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OPM REVIEW

Supporting strategies for economic and social reform

Paper 2

Medium Term Expenditure Frameworks – panacea or dangerous distraction?

The failure to link policy, planning and budgeting is the single most important cause of poor budgeting outcomes in developing countries. That is the view of the World Bank in its Public Expenditure Management Handbook (World Bank, 1998) and it has also been the experience of Oxford Policy Management when dealing with policy and budget issues in South Asia and Sub-Saharan Africa.

The implementation of a Medium Term Expenditure Framework (MTEF) is increasingly being accepted as an appropriate response to the problem. In many respects MTEF has become the new panacea of public expenditure management – proposed as a cure not only for the inadequacies of planning and budgeting systems but also for the broader performance problems of government.

It is not surprising that MTEFs should receive universal support. It is rational to plan and manage finances in an integrated manner, with a medium term perspective. Yet there are dangers in applying MTEF as a prepackaged solution to diverse countries' budget problems.

This article questions whether such a sophisticated mechanism is really the best place to start in reforming public expenditure management systems.

OXFORD POLICY MANAGEMENT

Oxford Policy Management works with governments, agencies and corporations to encourage and develop policy reforms to reduce poverty and promote efficient and sustainable economic growth

This article builds on material used in a background paper prepared by OPM for the World Bank 2000 Annual Review of Development Effectiveness: *"Scaling up": Issues in moving from projects to programmatic aid,* Stephen Jones and Andrew Lawson, August 1999.

Medium Term Expenditure Frameworks – panacea or dangerous distraction?

In theory …

Experience illustrates that MTEF is not a panacea. A successful MTEF must be diagnostic, rather than formulaic, so as to ensure that efforts are focused on where the real and most urgent problems lie.

The clearest message is that defining national and sectoral policies which are clear, affordable and consistent is crucial to the success of any budget process.

The international aid community fuels the enthusiasm for Medium Term Expenditure Frameworks. Donors and lenders, including DFID and the World Bank, support MTEF as the logical mechanism around which to structure the design of government-wide instruments of budget support.[1] In *Public Expenditure Reviews* (PERs) undertaken by the World Bank in Sub-Saharan Africa and other regions of the Bank's operations, the need for an adequate medium term framework is arguably the issue given the most attention.[2]

Putting the Panacea to the Test

Is MTEF really the universal cure for public expenditure management problems? To answer this question, this article:

- Clarifies the definition of MTEF.
- Evaluates experience to identify the institutional and technical features of effective MTEFs.
- Draws tentative conclusions about approaches to designing budget reform and essential pre-conditions for success of medium term budgeting frameworks.

Understanding the concepts

In defining a medium term framework as an operational concept, it is useful to distinguish three levels of development:

A ***Medium Term Fiscal Framework (MTFF)*** is the first, necessary step towards an MTEF. It typically contains a statement of fiscal policy objectives and a set of integrated medium-term macroeconomic and fiscal targets and projections.

A ***Medium Term Budget Framework (MTBF)*** builds on this first step by developing medium term budget estimates for individual spending agencies. The objective of an MTBF is to allocate resources to the nation's strategic priorities and ensure that these allocations are consistent with overall fiscal objectives. This gives some degree of budget predictability to spending agencies, while ensuring overall fiscal discipline. In fact, an MTBF is the most basic type of MTEF.

A ***Medium Term Expenditure Framework (MTEF)*** develops the approach further by adding elements of activity and output based budgeting to the MTBF framework. These methods seek to improve the value for money of public spending, in addition to reinforcing fiscal discipline and strategic prioritisation. In this discussion we refer to these approaches as 'extended MTEFs', in comparison to the basic MTBF.

Lessons from Experience

Experience suggests that identifying the essential components of a successful MTEF is not easy. Despite their theoretical popularity, there are few established medium term frameworks.[3] Those that do exist, especially in developing countries, have only been recently introduced and are still evolving. As one set of pioneers resolve their teething problems, other apparent successes unexpectedly collapse. But some lessons are emerging from the MTBFs in OECD countries, as well as from the contrasting experiences of the extended MTEFs currently under development in Ghana and Malawi and the more basic MTBFs introduced in South Africa and Uganda. In particular:

- Experience in OECD countries suggests that stringent conditions have to be fulfilled before the full benefits of medium term frameworks can be realised (IMF, 1999).
- These conditions are unlikely to be fulfilled in most developing countries. However, even the basic acceptance of the principles of medium term budgeting may improve the realism of sector budgets. This is a significant gain for many developing countries where a large gap between stated policies and actual resources leads to *ad hoc* spending cuts in budget implementation.
- Budget reforms are only sustainable if they demonstrate early benefits to key players in the process. It is particularly important that the introduction of any form of medium term framework brings improvements in the predictability of organisational funding. This appears to have been achieved in South Africa,[4] despite

resistance from those agencies facing reductions in funding. In Uganda the designation of protected sectors (health, education, roads) has restricted unpredictability to lower priority areas. In contrast, little predictability seems to have been achieved in Ghana or Malawi and there are indications that this is impeding progress.[5]

◆ Improved predictability relies on reducing the gap between forecast and actual revenues, thereby reducing the need to cut expenditures during the budget year. Technical improvements to revenue and debt forecasting are therefore key to giving public sector managers the budget predictability they need to manage effectively. They can also highlight situations where revenue estimates are being inflated in order to avoid hard budget decisions.

◆ Improvements in the costing of policies and programmes will take longer to achieve. They require a fuller information base and cannot be delivered without the active involvement of sector ministries. Successful budget reforms depend on introducing and sustaining appropriate incentives for these ministries to support the changes. The Ugandan experience with protected sectors may suggest a useful way forward where such conditions are difficult to establish for government as a whole.

Creating an effective platform

Experience of budget reform in OECD and developing countries suggests that MTEFs can help improve budget processes and outcomes through greater:

- clarity of policy objectives
- predictability in budget allocations
- comprehensiveness of coverage
- transparency in the use of resources.

But experience also illustrates that the MTEF is not a panacea – a successful MTEF must be diagnostic, rather than formulaic. In other words, improving budget outcomes requires a focus on where the real problems lie:

◆ If the release of budget funds is unpredictable, it will be difficult to instil confidence in medium term projections.

◆ If Ministers, Parliamentarians and budget holders are not held to account, then no gains can be made from attempts to link budget outcomes to policy objectives.

◆ If the bulk of aid financing is not reflected in the budget, then integrating the recurrent budget with the domestically financed component of the development budget is just an academic exercise.

◆ Similarly, trying to achieve transparency in the allocation of resources to specific activities is futile where overall sector policies are unclear, inconsistent or unrealistic.

More specifically, experience from developing countries tends to support the use of more narrowly focused MTBFs. There are, however, some potential advantages to introducing extended MTEF initiatives. They encourage consistency among different aspects of budgetary reform and add a performance focus to budgetary initiatives. The application of output-focused budgeting also allows a more informed debate over strategic priorities and resource allocation across and within sectors.

Implementing a rigorous extended MTEF is a significant challenge, however, particularly for a developing country. It absorbs a large amount of technical and human resources and runs the risk of distracting attention from the basic elements of the MTBF. The clearest message from the often-contrasting experience of different countries is that clarity of national and sectoral objectives is crucial to the success of any budget process. Without such basic elements in place, output or activity based budgeting is limited in its ability to improve fiscal decision-making. Introducing these budgeting tools at an early stage of budget reform can divert attention from the critical changes essential for success.

The MTEF may well be a useful treatment for many dysfunctional public expenditure management systems, but exactly how the MTEF pill is prescribed - or sugared – is likely to be different in each case. Strong diagnostic tools are essential to ensure that the prescription is the right one and that activities are focused on where the real problems lie.

Comments from readers are very welcome

1 The PEM Handbook makes this point quite explicitly. World Bank (1998), p.83. The use of MTEF is also stressed in the *IMF "Manual of Fiscal Transparency"*, IMF (1999).

2 See Kostopoulos, C., *Progress in Public Expenditure Management in Africa: Evidence from World Bank Surveys*, Africa Region Working Paper No.1, World Bank, 1999.

3 In only four out of 19 African countries surveyed in 1998 was there an expenditure framework in place which projected an aggregate expenditure ceiling over a 3–5 year horizon, consistent with macroeconomic targets. (Kostopoulos, 1999.)

4 The MTBF is described in Department of Finance (1997). An analysis of initial lessons is contained in Abedian (1999).

5 In Ghana budget outcomes have been significantly out of line with the MTEF even during the first year of implementation (Foster, 1999).

References

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In practice … MTEFs – Panacea or dangerous distraction?

Malawi:
Review of MTEF

Since 1995 the Malawi Government has been introducing an MTEF approach. Early progress was made in defining spending objectives and attaching costs to activities. However, a comprehensive MTEF has remained elusive.

OPM is providing assistance ...
to identify critical changes required to the budgetary process. Preliminary analysis has pointed to the difficulties in obtaining properly costed and feasible sectoral expenditure plans from the line ministries. Yet line ministries complain about the consistent discrepancies between approved budgets and actual releases of funds. In this context, the usefulness of engaging in detailed budget preparation processes has been repeatedly questioned. The immediate challenge is to introduce a level of predictability in budgetary funding so as to change the underlying incentives for line ministries and close the gap between budget demands and available resources, whilst also strengthening budget and performance monitoring systems.

Rwanda:
Development of an action plan for MTEF

Following recommendations made in the 1997/98 Public Expenditure Review, the Government of Rwanda has decided to introduce an MTEF. Given the economic and institutional reforms for Government to manage, careful prioritisation and sequencing of actions was necessary for the MTEF to be introduced successfully.

OPM were contracted ...
to assist in defining the key elements of an action plan. The need for a clearer definition of national policy priorities was emphasised. Attention was also given to managing aid resources (including those due from HIPC arrangements) in a more consistent and predictable manner. Out of these ideas, OPM were able to develop a framework Plan of Action based upon a three-year development process.

Nepal:
Institutional issues in Public Expenditure Management

OPM led a team of international and Nepali experts in a World Bank-managed *Public Expenditure Review*. The aim was to assess the effectiveness of the existing framework in achieving positive budgetary outcomes with regard to fiscal discipline, strategic prioritisation of resources and value for money in delivery of public services.

The OPM team concluded that ...
the Nepali Government's success in maintaining fiscal discipline and controlling the accumulation of debt was largely achieved at the expense of effective prioritisation and operational efficiency. In large part, this was due to a budget process which allowed revenue forecasts to be regularly exaggerated so as to accommodate expenditure demands and new project requests into the budget. Compensatory actions to delay release of funds and control expenditures through sequestration then became necessary, undermining the usefulness of the budget as a tool of expenditure planning.

... and recommended:
a series of changes to permit the more constructive engagement of Parliamentarians in the budget preparation process, including steps to provide improved information on the significance and nature of budget constraints. A separation of the processes of revenue forecasting and expenditure programming was also proposed, in addition to improvements in project screening, budget monitoring and treasury release procedures.

OXFORD POLICY MANAGEMENT

Oxford Policy Management's work is divided between three programmes:

Economic Policy Programme
The EPP applies international experience in economic analysis to public policy and organisational development problems. Our work focuses on six main areas: (i) Reform of development assistance (ii) Financial sector reform; (iii) Rural development and agricultural policy; (iv) Integration of livelihoods approaches into development practice; (v) International trade policy, and (vi) Strengthening the regulatory and policy environment for the private sector.

Public Finance and Management Programme
The PFMP provides support to improvements in public expenditure management and assistance to long-term processes of government reform. Major areas of work relate to civil service reform, local government and municipal reforms, sector expenditure analysis, and the development of budgetary systems and processes.

Social Policy Programme
The SPP focuses upon poverty analysis and health and education sector reform. Services provided include support to the design and implementation of public policies for reducing poverty and improving social service provision, and the analysis of large-scale surveys to inform social policy development.

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