in particular by preventing unconstrained increases in spending as a result of additional new spending decisions taken after the budget is approved (e.g. via supplementary budgets). The amount of such additional “out of budget cycle” new spending is strictly limited by the *contingency reserve* which is incorporated within the ceiling.¹

Top-down budgeting requires that budget preparation is guided by expenditure ceilings which are set for at least the coming budget year. A number of countries go even further and set firm *multi-year* ceilings which constrain both budget preparation and execution over a timeframe of three years or more.

The popularity of aggregate ceilings has been reinforced by the adoption by number of countries (and by the European Union) of expenditure rules, with ceilings being used to give practical effect to expenditure rules.

It is important when discussing expenditure ceilings to clearly distinguish between expenditure ceilings and expenditure rules. An aggregate expenditure ceiling is a quantitative upper limit on all, or a large part, of government expenditure *which is set for a specific year*. For example, a government is setting an aggregate expenditure ceiling if it makes a commitment in year n that government expenditure (possibly excluding certain items) will not exceed 380 billion in year $n+1$. Expenditure rules, on the other hand, are limits on government expenditure which are formulated in a general form intended to have *continuing* application. A commitment that total government expenditure will not exceed 35% of GDP is, for example, an expenditure rule (Robinson, 2012).

Notwithstanding the increasingly widespread use of aggregate ceilings, there are significant differences between countries with respect to the comprehensiveness of these ceilings. At one end of the spectrum lies Sweden, where almost all categories of government expenditure are covered. At the other end of the spectrum are countries which exclude all or most social security benefit expenditure (such as the UK) and even much health expenditure as well (e.g. France²). Lying in between are countries where, although a large part of social security expenditure is included with the ceilings, unemployment benefits expenditure is (partly or wholly) excluded. There are also countries which include part but all of unemployment benefits and other social security expenditure, such as Finland.³ While most countries exclude interest expenditure, but some have not. Nowhere, in fact, are ceilings completely comprehensive.

What is the correct approach? Should ceilings be completely comprehensive, or are there practical reasons which argue for the exclusion of specific major categories of expenditure? If exclusions are appropriate, what does this mean for the effectiveness of ceilings as a tool for controlling expenditure? These are the questions upon which this article focuses.

2. The objectives of aggregate expenditure ceilings and their coverage

Experience indicates that governments usually have one of two objectives in mind when they set ceilings and rules. These have direct relevance to the comprehensiveness of ceilings.

The first objective is to prevent expenditure fluctuating in line with purely temporary fluctuations in revenue by linking the level of aggregate expenditure to *trend* revenue, thus breaking the link with actual annual revenue. Following the Dutch, this can be labelled the *trend-based expenditure policy* rationale for ceilings. Expenditure ceilings based on trend revenue promote fiscal sustainability by preventing governments from deceptively “paying for” new spending initiatives with temporary revenues, thereby setting the scene for future deficits while maintaining the appearance of fiscal responsibility in the short term. One specific consequence of this is that trend-based expenditure policy prevents unsustainable pro-cyclical surges of expenditure when revenue exceeds trend levels during the upswing of the business cycle – although this is a less relevant consideration under present macroeconomic conditions than in the past.

Some governments have, however, had an alternative objective in mind when setting expenditure ceilings – that of permanently reducing government expenditure.⁴ This was, for example, the main objective of the Swedish system of medium-term ceilings, the success of which is shown by the reduction in Swedish government expenditure as a proportion of GDP from 33% in 1997 (when the system was introduced) to 27% in 2013 (Finanspolitiska Rådet, 2013: 78-79; 2014: 157). The use of ceilings to permanently reduce government expenditure is motivated by a desire to substantially reduce taxes and/or reduce debt. In Sweden’s case, both these objectives were important: from 1997 to 2013, Sweden reduced revenue/GDP by approximately 10% while cutting debt/GDP by more than half. The use of expenditure ceilings as a means of permanently reducing government expenditure may be referred to as the *smaller government* rationale for expenditure ceilings.

In Sweden’s case, there was no expenditure rule to guide the setting of the expenditure ceilings. The same was true of other countries which pioneered expenditure ceilings in top-down budgeting processes (e.g. Canada) and/or multi-annual budgeting (e.g. Netherlands and Finland). The widespread use of expenditure rules arrived much later than that of ceilings. When, as it is increasingly the case these days, there is an explicit expenditure rule to which the ceilings must give effect, the choice between the objectives of trend-based expenditure policy and that of smaller government will typically be reflected in the way in which the expenditure rule is formulated.

The Swiss “debt brake” expenditure rule, which has operated since 2003, is an excellent example of an expenditure rule which is intended to enforce a trend-based expenditure policy. The rule limits expenditure to the amount of cyclically-adjusted expenditure, with the objective of structurally balancing the budget. It is therefore explicitly “aimed at keeping total federal government expenditures relatively independent of cyclical variations”. Implementation of the debt brake rule led directly to the introduction of a top-down budget preparation process in which an aggregate expenditure

ceiling consistent with the rule is defined at the start of each annual budget preparation process (Geier, 2011: 12, 21).

The EU “six-pack” expenditure rule is another example of a rule which aims to institute trend-based expenditure policy. This rule requires that government expenditure (with certain exclusions⁵) must not grow faster than trend GDP (which is a proxy for trend revenue⁶) *unless there is an offsetting permanent change in tax levels*. By allowing increases in expenditure/GDP as long as they are financed by permanent changes in tax levels, this rule is quite deliberately neutral with respect to the size of total government expenditure.

By contrast, if there is an expenditure rule which set expenditure limits which are independent of trend revenue, the objective is generally smaller government. This is the case, for example, for the French *zéro volume* expenditure rule (“norme”), in place now for over a decade, which requires that budget expenditure (with certain exclusions) must not increase in real terms, irrespective of revenues. The fact that coverage and other design deficiencies in the French system of expenditure rules⁷ have limited their effectiveness in downsizing the French state does not change the fact that their underlying rationale is smaller government.

Whether the objective of government when setting expenditure ceilings (or rules) is smaller government, or whether it is to establish trend-based expenditure policy, one would think that the coverage of ceilings should be comprehensive – in other words, that all categories of expenditure should be included, with none of the exclusions of whole categories of expenditure which one sees in practice in many countries. If the aim is to cut spending in order to be able reduce taxes and/or debt, then it is the totality of government expenditure – and not merely some part of expenditure – which needs to be cut. If, alternatively, ceilings are designed to enforce a trend-based expenditure policy, the ceilings should presumably be consistent with the prevailing targets for the fiscal balance. Because fiscal balance targets should in principle be comprehensive in their coverage, expenditure ceilings should be similarly comprehensive.⁸

In neither case is distinctions between budget and off-budget expenditure of any relevance: logic suggests that both should be covered. In any event, what is deemed to be “budget” expenditure and what is considered “off-budget” varies enormously between one country and another, making this an essentially useless criterion for the coverage of aggregate ceilings.

3. The challenge of explaining partial coverage

If the objectives behind setting expenditure ceilings suggest that comprehensive coverage is appropriate, why in practice does the coverage of ceilings fall well short of comprehensiveness in most countries?

One obvious possible explanation is the desire of governments to circumvent the disciplinary effect of expenditure ceilings, so as to be able to simultaneously reap political advantage from the appearance of maintaining discipline while in practice avoiding it. It seems reasonable, for example, to suggest that precisely this has been the motivation of successive French governments in excluding from the coverage of ceilings certain substantial expenditures which they deem to be temporary in nature. These and certain other exclusions from the ceilings have been condemned as inappropriate by the *Cour des comptes* (the supreme audit institution), which has pointed out that they make it possible even for narrowly-defined budget expenditure to continue growing notwithstanding the

supposed respect by the government for its announced ceilings (Cour des comptes, 2013: 104). This is merely one example of the risk, identified by the Finnish MOF (2011: 47), that when expenditure ceilings only cover part of government expenditure, “merely staying within the spending limits [i.e. ceilings] will lead to the mistaken belief that growth of public spending as a whole is on a sustainable level”.

Might there nevertheless be persuasive reasons for excluding specific major categories of expenditure from expenditure ceilings? This is a point on which the technical literature – including that emanating from ministries of finance with expenditure ceiling systems – is unsatisfactory. The only criterion which is clearly and explicitly recognised in this literature as relevant in determining the coverage of ceilings is the cyclical sensitivity of some expenditure. Everyone with a background in basic macro-economics is familiar with the concept of automatic stabilisers, the clearest example of which on the expenditure side is the tendency of unemployment benefit expenditure to automatically increase during recessions and to automatically decline during booms. It is therefore unsurprising that the question of how to handle cyclical sensitivity in the design of expenditure ceilings has received considerable attention. This has led to near-consensus that unemployment benefits (and perhaps also certain closely-related benefits expenditure) should either be excluded from the coverage of expenditure ceilings or should be “smoothed out” by excluding its cyclical component (see Box 1). Sweden is an outlier in this respect.

Box 1. Unemployment benefits and expenditure ceilings

In order to prevent expenditure ceilings from blocking the operation of expenditure-side automatic stabilisers some countries – such as the Netherlands in 2009 [Ministerie van Financiën, 2010: 60] – have chosen to entirely exclude unemployment benefits expenditure from their ceilings. An alternative approach is to leave unemployment benefits within the ceilings, but exclude cyclical fluctuations in benefits expenditure. This can be, at least in principle, achieved by using (for the purposes of the expenditure ceilings) a cyclically adjusted measure of unemployment benefits expenditure. This ensures that the costs of discretionary changes to unemployment benefits (i.e. explicit decisions to change benefit levels or entitlement criteria) are covered by the ceilings. Another approach which aims to achieve the same effect is to exclude unemployment benefits while requiring that the cost of any discretionary changes to benefits is included within the ceiling. This is the approach which for Finland takes (and which has also been used in the EU expenditure rule).

This focus on cyclical sensitivity is, however, unduly narrow. A central contention of this paper is that the main problem facing the design of expenditure ceilings is a more general one of how to handle uncertainty pertaining to *automatic changes* in expenditure which may arise from a wide range of factors. These “automatic changes” are increases or reductions in spending which occur without any decision on the part of government, usually as the result of the provisions of standing laws or contracts. The state of the business cycle is only one of the factors which produce such automatic changes, and it is therefore inappropriate to focus exclusively on the problem of the cyclical sensitivity of expenditure.

4. Indeterminate versus determinate expenditure

In this paper, we will use the term *indeterminate expenditure* to refer to categories of expenditure in relation to which there is significant uncertainty due to automatic changes

(as defined above). By contrast, *determinate expenditure* refers to categories of expenditure which are either not subject to automatic changes or where there is little uncertainty about the magnitude of any automatic changes. The distinction between indeterminate and determinate expenditure is related to, but is not the same as, the familiar distinction between discretionary and non-discretionary expenditure.⁹ It should also not be confused with the distinction between budget and off-budget expenditure.¹⁰

Unemployment benefits constitute one important category of indeterminate expenditure, but by no means the only one. Interest expenditure is another particularly important one. Not only is the level of interest expenditure not subject to discretionary government decision, but it tends to be subject to significant uncertainty even twelve months ahead. For example, in the United States over the four financial years from 2010 to 2013, the difference between the budget estimate of interest expenditure for the year ahead and the actual interest expenditure ranged from 0.5 to 0.7% of total federal government outlays, with an average (absolute value) of 0.6% (OMB, various years). Such differences between estimates and actuals arise from a number of sources, including errors in forecasts of interest rates for newly issued debt instruments, and errors in inflation forecasts which affect the nominal interest rate paid on indexed debt. The sheer magnitude of government debt in most countries means that small differences between projected and actual interest rates have an impact on expenditure which is far from trivial.

The uncertainty of interest expenditure is not primarily cyclical in nature. While it is true that interest rates are cyclically sensitive and tend to decline during recessions, interest expenditure is equal to the average interest rate *multiplied* by the stock of debt, and the stock of government debt tends to increase during recessions. Moreover, many non-cyclical factors also impact on interest rates. It would, for example, be misleading to characterise as exclusively or mainly cyclical the exceptionally low interest rates which have prevailed since the global financial crisis. These low rates are a more enduring phenomenon related, according to one's analytic taste, to "secular stagnation", excessive reliance upon monetary stimulus, or to the unavoidably slow process of deleveraging after a "balance sheet recession".

The ministries of finance of countries which exclude interest expenditure from their aggregate expenditure ceilings have had considerable difficulty presenting a clear rationale for this exclusion. Many have muddled the issue with that of the cyclical sensitivity of expenditure. Thus, for example, when the Netherlands, which had originally included interest within its aggregate expenditure ceilings, decided to exclude it, the decision was justified by reference to the need to "diminish pro-cyclicality" (Ministerie van Financiën, 2008: 4). In Finland, a review of the expenditure ceiling system undertaken by the MOF in 2007 wrestled unsatisfactorily with the question of whether the exclusion of interest from the ceilings was justifiable. Starting from the assumption that the only clear possible justification for exclusion of major categories of expenditure was cyclical sensitivity, the review considered carefully whether this justification applied properly to interest expenditure. It concluded that it did not, and recognised that "continuing to exclude interest payments from the spending limits is not necessarily justified in cyclical policy terms". Notwithstanding this, the review went on to recommend, in a distinctly ambivalent and unpersuasive manner, that the exclusion should be maintained (Finnish MOF, 2007: 78-79; 2011: 86-87).

Interest expenditure is, however, not the only important category of indeterminate expenditure which is subject to automatic changes which are not due to the state of the business cycle, and which cannot therefore appropriately be labelled as automatic stabilisers. In many advanced countries, expenditure on numerous major categories of

social security benefits other than unemployment benefits – such as housing benefits, incapacity and disability benefits, and family allowances – are also subject to significant uncertainty which is not primarily cyclically-related. As highlighted in a careful recent analysis of its own forecasting errors by Britain's independent Office for Budgetary Responsibility (OBR, 2014a: 59-71), major non-cyclical sources of forecasting errors for these types of benefits include the inflation rate, demographics and housing market developments (e.g. movements in private sector rent levels). Illustratively, the forecasting error in the OBR's March 2013 forecast of 2013-14 welfare expenditure *excluding unemployment benefits*¹¹ was approximately 0.08% of total 2013-14 central government expenditure (OBR, 2014b: 84, 89). This might not sound much, but if the contingency reserves is, say, around 0.25% of government expenditure (see below), it is far from trivial.

In one way or another, any system of expenditure ceilings must be capable of dealing with uncertainty pertaining to all of these categories of indeterminate expenditure, and not merely to the expenditure-side automatic stabilisers. As discussed below, the problems created by uncertainty arise first and foremost during budget execution, as opposed to during the preparation of the budget.

5. Aggregate ceilings and budget predictability

When discussing the problems which may affect expenditure ceilings during budget execution as a result of indeterminate expenditure, a crucial consideration is that of budgetary stability and predictability for spending ministries. Advocates of expenditure ceilings (particularly multi-year ceilings) often emphasise the benefits of ceilings in increasing budgetary stability and predictability, thereby enabling ministries to plan expenditure better and as a consequence improve efficiency and effectiveness. However, this over-simplifies the matter. In fact, the impact of ceilings on budgetary stability and predictability depends very much on the coverage of the ceilings.

Budgetary stability and predictability mean quite different things in respect to indeterminate and determinate expenditure. In the case of determinate expenditure, it is stability and predictability in respect to the *amount* (dollar value) of the budget allocation which is important. Managers need to know, firstly, that their ministry will actually receive during budget execution the full allocation which is appropriated for it in the budget law, and that they will not suffer unpredictable *sequestration* (the withholding of some portion of their approved budgets) during the year. Secondly, they need to be assured that there will not be sharp unanticipated fluctuations from one year to the next in their ministry's budget allocation.

By contrast, in respect to indeterminate expenditure, stability and predictability requires that the government provide sufficient funding to meet all of the expenditure obligations which arise from relevant standing laws and contracts, even when this implies significant variations in the total amount of expenditure. In the case of social security benefits, for example, stability and predictability mean that benefits are paid out as required by existing legislation irrespective of exogenous changes in the number of persons entitled to benefits. In the case of interest expenditure, it means that government meets all of its interest obligations even when the required interest expenditure is subject to significant unanticipated variation. In short, for indeterminate expenditure, stability and predictability require a willingness on the part of government to vary the budget allocation to accommodate automatic changes.

6. Indeterminate expenditure and expenditure ceilings during budget execution

The distinction between determinate and indeterminate expenditure is a great importance for the way in which expenditure ceilings operate during budget execution. Enforcing expenditure ceilings requires control over expenditure. However, during budget execution, governments have much less control over indeterminate expenditure than they have over determinate expenditure. Interest expenditure is essentially uncontrollable. Social security expenditure, while controllable in the medium and longer terms, is under most social security regimes essentially impossible to cut in the short term. Implementing cuts to benefits in most cases requires legislative change plus significant implementation time, while the alternative path of tightening up administration usually also involves substantial time lags.

To reflect this, the analysis which follows makes the assumption (which admittedly over-simplifies the matter) that the amount of indeterminate expenditure can only be controlled (if at all) by government by decisions taken during budget preparation, and that this expenditure is subsequently uncontrollable during budget execution (i.e. for the twelve-month period of the execution of each annual budget).

By contrast to the short-term controllability of indeterminate expenditure, governments have some degree of control during budget execution over the total amount of determinate expenditure, making it possible (if not necessarily desirable) to use sequestration to cut such expenditure even during budget execution.

The uncertainty of indeterminate expenditure, and its relative immunity to short-term control, have major implications for the coverage of expenditure ceilings during budget execution.

To clarify this, consider firstly the possibility that, rather than setting a single comprehensive expenditure ceiling, the government sets two separate ceilings, one covering determinate expenditure and the other covering indeterminate expenditure.¹²

During budget execution, the ceiling applying to indeterminate expenditure would directly confront the problem of unanticipated automatic changes in interest, social security and other indeterminate expenditure. The lack of any ability to make within-year cuts to these expenditures would make this this “ceiling” a pseudo-ceiling without constraining effect upon these automatic changes. The only tool available to maintain the *appearance* of respect for the ceiling in the face of unanticipated automatic changes in expenditure would be to incorporate within the contingency reserve what might be called (following British terminology) a *forecasting margin*, the primary function of which would be explicitly to absorb unanticipated changes in indeterminate expenditure. This forecasting margin, and therefore the contingency reserve itself, would in general need to be relatively large.

Contrast this with a hypothetical ceiling covering only determinate expenditure. In this case, the ceiling would not need to cope with the problem of automatic changes in indeterminate expenditure. The contingency reserve applying to this ceiling would therefore only need to play the standard role of limiting the amount of discretionary new spending approved by government outside the normal budget preparation cycle. It would therefore essentially constitute what might be called an *unplanned discretionary spending reserve*. The reserve could and should therefore be kept small, in order to tightly constrain unplanned discretionary spending and thereby make the ceiling as effective as possible in controlling expenditure. The availability of the sequestration tool as a last resort mechanism for ensuring that the ceiling is respected would also help in this respect.

A ceiling applying exclusively to determinate expenditure would therefore have a very real constraining effect and would fully deserve the label “ceiling”.

Consider now the alternative of setting a single comprehensive ceiling covering both determinate and indeterminate expenditure. How large would the contingency reserve need to be? Presumably large enough to provide both a forecasting margin for indeterminate expenditure and an unplanned discretionary spending reserve. It might be thought that the contingency reserve applying to the comprehensive ceiling should therefore equal the sum of the contingency reserves which would apply to two hypothetical separate ceilings – in other words, the sum of the relatively large forecasting margin which would apply to the indeterminate expenditure ceiling, and the much smaller unplanned discretionary spending reserve which would apply to the determinate expenditure ceiling. However, this would result in a relatively large contingency reserve, with significant negative consequences. Specifically, the inclusion within the contingency reserve applying to a comprehensive ceiling of the relatively large forecasting margin would make it possible, particularly in the later part of the budget year, to divert any unused amounts of the forecasting margin to finance additional unplanned discretionary spending.¹³ The single comprehensive ceiling would under these circumstances be much less effective in limiting additional discretionary “out of budget cycle” expenditure than the two separate ceilings – simply because the larger the contingency reserve, the less effective the ceiling is as a means of limiting government expenditure.

In the context of a single comprehensive ceiling, the alternative would be to set a contingency reserve which is significantly less than the sum of the reserves which would apply to separate ceilings. Because the unplanned discretionary spending reserve component is already small, this would require substantially reducing the forecasting margin component. The risk that the contingency reserve might prove inadequate to cope with unanticipated automatic changes in indeterminate expenditure would increase significantly. This would in turn increase the risk that the government would be forced to have recourse to the single alternative means of coping with unanticipated automatic increases in indeterminate expenditure – sequestrations (within-year cuts) of determinate expenditure.

The use of sequestration to ensure respect for the comprehensive ceiling while keeping the contingency reserve relatively small has, however, major disadvantages. If unanticipated automatic changes in indeterminate expenditure are potentially large, so also must be the size of the sequestrations required to compensate for them. Routine recourse to sequestrations as a means of enforcing a comprehensive expenditure ceiling would run directly counter to the objective of providing budgetary stability and predictability to spending ministries. It would gravely undermine spending ministry confidence that will receive their annual budget allocations, thereby adversely affecting efficiency and effectiveness. This would run the risk of reintroducing into budgeting in advanced countries the type of within-year budgetary uncertainty and instability which does so much damage in many developing countries.

Under a comprehensive ceiling, there is thus a direct trade-off. The more the contingency reserve is tightened to ensure the disciplinary force of the ceilings, the greater the risk that disruptive sequestrations of determinate expenditure will be required from time to time. Conversely, increasing the size of the contingency reserve in order to avoid the risk of being forced to undertake sequestrations weakens the disciplinary force of the ceilings.

The only imaginable way of avoiding this problem while retaining indeterminate expenditure within the expenditure ceiling would be to somehow adjust the measure of indeterminate expenditure so as to exclude unanticipated automatic changes. In some countries, this is possible in the case of unemployment benefit (see Box 1). The problem is that this is much more difficult with respect to other major categories of indeterminate expenditure. No robust methodology exists for adjusting measures of non-cyclical social security benefits expenditure so as to exclude the impact of automatic changes. With respect to interest expenditure, it is not even clear at a conceptual level what such adjustment would mean.

7. The Swedish experience

The problems which can arise from the inclusion of major categories of indeterminate expenditure within relatively comprehensive expenditure ceilings may be illustrated by the Swedish experience.

As noted above, Sweden has for almost two decades operated a system of multiannual comprehensive expenditure ceilings with very wide coverage. Apart from interest expenditure, essentially all other indeterminate expenditure – including social security benefits and even unemployment benefits – is covered. The exceptionally wide coverage of the Swedish ceilings means that the measure of aggregate expenditure covered by the ceilings is much more affected by unanticipated automatic changes in indeterminate expenditure than in other countries with expenditure ceilings systems. This has meant that the contingency reserve has throughout needed to be substantially larger than in those other countries. The intention when the Swedish system was originally designed was that the “budget year” contingency reserve should be approximately 1% of outlays.¹⁴ This compares, for example, with the target contingency reserve of 0.25% in Finland and 0.5% in the Netherlands (Mears et al., 2010: 18).

The Swedish system has, as a consequence, experienced major problems from both the undershooting and overshooting of indeterminate expenditure.

On the one hand, when indeterminate expenditures have been lower than forecast, the contingency reserve has been used to finance increased discretionary spending. As Flodén (2012: 16), puts it the contingency reserve was “often ... used for unplanned expenditure when budget outcomes were favourable”. This happened, for example, in the late 1990s (Heeringa and Lindh, 2002: 504-5).

Conversely, when indeterminate expenditure has been higher than anticipated, the ceilings and/or contingency reserves have come under considerable pressure. The most serious source of such pressure has, unsurprisingly, has been unexpected cyclically-related surges in unemployment benefits expenditure, firstly in the early 2000s and subsequently during the global financial crisis (GFC). However, before discussing the difficulties that the system experienced in the wake of the GFC, it is important to emphasise that the cyclically-sensitive expenditure has by no means been the only source of pressure. Forecasting errors in respect to other social security benefits have also been a problem. In particular, it has repeatedly proven difficult to accurately forecast expenditure on sickness leave benefits, early retirement benefits and disability benefits, and the forecasting errors have had little obvious relationship to the state of the economy. The first time this occurred was between 1997 and 2003 when, after trending down over many years to exceptionally low levels, spending in these areas surged significantly for a time (Hansson-Brusewitz and Lindh, 2006: 674),

absorbing a large portion of the contingency margin and putting considerable pressure on the ceilings. A similar problem arose from 2010, when once again major errors arose in forecasts of expenditure in these areas added to the GFC-related pressures on the system (Swedish MOF, 2010: 6; Finanspolitiska Rådet, 2013: 79-85; 2014: 13).¹⁵

However, it was in the wake of the GFC that the system experienced extreme stress. Even the relatively large contingency reserve proved hopelessly inadequate to cope with the unanticipated automatic changes in unemployment benefits expenditure. Critics – including the official Swedish Fiscal Policy Council (Finanspolitiska Rådet, 2010: 45) – were not slow to blame tight ceilings and insufficiently large contingency reserves for keeping fiscal policy too restrictive.¹⁶ In response to this criticism, the Government increased substantially both the contingency reserve and the ceilings themselves, citing the need to cope with increased expenditure uncertainty and to avoid being forced to inappropriately cut expenditure in the event of further deterioration in macroeconomic and financial system conditions (Finanspolitiska Rådet, 2011: 99; Swedish MOF, 2010: 6; Swedish MOF, 2011: 18; IMF, 2011: 12). For budget year 2011,¹⁷ the contingency reserve was set at an unprecedented 5.7% of expenditure (Swedish MOF, 2010), followed by 5.2% for budget year 2012 (Swedish MOF, 2011).

However, dramatically increasing the contingency reserve levels greatly weakened their disciplinary force. This unleashed an avalanche of criticism, including from the Swedish National Audit Office and even from the Fiscal Policy Council (notwithstanding its earlier stance). The Council now opined that contingency reserves had become “very large and are hardly a constraint on spending”, and worried that this would open the door to a substantial increase in unplanned new expenditure (Finanspolitiska Rådet, 2012: 31; 2011: 102). Given past experience (see above), this fear was a reasonable one.

In 2013 and 2014, as expenditure uncertainty declined, the budget year contingency reserve was reduced (to respectively 2.7% and 1.5% of expenditure) and the ceilings themselves were tightened (Swedish MOF, 2012, 2013). Despite – or rather because of – these reductions, the Government once again found itself criticised, with the Fiscal Policy Council now suggesting that the reserves were now once again too small (Finanspolitiska Rådet, 2014: 153-158). However, even at these reduced levels, the budget year contingency reserve remained well above the 1% indicative level set when the system was established.

The MOF (Swedish MOF 2011: 18-19) has explicitly recognised in that the inclusion of unemployment benefits is a major source of the difficulties which Sweden’s expenditure ceiling system has faced.¹⁸ However, as noted above, the pressures experienced by the Swedish system are not exclusively the result of its flawed treatment of the automatic stabilisers. Even if unemployment benefits had been excluded from the Swedish ceilings, the inclusion of other social security benefits expenditure alone would still have made it necessary to set contingency reserves much higher than in other countries, creating the risk of diversion of the unused forecasting margin component of the contingency reserve to the financing of additional new discretionary expenditure.¹⁹

It seems strange that the Fiscal Policy Council and other Swedish commentators have not recognised that a key source of the recent difficulties faced by the system is precisely the “original sin” of adopting a largely comprehensive expenditure ceiling without regard to the difference between determinate and indeterminate expenditure. Instead, these commentators have focused on second-best partial solutions such as dividing the contingency reserve into two parts.²⁰

The exclusion of interest expenditure from Sweden's expenditure ceilings is also at odds with the general emphasis on comprehensiveness. The principal architect of the Swedish system, Per Molander, has indicated that the reason for this exclusion was the "volatility" of interest expenditure and the fact that it was the "largest single item on the budget" (Molander and Holmquist, 2013: 27). These are persuasive considerations. During the randomly selected four financial years 2010-13, errors in budget forecasts of next year's interest expenditure were between 0.0 and 1.1% of total outlays, with an (absolute value) average of 0.6% (Ekonomistyrningsverket, various years). If interest expenditure had been included within the ceilings, it would therefore have been necessary either to approximately double the intended contingency margin – thereby significantly loosening the disciplinary effect of the ceilings – or to have been willing to engage in substantial sequestering of determinate expenditure from time to time in order to absorb part of the forecasting error for interest expenditure.

The problem is that the volatility rationale for excluding interest expenditure is also a rationale for excluding other major categories of indeterminate expenditure which have been left within the coverage of Sweden's expenditure ceilings.

The real reason that interest expenditure was excluded while these other categories of indeterminate expenditure were left within the expenditure ceilings was a different one – that unlike social security benefits expenditure, interest expenditure is (again in the words of Molander and Holmquist) "not politically decided". Quite understandably, the Swedes did not wish to leave unemployment benefits or other social security benefits outside of the expenditure ceilings because, as they saw it, there would then be no constraint on discretionary policy decisions by government to raise benefits or broaden eligibility.

8. Comprehensive vs partial ceilings – the UK experience

The Swedish system of comprehensive expenditure ceilings may usefully be contrasted with the UK system of partial expenditure ceilings which was introduced at about the same time (in 1998) and which still operates today. This is a system in which the aggregate expenditure ceiling – the Departmental Expenditure Limits (DELs) – quite deliberately excludes essentially all indeterminate expenditure. Indeterminate expenditure is categorised as Annually Managed Expenditure (AME), and lies outside the DELs. AME includes interest expenditure, social security benefits and number of other categories of indeterminate expenditure.

Even after the recent introduction of the so-called "welfare cap" as a mechanism for controlling the evolution of social security expenditure (discussed below), it remains the case that social security expenditure is not part of the DEL expenditure ceilings.

The decision in 1998 to exclude all indeterminate expenditure from the aggregate expenditure ceiling was the culmination of two decades of previous experience with the problems created by more comprehensive aggregate expenditure ceilings or targets. In 1979, the UK had introduced "Planning Totals" – not quite an aggregate expenditure ceiling, but more than merely a target – which were as broad in their coverage of aggregate expenditure as the Swedish ceilings are today. (That is, the Planning Totals included all social security expenditure and excluded essentially only interest expenditure.) The impact of unanticipated autonomous changes in indeterminate expenditure was one of the key reasons why these Planning Totals were often breached during the execution of the budget (Thain and Wright, 1995: 293, 489-91). In 1992, the Planning Totals were replaced

with the “New Control Total”, which was a firm top-down ceiling, and which excluded cyclical social security expenditure (particularly unemployment benefits) (Heald, 1995; Heald and McLeod, 2002; Thain and Wright, 1995; IFS, 2009: 8-9).

The subsequent move from the New Control Total to the DELs/AME model went significantly further and also excluded non-cyclical social security expenditure. One of the key reasons for the exclusion of all social security benefits and other indeterminate expenditure from the new aggregate ceiling was that the newly-elected Labour government wanted to be able to give spending ministries (“departments” in UK parlance) certainty about their budgets over the medium-term, to enable them to “prioritise resources and plan ahead” (HM Treasury, 1998). This is the budgetary stability and predictability objective of ceiling-setting discussed earlier in this paper.

Under the new DELs/AME system, stability and predictability were to be achieved by setting the aggregate DELs ceilings over a three-year time horizon, and then within the aggregate DELs designating guaranteed ceilings for each spending ministry for each of the three years. This essentially made the aggregate DELs a minimum as well as maximum for expenditure covered by the ceiling. In this context it was essential to ensure that the government would not find itself forced during the course of each three-year medium-term budget to make cuts to the ceilings which had been guaranteed for individual ministries in order to compensate for unanticipated automatic changes in indeterminate expenditure. As the White Paper establishing the new system put it, AME (indeterminate) expenditure was excluded from the DELs precisely because it “cannot reasonably be subject to firm multi-year limits” (HM Treasury, 1998).

Box 2. **Expenditure ceilings in the USA**

The UK is not the only country which limits expenditure ceilings in the manner described above. A system of expenditure ceilings was introduced in the United States by the Budget Control Act (BCA) of 2011. These ceilings only apply (approximately speaking) to determinate expenditure. More precisely, BCA introduced “limits (‘caps’) on the amount of discretionary budget authority that can be provided through the annual appropriations process.” “Mandatory” expenditure – which includes most indeterminate expenditure as defined in this paper is not subject to the limits. Instead, it is controlled by an entirely separate statutory “pay-as-you-go” mechanism which requires “that any bills increasing mandatory expenditures must be fully offset by revenue increases or cuts in mandatory programs” (OMB, 2013: 128-129).

9. The downside of ceilings with partial coverage

The exclusion of indeterminate expenditure from the aggregate expenditure ceiling avoids the problems which arise from unanticipated automatic changes in social security, interest and other indeterminate expenditure. However, such exclusion is undeniably problematic. A regime of aggregate expenditure ceilings with only partial coverage of government expenditure would appear inconsistent with the basic objectives which aggregate expenditure ceilings to achieve – whether these are implementation of a trend-based expenditure policy, or smaller government.

In the first place, if these are the objectives behind the ceilings regime, then even if unanticipated automatic changes in indeterminate expenditure may create problems

during the implementation of aggregate expenditure ceilings, it remains crucial to *plan* aggregate expenditure with an eye to limiting the comprehensive total of all government expenditure. Only in this way can the objectives of smaller government or of a trend-based expenditure policy be achieved. This means that the coverage of ceilings applied during expenditure planning (budget preparation) should be comprehensive, with essentially no exclusions.²¹

The importance of applying a comprehensive aggregate expenditure ceiling *during expenditure planning* is reinforced by the importance of promoting allocative efficiency. Allocative efficiency means making the right choices between alternative expenditure options. As noted at the outset, one of the key advantages of the setting of an aggregate expenditure ceiling at an early stage in the budget preparation process – that is, of top-down budgeting – is to promote enhanced allocative efficiency. An aggregate ceiling which is respected during budget preparation does this by making clear the zero-sum nature of expenditure decisions – in other words, making it clear that the opportunity cost of each new spending decision (or, indeed, of each decision to maintain an existing programme) is the sacrifice of an alternative spending option. However, the coverage of the expenditure ceiling is crucial, because the obligation to make choices which arises from the zero-sum constraint of the aggregate ceiling applies only to choices between categories of expenditure which are covered by the expenditure ceiling. To exclude social security expenditure from the aggregate ceiling which sets the framework for budget preparation inevitably removes the need to make choices between, on the one hand, social security expenditure and, on the other hand, expenditure covered by the ceiling. This is most undesirable because, although social security expenditure may be rigid in the short run, it can be changed through decisions, taken with sufficient lead-time, to modify entitlement criteria and benefit levels. There is a therefore direct trade-off between the level of such expenditure and the level of other (determinate) expenditure. Applying during the preparation of the budget a comprehensive ceiling which incorporates both types of expenditure forces government to recognise these trade-offs.

The desirability of a holistic perspective on expenditure prioritisation was precisely one of the key considerations behind Sweden's decision to adopt relatively comprehensive ceiling coverage.

The allocative efficiency argument for comprehensive ceilings does not apply to interest expenditure, because it constitutes only an argument for the inclusion within the aggregate expenditure ceiling of all expenditure which is subject to *ex ante* discretionary control – which interest expenditure is not. However it remains important to target a comprehensive measure of aggregate expenditure *including* interest expenditure if the objectives of smaller government or trend-based expenditure policy are to be achieved.²²

In addition to the problems which partial coverage of expenditure ceilings would create during expenditure planning, there is also an obvious problem during expenditure execution. If social security and similar expenditure is excluded, what is to prevent its continued upward drift? This is exactly the problem which the UK government found itself faced with under the DEL/AME regime – there was a sustained upward trend in AME expenditure which the ceilings regime itself did not address.

10. The appropriate coverage of aggregate ceilings

The analysis above points to two key problems. Firstly, the appropriate coverage of aggregate expenditure ceilings is not the same during expenditure planning as it is during

expenditure execution. To meet the needs of good budget preparation, aggregate expenditure ceilings should include every category of expenditure. However, to work optimally during budget execution, ceilings should cover essentially only determinate expenditure. This points to the second problem – if indeterminate expenditure is excluded from expenditure ceilings during budget execution, how is control to be maintained over this important category of expenditure and, consequently, on total aggregate government expenditure?

With respect to the first of these problems, the difficulty of reconciling the differing coverage requirements of aggregate expenditure ceilings during expenditure planning and expenditure execution is apparent rather than real. There is no reason why the aggregate expenditure ceiling used during budget preparation need have the same coverage as that applying during budget execution. There is nothing to prevent the inclusion of indeterminate expenditure in the ceilings used during budget preparation, and its subsequent exclusion from the ceilings applied during budget execution. This means that, rather than using the term expenditure ceilings in a way which implicitly assumes that the same ceilings will apply at both stages of the expenditure cycle, one should explicitly distinguish between budget preparation (expenditure planning) ceilings and budget execution ceilings.

The view put forward in this paper then, is that the budget preparation ceiling should be comprehensive – in other words, that the budget should be prepared so as to respect a top-down ceiling which covers all categories of government expenditure, whether determinate or indeterminate, and whether on or off budget. However, when budget preparation has been completed and the budget is presented for legislative approval, determinate and indeterminate expenditure should be distinguished and treated differently. At that time, government should propose a budget execution ceiling which covers essentially only determinate expenditure. The budget documents should present forecasts of indeterminate expenditure, but without any suggestion that these forecasts constitute a ceiling which the government has the power to ensure is not breached.

Under this approach, the contingency reserve would apply only to the determinate expenditure ceiling, and would therefore not need to include any forecasting margin to cope with unanticipated automatic changes in indeterminate expenditure. It would serve only as an unplanned discretionary spending reserve. The contingency reserve could therefore be kept small, so as to maximise its effectiveness as a tool for limiting new spending decisions taken outside the budget preparation process.

This brings us to the second problem – how to maintain control over indeterminate expenditure if it is excluded from ceilings. The fact that indeterminate expenditure would be covered by ceilings only during budget preparation and not during budget execution implies an acceptance that from time to time the level of indeterminate expenditure will exceed forecasts and that, when this happens, the comprehensive aggregate expenditure ceiling applied by the government during budget preparation will be exceeded during budget execution. If this is due only to random forecasting errors which cancel themselves out over time, no problem arises. If, however, actual indeterminate expenditure systematically exceeds forecast levels, there is a problem.

There are a number of potential means of dealing with this problem.

One is to require *ex post* compensation – offsetting expenditure reductions – if indeterminate expenditure systematically exceeds forecast levels. Given that it is not

feasible or desirable to use within-year sequestration to compensate for overruns, such compensation must necessarily take place in subsequent years. This is essentially what is achieved by the *ex post* “compensation mechanism” first introduced in Switzerland (Geier, 2011) and subsequently adopted in certain other countries. Under this mechanism, if the cumulative excess of actual expenditure over expenditure ceilings exceeds a threshold level, mandatory expenditure cuts must be made in subsequent years.²³

Another valuable instrument for controlling indeterminate expenditure is to use independent verification to ensure the integrity of expenditure forecasts for indeterminate expenditure which the government uses when asserting that it has respected a comprehensive budget preparation expenditure ceiling. Independent verification is essential to prevent governments from engaging in persistently optimistic forecasting of indeterminate expenditure so as to “game” the expenditure planning ceilings. It is appropriately part of the broader task of independently verifying fiscal forecasts which is assigned to independent fiscal councils in many countries, such as the UK Office for Budget Responsibility.

A particularly notable development in this context is the recent introduction by the UK government of a “welfare cap” designed to discipline social security expenditure (IFS, 2014: 45-50; Rhodes and McInnes, 2014), in conjunction with the DEL expenditure ceiling system. Under the welfare cap system²⁴ the government sets rolling multi-year planning ceilings (“caps”) which cover most social security expenditure.²⁵ It is then required to ensure that the budget presented to parliament respects these ceilings – in other words that *forecast* (not actual) social security expenditure is not in excess of the ceilings. The Office for Budget Responsibility independently checks these forecasts and reports on whether the government’s social security policies are consistent with respect for the welfare caps which it is announced. The entire emphasis is on *ex-ante* respect for the ceilings, and there is no mechanism for *ex post* enforcement if actual social security expenditure exceeds the cap. In other words, the welfare caps represent expenditure planning ceilings, and not budget execution ceilings. The design of the system is in this respect driven by the explicit recognition that it takes time to change the level of social security expenditure.²⁶

11. Summary of policy implications

The main conclusions of this paper may be summarised in three propositions:

Proposition 1: Aggregate expenditure ceilings need not, and should not, have the same coverage during budget preparation and budget execution. In recognition of this, it is appropriate to distinguish explicitly between budget preparation (expenditure planning) ceilings and budget execution ceilings.

Proposition 2: Budget preparation ceilings should be comprehensive, including all social security expenditure (with the single exclusion of the cyclical component) and interest expenditure.

Respect for these comprehensive budget preparation ceilings should be assured through independent verification of the expenditure forecasts (especially for indeterminate expenditure) which underpin them.

Proposition 3: Budget execution ceilings should exclude indeterminate expenditure (including interest expenditure and all categories of social security and other entitlements expenditure which are subject to significant forecasting uncertainty).²⁷

In this context, additional consideration should be given to *ex post* compensation mechanisms which force compensating expenditure reductions in future years in the event that indeterminate expenditures systematically exceeds forecast levels.

12. Concluding reflections

The analysis in this paper makes it clear that the view advanced by some – that the more comprehensive the coverage of expenditure ceilings, the better – is simplistic. To the contrary, it is highly desirable that ceilings which apply during budget execution exclude major categories of expenditure.

A further implication of the analysis is that the degree of comprehensiveness of expenditure ceilings which apply during expenditure execution will appropriately vary between countries and levels of government. For example, the ceiling should logically be more comprehensive for a sub-national government with limited or no responsibility for social security than for, say, a national government with primary responsibility for running a “welfare state”.

It is also relevant in this context that the degree to which certain categories of expenditure may be considered “determinate” or “indeterminate” can vary between countries depending on institutional and legal arrangements. For example, in some countries health expenditures may fit more naturally into the indeterminate category. This has implications for the design of expenditure ceilings which have been abstracted from in the analysis in this paper. However, it is relevant to the fact that some countries set separate sub-ceilings for health expenditure within their aggregate expenditure ceiling.

Calling on all governments around the world to adopt highly comprehensive expenditure ceilings is therefore an unfortunate example of “one size fits all” policy advice.

A further implication of the analysis in this paper is that if expenditure rules cover broad expenditure aggregates which include, whether partially or wholly, major categories of indeterminate expenditure, it is inappropriate to expect that these rules can or should be uncompromisingly enforced during budget execution through the application of similarly comprehensive expenditure ceilings. It is realistic only to require that the expenditure rules be faithfully observed during the preparation of the budget. During budget execution, the possibility of some departure from the expenditure rule must be recognised due to automatic changes in indeterminate expenditure. Independent verification of fiscal forecasts and *ex post* correction mechanisms, as discussed above, become particularly important for the enforcement of the expenditure rule under these circumstances.

Notes

1. Subject to “escape clauses” which may permit expenditure ceilings to be breached under circumstances of severe recession or natural disaster.
2. In France, expenditure ceilings and the two expenditure rules (“normes”) which underlie them (see the main text below and note 7) apply only to the budget and exclude off-budget expenditure. This means that most social security expenditure and health expenditure lies outside the ceilings. It is true that the French government also sets an “objective” for total public expenditure, as well as an objective for social security and health expenditure (“ONDAM”). However, these objectives are not ceilings and have frequently been breached. For example, in 2013 the objective for total government expenditure was 0.9% real growth, whereas actual growth was 1.7% (according to the Cour des comptes (2014: 47) or 1.3% (according to the government [République française, 2014: 22]).

3. The main social security expenditure exclusions in Finland are “unemployment security expenditure, pay security, housing allowances and the central government contribution to the cost of basic benefit of social assistance” (Finnish MOF, 2013: 5). Crucially, however, that expenditure resulting from “discretionary” changes to these categories of social security expenditure is included in the ceilings.
4. This may mean cutting expenditure in nominal or real terms, or as a percentage of GDP, or it may mean reducing the underlying trend growth of expenditure.
5. Interest and “non-discretionary” changes to unemployment benefits expenditure.
6. The assumption is that with stable tax policies trend revenue should usually grow in line with trend GDP.
7. In addition to the “zéro volume” norme (which applies to budget expenditure with certain limited exclusions), France also has a more recently-introduced additional “zéro valeur” norme (which applies to budget expenditure with the further exclusions of interest payments and government employee pension expenditure). The reason for excluding interest payments from the second norme is discussed in note 22 below.
8. The sole qualification to this is the possible exclusion of extra-budgetary funds which are wholly self-financing from non-tax sources.
9. Non-discretionary expenditure is expenditure pursuant to standing legislation (i.e. laws with continuing application) or contracts – such as social security benefits and interest expenditure. Discretionary expenditure, on the other hand, is expenditure undertaken only by virtue of its authorization in the annual budget law. Determinate expenditure is essentially discretionary expenditure plus that part of non-discretionary expenditure which can be estimated in advance with a high degree of confidence. (For example, salaries of judges and other “statutory” public officials qualify in some countries as non-discretionary expenditure because they are made pursuant to standing legislation rather than to budget appropriations. The amount which has to be paid is nevertheless quite clear, making these part of determinate expenditure.) Indeterminate expenditure, by contrast, is that (considerable) portion of non-discretionary expenditure the amount of which varies significantly due to automatic changes, the magnitude of which variation is subject to significant uncertainty.
10. Not all expenditure authorized in the budget is discretionary (or determinate) expenditure, because in almost all countries budget appropriations include some expenditure which must be undertaken by virtue of standing laws or contracts irrespective of whether it is also authorised in the budget law. Interest expenditure, which in most countries is “authorized” by the budget law, is the most common example of this. In France, the budget includes a number of so-called crédits évaluatifs which are appropriations for the estimated amount of certain non-discretionary expenditures. These contrast with the crédits limitatifs, where the amount to be spend is fixed. In the US, the same concepts are captured in a distinction between definite and indefinite “budget authority”. An extreme – and very unusual – example of the inclusion within the budget of non-discretionary items is that of Sweden where all non-discretionary expenditure, including social security benefits, is covered by formal budget appropriations which specify the maximum amount to be spent. This arrangement, however, “in no way nullifies the rights [to benefits] laid down in social security legislation” (Molander and Holmquist, 2013: 22). In short, in all countries some budget expenditure is non-discretionary, and some of that on-budget non-discretionary expenditure qualifies as “indeterminate” in the terminology used in this paper.
11. And certain other highly cyclical benefits.
12. The Netherlands, approximately speaking, has separate ceilings for determinate and indeterminate expenditure (more precisely, there is one ceiling for the central government budget; and two others respectively for social security and labour market policy expenditure, and for health care expenditure.
13. This latter problem may in principle be avoided by partitioning the contingency reserve into two separate reserves (an uncertainty reserve and an unplanned discretionary spending reserve). This is, however, a move back in the direction of two separate ceilings, one for determinate expenditure and the other for indeterminate expenditure. The problem would remain that either the ceiling would fail to exercise any constraining effect upon indeterminate expenditure or it could do so only by destabilising determinate expenditure.
14. The “budget year” contingency reserve means the reserve which would be included in the year n budget as passed by parliament in year n-1. The reserves for the outer years – years subsequent to year n – of the medium-term framework are deliberately larger, because they include fiscal space

for additional new spending measures (what has sometimes been called a “planning reserve”) which will only be decided when it comes time to prepare the budget for the year concerned. Over time, as these outer years get closer, their reserves are gradually reduced.

15. These forecasting errors were not obviously related to the business cycle. Expenditure in these areas was (and remains today) below pre-GFC levels.
16. The government’s use of creative accounting to partially circumvent the ceilings in 2009 (Finanspolitiska Rådet, 2009:79) implicitly acknowledged the validity of this critique.
17. Note that the fact that ceilings are set for 3-4 years in advance resulted in a time lag in increasing the contingency reserve.
18. An additional major design flaw in the Swedish system – which has been pointed out by the Fiscal Policy Council and other critics – is the lack of an escape clause which would have permitted the ceilings to be suspended under conditions of serious macroeconomic crisis.
19. The inclusion of non-UB social security benefit expenditure would, for example, have made it impossible to operate with the contingency reserve anywhere near as low as the 0.25 per cent level set in Finland. If one takes the three major non-unemployment benefit categories of social security benefits in Sweden (sickness and handicap benefits, family and child benefits and old-age benefits excluding pensions), the average absolute value of one-year forecasting errors for these three areas taken together in the four years 2010-13 equalled 0.15 per cent of expenditure covered by the expenditure ceilings, with a peak value (in 2013) of 0.21 per cent (calculated from data in Ekonomistyrningsverket [various years] and Regeringskansliet [various years]).
20. The Fiscal Policy Council has suggested the splitting of the contingency reserve into two reserves, one to cover cyclically-induced additional expenditure and the other to cover other unplanned additional expenditure (Finanspolitiska Rådet, 2009: 36). This is somewhat similar to the notion, discussed in footnote 13, of dividing the reserve into a forecasting margin and an unplanned discretionary spending reserve, and as such suffers from the same deficiencies. Moreover, the Government and retired senior officials close to the government (Molander and Holmquist, 2013: 41) have criticised this suggestion on the grounds that the distinction between these two types of expenditure is not always clear in practice, so that splitting the reserve would leave the door open to manipulation by the misclassification of additional expenditures. An alternative suggestion from the IMF (2013: 15) – that the use of the contingency reserve during budget execution should be made conditional upon indicators of the state of the macroeconomy – is flawed because it fails to recognize that coping with cyclically-related expenditure uncertainty is not the sole function of the contingency reserve.
21. The one obvious qualification to this is that it remains necessary to exclude the cyclical component of social security expenditure from the ceilings during budget preparation in order to permit the full operation of the automatic stabilisers.
22. There may be a case for setting both a comprehensive expenditure ceiling which includes interest expenditure and, within that, a sub-ceiling excluding interest expenditure. This is what the UK did under the New Control Total regime. In the UK’s case, the NCT ceilings were based on an indicative expenditure rule which limited the real growth rate of expenditure covered by the ceilings (i.e. excluding interest expenditure and cyclical social security expenditure) to a maximum of 1.5% per year. At the same time, the government aimed to limit total government expenditure (“General Government Expenditure”, which included interest and also for security expenditure) to a maximum of 2% per year. Although France’s expenditure ceilings (normes) have always been far from comprehensive, it is worth mentioning that in France, the government in 2011 started to set an expenditure sub-ceiling excluding interest expenditure (guided by a so-called *zéro volume norme*) within the overall budget expenditure ceiling including interest expenditure which it had been setting for over a decade (based on the so-called the *zéro valeur norme*). The reason it did so was that the exceptionally low interest rates which have prevailed in the post-GFC period create a challenge for a ceiling system the basic objective of which was smaller government. Because they artificially lower interest expenditure, the low post-GFC interest rates create additional room, within a comprehensive ceiling which includes interest expenditure, for additional discretionary spending. This essentially took off some of the pressure for expenditure reduction. Establishing the sub-ceiling excluding interest expenditure avoided this problem. The desirability of ensuring that “lower than expected interest expenditures will not increase room for other expenditures” was also a factor in the exclusion of interest expenditure from the recent expenditure ceiling in the Netherlands (Ministerie van Financiën, 2011: 33). However, it would arguably have been better to have established a sub-ceiling excluding interest.

23. Simplifying somewhat, under the Swiss compensation mechanism, when actual expenditure exceeds the ceiling, the difference is added to a notional account. If and when the amounts added to the notional account exceed certain thresholds, equivalent automatic expenditure cuts are required. (An addition compensation mechanism is also applied during budget preparation – for details see Geier [2011]).
24. Note that the system is complex and the description here is somewhat simplified.
25. With limited exceptions one of which is unemployment benefits (because of its cyclicity). For coverage see HM Treasury (2014: 88).
26. In fact, the welfare cap applies only with a 12-month lag, “in order to allow the government time to implement policy changes to bring down spending if necessary” (HM Treasury, 2013: 35).
27. The sole potential exception to this is the costs of any deliberate changes to social security benefits made during the period of budget execution, which may appropriately (insofar as they are permitted) be included within the budget execution ceiling. It should, however, be noted that not only are benefit changes at short notice during budget execution uncommon, but they should be discouraged.

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