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Linking Planning and Budgeting:

The Medium Term Expenditure Framework (MTEF)

1. Why a Medium Term Expenditure Framework *(MTEF)?*

In most developing countries, the government prepares a medium term development plan that lays out the strategic priorities and key objectives for the country over a three- to five-year period. This exercise however is almost always done independently of the annual budget process, and often results in a wish list of programs and activities which cannot be realistically achieved given the finances of government. The plan thus becomes de facto more of an academic exercise rather than an effective instrument for promoting socio-economic development.

The annual budget process compounds matters because the medium term expenditure implications of programs and projects that are funded in a given budget year are generally not considered during budget deliberations. This can have the unfortunate effect of generating expenditures that are financially unsustainable *over the medium term and* negating the potential positive impact *of current budget year capital expenditures.*

Figure 1 below illustrates this for investments with recurrent expenditures. Data comes from a developing country outside the Asia region. A development plan often calls for capital investment over a number of years. The bottom line represents capital investments made each year, the top line the recurrent expenditures implied by those investments, and the middle line the actual recurrent expenditures made. Note the persistent gap between required/implied and actual recurrent expenditures, as the maintenance costs of investments are not adequately budgeted for. The gap reflects the deterioration over time in the investments made (and the implied failure of the development plan).

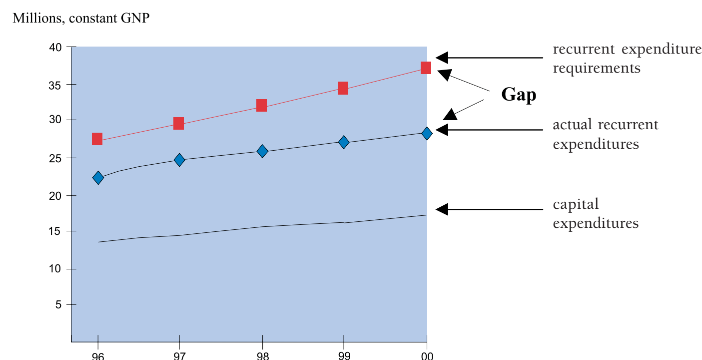

Figure 1

The complications introduced by public sector budgeting do not end here. As practiced in many countries, a development plan essentially establishes the outcomes that the country wishes to achieve over the medium term, but budgeting is focused on "inputs" rather than outputs and outcomes. Discussions and debates between the budget agency and a line agency are normally about line items (see Governance Brief issue 1-2001), e.g. how many new staff the latter can hire, instead of what outputs does the agency need to produce in order to contribute to achieving some of the desired social outcomes. The concomitant arduous process of defending each and every line item in its proposed budget effectively pushes the line agency into a myopic view of its tasks with little regard for the bigger picture. Thus the resulting budgets are only weakly linked to the socially desired outcomes.

An MTEF is a framework designed specifically to link planning, which has a medium term outlook, with the annual budget, and, as a consequence, to link budgetary expenditures more systematically with socially desired outcomes, e.g. gender balance, slower population growth, higher literacy rates, lower infant mortality rates. Its principal focus is on getting the government to allocate budgetary resources to programs, activities, and projects that promote the strategic priorities of the country.

[1] *This problem is exacerbated by macroeconomic crisis during which a country is often forced to make across the board cuts in its budget just to contain a burgeoning budget deficit.*

2. How is an MTEF related to Public Expenditure Management (PEM)?

A PEM oriented budgeting system focuses on promoting three budgetary outcomes — aggregate fiscal discipline, allocative efficiency, and operational efficiency (see *Governance Brief* issue 1-2001). As will become evident in the ensuing discussion, an MTEF is one mechanism through which a PEM system can be operationalized. While its principal focus is to promote allocative efficiency, an MTEF necessarily instills aggregate fiscal discipline and enhances operational efficiency.

3. Promoting Allocative Efficiency

A. The Ministry Budget — Three Years vs. One Year Proposals

Under an MTEF, each government ministry prepares a medium term (for specificity, let's assume three years) rolling budget. For example, in FY2000, it would prepare a budget for each of three years — from FY2001 to FY2003. Actual budgets are prepared for FY 2001 (the first year) and budget estimates are prepared for FY 2002 (the second year) and FY2003 (the third year). FY2002 and FY2003 are referred to as the *outer years* of the three-year period and the budget estimates for these years are technically called *forward estimates*.

The ministry budget for the first year can be broken down into two components. The first is what is referred to as the *baseline budget* and the second the *"above the baseline"* budget (ABB). The baseline budget includes all expenditures on *on-going* programs including those that will be completed during the year while the ABB includes expenditures on all *new programs* to be started during the year.

The ABB has expenditure implications for the outer years of the three-year period. A highway that is built in year 1 needs to be maintained in years 2 and 3 (and thereafter). Hence, while the government might spend $ xM to build the road in year 1, it will have to allot additional expenditures in future years to maintain it. Moreover, the highway may take three years to complete so that capital expenditures needs to be allotted in each of the three years. Whatever the case, the estimated budgets for years 2 and 3 have to incorporate these additional expenditures. These expenditures can be referred to as "above the baseline" estimates. Table 1 illustrates how this works in general for ABB expenditures. In year 1, the baseline budget is assumed to be $400M. Assuming further that there are no new program expenditures for the year (and so the baseline budget is the proposed budget for the year) and an inflation rate of 10% then, the estimated budgets for years 2 and 3 are $440M and $484M respectively – i.e. the year 1 baseline budget adjusted for inflation. If however new program expenditures totaling $100M are proposed for year 1 (ABB is then $100M) and to continue these programs over the period, $10M needs to be expended in year 2 and $15M in year 3, then the estimated budgets for years 2 and 3 are adjusted upward by the said amounts.

Note that Table 1 illustrates one major difference between a typical agency budget and a budget developed under an MTEF. A typical budget would include and present expenditures <u>for year 1 only</u> – there would be no year 2 or 3.

Table 1				
	Year 1	Year 2	Year 3	Year 4
Baseline/Est. Ministry budget	400	440 *(est.)*	484 *(est.)*	
ABB	100	10	15	
Proposed/Est. Ministry budget	500	*450 (est.)*	*499 (est.)*	

(Note: the budget for year 1 are actual figures while the budgets for years 2 and 3 are estimates)

B. A "Rolling" Ministry Budget

In an MTEF, the three-year agency budget is continuously rolled over into the next (overlapping) three-year period. Table 2 shows how this is done based on Table 1. When year 2 comes along, it becomes the first year (year 1') in the next three-year period; year 3 becomes the second year (year 2') and year 4 is added as the third year (year 3'). The estimated budget for year 2 in table 1 becomes the baseline budget for year 1" in Table 2; correspondingly, the estimated budget for year 3 becomes year 2' estimated budget, <u>assuming no new program expenditures are introduced (and thus no ABB)</u>. The estimated budget for year 4 is derived by compensating for inflation of 10%.[2]

Suppose now that, in year 2, new capital expenditures of $80M are proposed which would require recurrent expenditures of $10M each for years 3 and 4, i.e. ABB is $80M. Then the estimated baseline budgets for years 3 and 4 are adjusted upward by $10M. Columns 3 to 5 represent the new three-year (proposed) rolling budget.

In sum, at any point in time, there are always three years for which budgets must be prepared or updated – an actual (proposed) budget for the first year and estimated budgets for the second and third years. Estimated budgets are "rolled over" into the next (overlapping) three-year period.

C. Implications for Allocative Efficiency

The "rolling over" feature is relatively simple and straightforward, but it has significant implications for the budget process. Again, going back to table 1, the estimated budget for year 2 becomes its baseline bud-

[2] *In practice, more adjustments may have to be made. For instance, the estimate of $549 assumes that the recurrent/maintenance expenditures for the new programs introduced in year 1 will be the same as year 3's adjusted for inflation. It may be the case that the recurrent costs may drop or increase in which case additional adjustments would be made.*

get the following year (Table 2). What this means is that, during actual budget deliberations in year 2, there will no longer be any discussions of on-going programs except for possible adjustments that have to be made in response to changes in macroeconomic conditions, e.g. inflation, exchange rate, if any. The budget for those programs is already covered by the estimated budget from the previous year so no further substantive discussions are needed on those programs. This of course frees up a lot of time for the government to focus on new programs for the year. Under conventional budgeting, so much time is wasted going over on-going programs which were already "discussed to death" the previous year. Consequently, there is much less time to debate and discuss new programs, a further consequence of which is the loss or weakening of a strategic focus on the allocation of funds to these programs. *The MTEF effectively biases the time spent in budget deliberations towards the discussion of new programs and their future expenditure implications – which makes it a powerful instrument for promoting the strategic priorities of the country and thus for "spending money on the **right** things."*

Table 2

	Year 1	Year 2= Year 1'	Year 3= Year 2'	Year 4 = Year 3'
Baseline/Est. Ministry Bgt		450	499 *(est.)*	549 *(est.)*
ABB		80	10	10
Proposed/Est. Ministry Bgt		530	509 *(est.)*	559 *(est.)*

Tackling the Cost Revelation Problem

Line agencies have the strategic advantage over the budget agency of knowing how much it will cost to initiate and maintain a program. The incentive of a line agency of course is to reveal only what is necessary. In particular, it will have a tendency to misrepresent the true cost of a program in order to get that program into the budget. The MTEF helps address this asymmetry, by requiring line agencies to present additional costs over the medium term. For instance, if an agency understated costs in year 1, the additional funds will need to be revealed in later years otherwise it will not get any more funds for this program since it cannot claim it as a new program in the succeeding years. Hence, the budget agency will be able to get a better picture of the project's true cost.

By providing a clearer basis for allocating the overall budget across programs and projects the MTEF helps improve allocative efficiency. Roughly speaking, allocative efficiency means that the government should spend money on the "right" things (see *Governance Brief* issue 1-2001). But what is "right" depends on how much things costs and whether those things are appropriately valued by the citizenry. Getting accurate costs of programs and projects is thus a necessary condition for promoting allocative efficiency.

Linking the Plan to the Budget

By biasing budget discussions towards new programs, the rolling budget creates an environment where the pros and cons of each (new) program can be presented and debated and where program costs are made more transparent. Priorities can thus be better sorted out. The discussions however would be more productive if in fact a general set of priorities (and their implied desired social outcomes) were already established, i.e. there are criteria for choosing among programs and projects.

This is where the medium term development plan becomes useful. The plan generally sets out the strategic priorities of the country and the social outcomes that it wishes to achieve over the long term.[3] It thus provides criteria for selecting which programs and projects should be funded and which to postpone or cut off. The challenge then is to develop a systematic way of linking the plan priorities to the annual budgetary deliberations. As discussed below, this can be done in part by imposing hard budget constraints on expenditures in each year of the rolling budget and requiring line ministries to prioritize their new programs within their respective ceilings and in accordance with the plan's priorities.[4]

4. Instilling Aggregate Fiscal Discipline

Line ministries have a tendency to propose as many projects as they can get away with – the so-called "common pool" problem. Hence, left to their own devices, line agencies will seek more funds than what is available, resulting in unsustainable deficits. To counter this tendency, the government needs to set credible ceilings on both aggregate and sectoral expenditures. The aggregate ceiling *for any given year* can be set at total domestic revenues plus a sustainable level of borrowing – foreign and domestic. The key is how to make this credible (see *Governance Brief* issue 1-2001).

"Hard" ceilings on sectoral expenditures, e.g. social, are more difficult to establish since they involve extensive discussions among the different ministries and how to allocate the aggregate ceiling among the different sectors. Moreover, for all practical purposes, the discussions boil down to allocations to ministries (not just sectors). There are no formulas for this as this is essentially a political exercise. One good starting point however is to conduct a hypothetical allocation exercise among the different ministers. Specifically, the Budget agency can ask each minister to allocate a fixed amount, say $X M, among all the ministries *excluding his own*. Then it collects the resultant allocations from each minister

[3] The plan would be even more valuable if it were prepared in (extensive) consultation with a wide range of stakeholders – business associations, NGOs, the church, other civil society groups etc. Under these circumstances the broad preferences of the citizenry are revealed and manifested in the priorities set in the plan. In this sense the plan becomes a so-called "preference revealing" mechanism.

[4] Budget deliberations between the line ministry and the Budget Ministry would then focus on the relative importance of programs vis-à-vis the priorities and desired social outcomes set forth in the medium term plan.

Table 3				
	Ministry A	Ministry B	Ministry C	*Sub-Total*
Minister of A	0	30	70	100
Minister of B	80	0	20	100
Minister of C	20	80	0	100
Sub-total	100	110	90	300
Allocation Ratio	.33	.37	.30	

and, for each ministry, adds up the individual ministerial allocations for each ministry. Let us say the individual allocations for the education ministry totals $y M. A benchmark allocation ratio of (y/(X times the no. of ministries)) to the education ministry can then be established.[5] Table 3 provides a simple example. Assume there are three ministries, A, B, and C and that the minister for each is asked to allot $100M among the two ministries that are not his own. The benchmark allocation ratio for each ministry A are derived below.

These ratios can be the starting point of the discussions on allocations. The end result will depend on other factors such as the personalities of the ministers, etc. *But the benchmark provides a basis from which the resultant allocations cannot stray too far away.*

The agreed upon allocation of the aggregate ceiling to a specific ministry for a given year becomes the hard budget constraint for that ministry for that year. This means that, for the three-year budget, the actual proposal for the first year must not exceed the budget constraint for that year and the estimates for second and third years must not exceed the budget constraints for those years.[6] This has implications for the prioritization of new programs for the first year of the three-year budget.

In practice, the ABB is derived by subtracting the baseline budget for the year from the corresponding budget constraint as illustrated in Table 4 below. The cost of new programs for year 1 must not exceed $50M and their implied outer year expenditures must not exceed $35M and $16M respectively. Let us assume the ministry is considering three new programs – A, B, and C – and that it ranks A above B and B above C in relation to their relative impact on desired social outcomes as implied by priorities in the medium term plan. *Then given its ABB for the three years, it would have to drop program C since the implied expenditures for this program in the third year will result in an excess of $4M above the ABB for that year.*

Table 4			
	Year 1	Year 2	Year 3
Baseline/Est. Ministry budget	400	440 (est.)	484 (est.)
Budget Constraint	450	475	500
ABB	50	35	16
New Program A	30	10	10
New Program B	15	10	5
New Program C	5	5	5
Total New Programs	*50*	*25*	*20*

5. Enhancing Operational Efficiency

An MTEF also helps improve operational efficiency. To continuously improve the delivery of services, ministries have to make plans over the medium term. In order to operationalize these plans, a ministry must have reasonable assurance that it will be able to get the funds it will need to implement the programs contained in the plans. One year budgets are poor mechanisms for providing such assurance. In contrast, an MTEF offers greater predictability (and thus assurance) since it establishes baseline budgets for future years. This means that, except when there are events that drastically reduce revenues, a ministry can expect its actual budgets for the outer years to be at least as much as the corresponding baseline budgets for those years. Hence, it can be assured of at least being able to continue with its on-going programs at the level of service it has planned for.

This is a contribution from Jose Edgardo Campos and Laura Walker of ADB

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Upcoming Issues:

- Understanding Public Procurement
- Setting up an MTEF: The South African Experience
- Civil Society and the Budget Process
- Guidelines on Capacity Building
- Governance Assessments

[5] This is essentially a delphi method for eliciting the preferences of each minister across all the areas of responsibility of the government and thus are a reasonable starting point.

[6] The budget constraint for each of the three years would just be the aggregate ceiling for the year times the allocation ratio.