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Tricks and tips in using Methodological Guidance for Costing of Structural Reforms (Costing Guidance)

– CLARIFICATION OF THE COMMON QUESTIONS –

Introduction

The Economic Reform Programmes (EPRs) are submitted to the European Commission each January following the instructions outlined in the annually published *Guidance for the Economic Reform Programmes of the Western Balkans and Turkey* (last one published in June 2019). Macro-fiscal framework and structural reforms are the two essential chapters of the ERP document. Structural reform measures (SRs) outlined in the ERP must include details on their estimated cost and financing sources. CEF and Expert Advisory Group members have developed the Methodological Guidance for Costing of Structural Reforms (Costing Guidance, March 2019) which is the reference guidance for the costing of SRs.

During the regional and in-country events delivered in 7 countries of Western Balkans and Turkey throughout 2019, the need to continue developing the Costing Guidance and complementary learning resources was recognized. This especially goes for issues that officials working on ERP preparation of their country kept putting forward or that were noticed as insufficiently clear in the current version of the Costing Guidance. The following list of tricks and tips provides an intuitive orientation for a unified approach to the most frequently asked questions and challenges faced in implementation of the Costing Guidance. They are divided in four parts, starting with (1) general and technical clarifications, (2) treatment of non-public costs and benefits, (3) peculiarities of external funding and (4) intra-governmental transfers. In the Conclusion, there is a reference to the template for structural reform writing.

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1. General and technical clarifications

- **CLARITY**:
To begin with, please bear in mind that the readers of ERP are not necessarily very familiar with the SRs measures you are describing, the policy goals you want to achieve or with the detailed system you are aiming to change. That is why you want to make sure that a SR description is simple with the necessary level of detail to make them comprehensible. When in doubt how to express something, use descriptions and footnotes for further clarifications.
If a SR does not incur any additional costs, an explanation of why this is the case should be included in the description of this measure. If this is the case, do not forget to show zero costs in the tables 10a and 10b.

- **CASH OR ACCRUAL BASIS?**
The difference between cash and accrual accounting lies in the timing of when costs are recorded in the accounts. The cash basis of accounting recognizes revenues when money is received and expenses when they are paid. The accrual accounting recognizes revenue when it is earned and expenses when they are billed but not yet paid.
Example 1 (Expenditure side): *Employment of a public worker on 1st January. She will receive her first salary of 100 in February; meaning she will in cash terms receive 11 salaries, which means* ***1.100 of wage expense in cash terms*** *of that year. In accrual terms, as February salary is for January, she will present* ***the wage expense for 12 months, i.e. in accrual terms*** *her cost for that same year is 1.200.*
Example 2 (Revenue side): *When mobile phone frequency concession is bid for 10 years' use of that frequency and the price at the auction is 3.500 EUR, the state budget receives in cash terms all revenue in one year. However, as the price is a "compensation" for 10 years, in accrual terms a 1/10 of this revenue is accounted for this and each of the following nine years.*

Despite the fact that the main EU public finance figures (general government balances and debts) are discussed and compared in accrual terms (using *ESA - European system of accounts methodology)*, taking into account that accrual accounting is not predominantly adopted in project beneficiaries, **costs should be accounted for on cash basis**.

- **GROSS OR NET SALARIES, INCLUSIVE OR NON-INCLUSIVE OF VAT?**
Despite the fact that the public finance is the recipient of social security contributions, personal income tax and value added tax (VAT), when costing a SR, gross salaries and prices inclusive of VAT should be included. Costing of SR is a basis for its

budgeting, therefore all cost (including overhead, maintenance and any additional costs) should be included in your calculation.

- **A STANDARDISED PRICE LIST?**

  A standardised price list is an inevitably important prerequisite for good costing, especially to ensure consistency between different line ministries / sectors. The elements of such price list could be the annual salary of an average public sector official (plus accompanying overhead costs), the average cost of a kilometre of local road / highway / railway; average cost of specific IT / medical equipment, price of organizing a promotion event for 50 participants, etc.

- **DIRECT VS INDIRECT COST – HOW TO DRAW THE LINE?**

  For example, are unemployment and social benefits paid to people laid off during restructuring of a public enterprise direct or indirect costs?

  The decision which costs are considered (in)direct is left to the drafters of SR measure. The principle to be followed is that only direct costs are included in the costs table in ERP. It is impossible to define a general rule for dividing costs between direct and indirect; with most measures, it will be straightforward, but in some cases, as in the one mentioned above, there is no general and uniform rule. You need to apply your own best judgement and take a decision; what is important is to be transparent about what was counted as direct costs and what other (indirect) costs may occur. This explanation should be mentioned in the narrative description of a SR measure or as a footnote to the table. Remember, this is your SR – so you hold the key!

- **CONSISTENCY OF COSTING OF "OLD" MEASURES**

  Some measures may have already been costed before, as part of a sectoral strategy, as part of line ministries' budget proposal, or while costing of a draft law. However, this existing costing may be unrealistic, outdated or based on a different methodology. How do we assure consistency between costing the same or similar measures in the ERP and in other national documents?

  Costing of SRs outlined in ERP should be as realistic as possible at the time of ERP preparation. When SR measures are taken from existing strategies, in principle the costing done for the strategy could also be used for the expressing the cost of that SR measure in ERP , but before doing so it should be checked whether the cost estimates and funding plans of the strategy can still be considered realistic (for example, time has passed since the strategy costing was done, or the strategy was over-ambitious). It may also be the case that some uncertainties regarding potential funding or precise costs have been cleared since the costing for strategy was done.

  Besides this, it may happen that the costing done for strategy is still realistic but followed a different methodology (e.g. different type of costs are considered to be direct costs). Since this may significantly influence the overall cost of a SR measure, it is important to make sure that overall methodological approach for costing of SR implemented while preparing a strategy is aligned with the principles of this Costing Guidance.

  In short, the "old" costing should always be checked for realism and new information.

When the check shows that updates of already available costing are needed, it should be updated and included in the ERP in the most realistic way, even when it deviates from other already existing documents with the same or similar measures.

- **A FEW MORE USEFUL TIPS:**

➢ Do not forget, use euros, not your local currency! When costs and funding sources are planned in national currency, prepare the 10a and 10b ERP tables in EUR by applying the unified exchange rate from the chapter on macro projections. You may also want to make the assumption about the exchange-rate explicit in general footnote to costing and funding tables.

➢ In following the principles of good financial planning, utilization of the 'To be determined' source of funding should be very limited. The Costing Guidance already clarifies that only project loans are included, but not general financial loans.

➢ To promote the principles of good policy planning, SR measures should not be defined too broadly because this prevents precise costing.

2. Treatment of non-public costs and benefits

- Regulatory measures intended to reduce administrative burden usually require small direct expenditures, but they may significantly reduce the costs for business and also for public administration. How are these savings accounted for in the Costing Guidance?
- On the other hand, some regulatory measures intended to influence behaviour of economic agents require small direct expenditures from national budget, but they may impose significant costs on private agents. For example, feed-in tariffs for renewable energy sources change the structure and level of energy costs for consumers which are not compensated for by the budget. Similarly, liberalization of energy prices may have important redistribution effects (from consumers to producers of energy). In such cases, wouldn't the principle of including only direct costs for public finance in the costing tables significantly underestimate the true cost of such measure?

  The Costing Guidance, as well as the ERP, are focused on budgetary items. But as the costs or benefits for the private sector (businesses, households) may be the focus of a SR, we encourage the countries to describe these non-public costs / benefits in the description of the measure. They should also be included in a footnote to the tables.

3. External funding - conditionality, timing mismatch, procedural delays

- **"PRIVATE FUNDING"**

  Should the 10a and 10b tables include only costs for the public finances and the funding coming from public financial sources or also non-public funding, such as private sources in public-private-partnerships (PPPs)? For example, a measure for increasing investment in an energy production capacity may be based on the PPP model with the major part of funding coming from private sources. The question is if the private funding component should be included in the tables or not?

Despite the fact that the ERP deals with public finance items, the financial standpoint of a SR where external funding comes from PPP will not add up unless the external funding is mentioned in the column “Other grants” of Table 10b. The “private funding component” of should be described in the narrative description of a SR measure and in a footnote to 10b table.

- **<u>INVESTMENT OR SUBSIDIES?</u>**

  When the government provides financial support to private investors (e.g. in RES generation capacity), the cost is entered in the 10a and 10b tables of ERP as a subsidy, because this is subsidy in terms of budgetary accounting; whereas when the government itself builds infrastructure, the same cost is entered in the 10a and 10b tables of ERP as a capital expenditure.

- **<u>UNCERAINTY / CONDITIONALITY OF FUNDS</u>**

  We have an agreed sector-budget support (SBS) financial envelope, but payment of tranches depends on meeting the agreed indicators, so it is not certain that the funds will be disbursed at the planned time or in planned amounts. Should we include this funding under "to be determined"?

  If SBS is agreed in a government document, government should do its best to pursue the policies and meet conditions for receive these funds – even in cases when such funds depend on fulfilling certain criteria / meeting certain target value of an indicator(s). Government should therefore also plan that the funds will be fully disbursed, rather than planning in advance that it will not meet the targets.

  Such funds should not be treated as “to be determined”, but should be presented as the IPA funds or EU funds or whatever their original funding source they may have. Uncertainties related to planned SBS funding may be mentioned in the description of SR measure, and in section on implementation risks.

- **<u>TIMING MISMATCH</u>**

  In EU-funded projects with national co-financing, the government first has to cover the costs of project and then claim the reimbursement from EU funds. There is a mismatch in the sense that the expenditures occur before the funding sources become available and "bridge" financing is provided from the budget. How do we account for this in costing and financing tables of ERP?

- Sometimes the external funding is already agreed and committed, but there may be delays in disbursement. For example, a technical assistance project may be planned in IPA programming documents, but procedural issues on the EU side may lead to delayed implementation and thus disbursement of funds. Or, a government may have already signed a loan agreement but it is still pending confirmation from the parliament which may be delayed or even denied. How do we account for this kind of uncertainty in the ERP?

  From the ERP prospective, these are EU funds. What we are in fact dealing here with is a liquidity risk, which is to be addressed at the budgeting level, not in the ERP. Again, these are EU funds – regardless of the fact when they are actually received from the liquidity point of view.

4. Inter-governmental transfers

- When a central government provides a grant to a local (subnational) governments that is earmarked for implementation of a specific SR measure, is this a **central government** or **local government** funding source?

  The source of funding in this case is central government, as in the government books there will only be an expenditure, whereas for the local government, there will be an ear-marked revenue and expenditure, a net neutral transaction. From top-down and big picture point of view, this is central government expense.

- When the central government provides a specific grant to local (subnational) government, earmarked for investment in schools, is this **transfer** from central to local governments or **capital expenditure** (which is the purpose for which the money will be spent)?

  The economic purpose counts; this is an example of a capital expenditure and not transfer.

Conclusion

There is no single, general rule on how to articulate and cost a SR measure. The tips and Tricks presented in this document were prepared to help with some of the most frequently asked questions and the common challenges identified during ERPs preparation over the course of 2019. Another pressing challenge is the 'base year', especially for »rolled over« measures that are in majority. For example, what is a base year if a measure consists of several activities that have not been introduced in the same year?

Before we manage to answer these questions, new ones are arising as well. It can be said with great certainty that the 2020 ERPs will be focusing more on economic recovery after the COVID-19 effects and it will be a good idea to flag / earmark these SR measures in order to be able to distinguish them from "regular" SRs (that are primarily aimed at stipulating economic growth, competitiveness and social equality) in order to be able to calculate their cumulative effect.

However, to make your efforts a bit easier, we advise you to use this template when preparing your well-articulated SR measures.

Good luck!