

## Part II: Resource Allocation: Policy Framework

### 1. Medium-term Fiscal Planning: Role of Expenditure Planning

*(Nature of Planning; Budget Expenditures and Types of Budgets: Medium-term Expenditure Framework (MTEF): Organizational Aspects, and Issues)*

(i.) *Nature of Policy Planning:* A key component of public expenditure management is allocation of resources consistent with policy priorities (strategic allocation). Implicit in this statement is a long process in which the government is engaged in the formulation of policies aimed at meeting the needs of the society. All policies have financial implications and these financial implications have to be recognized for the duration of the proposed policies. The collective implications of the proposed policies are evaluated in terms of the likely resources. In light of that evaluation, priorities are formulated. This entire process has three dimensions – structural aspects dealing with the formulation of goals, objectives and policies in terms of decision packages; analytical aspects or the application of objective criteria with reference to which the proposals are evaluated both for the costs and benefits and priorities formulated; and informational aspects dealing with the monitoring of the progress made in the implementation of policies. These aspects are applicable to expenditure management and are exemplified in the budgetary process of every government.

The budgetary process is illustrated in [Chart 4](#). The budgetary process does not, however, function in an independent or autonomous fashion but is viewed as an integral part of the overall management of the economy. The management of the economy requires, as an essential prerequisite, the internalization of the structural characteristics of the economy and its sensitivity to external and internal volatilities. With the growth of globalization, the explicit reckoning of these vulnerabilities gains added importance. In advanced and industrialized countries, the availability of automatic stabilizers lessens the dimensions of the problem. In most developing countries, the absence of well-organized social security systems, makes the governments potentially weaker in responding to changing economic fortunes. In some cases, governments may even reduce their spending to adjust to the declining revenues, thus worsening the cycle. In countries that have unemployment funds (e.g., former republics of the Soviet Union and now independent countries) they may be subject to rules that are independent of the annual budget policies and may contribute to 'enclave mentality' and diverse approaches to tackling the problem. Some countries have organized stabilization funds, social funds, and reserve stabilization funds to meet diverse needs. Stabilization funds seek to provide a kind of insurance when the external prices of export products are too low to be remunerative. Social funds are intended (e.g., post-Asian crisis after 1998) to provide assistance to low income and vulnerable groups. Reserve arrangements refer to the short-term flows into the country when the level of reserves is low. The measures intended to be deployed in the context of various phases of the business are of importance in the management of the economy. While they are not always integral parts of expenditure management, as is the case with reserve maintenance arrangements, some elements could be very prominent (e.g., automatic stabilizers and social funds) and therefore have to be internalized at

each stage depicted in [Chart 4](#). The extent to which this is done is a matter for additional review.

(ii.) *Budget expenditures and types of budgets:* Financial planning involves a closer examination of the links between the stated objectives and the available instruments. The links may be direct in some cases and indirect, in others. The broad categories of expenditures utilized for the purpose of achieving fiscal objectives have already been identified. For purposes of discussion, here, they may be regrouped into three broad categories: (a.) maintenance or continuing outlays or expenditures needed for the continuation of the existing or approved policies. This will involve the payment of wages for the approved personnel, associated outlays on the purchase of goods and services needed for the continued implementation of policies, transfers to individuals, organizations and other levels of government already approved and firmly entrenched in law, debt servicing and capital expenditures. In the absence of specific efforts aimed at reducing these proposed outlays, they are considered, for all intents and purposes, as unavoidable or mandatory; (b.) outlays where magnitudes are determined by the economic climate, e.g., subsidies. The nature of subsidies may be specified in law or in policy, but the actual outlay is determined by the difference between procurement and sale prices. To the extent that the former is higher than the latter, the outlays in this area tend to grow; and (c.) those that are intended to influence the functioning of the economy, (e.g., Korea after the crisis in 1997 and Japan during the last few years). Where governments are expected to provide stimulus, more expenditures may be incurred. The budgets may contain substantial stimulus packages and when these are not deemed to be adequate, supplementary budgets providing for additional stimulus may be planned and implemented. It is important to note that the new outlays may be incurred in the form of additions to existing services or totally new services.

Traditionally, for purposes of control, a distinction is made between 'new items' and 'new services'. In parliamentary systems of the Whitehall type, expenditure on a new service cannot be incurred except with the approval of the legislature. New items are technically viewed as additions to existing services, which, while requiring legislative approval, provides the executive with a little more flexibility than is the case with a new service. When new outlays are proposed, they are expected to be subjected to the same rigorous examination from a cost benefit point of view, as is the case with other outlays and are included in the budget only after successfully meeting the specified criteria.

Before the advent of dirigist approach to economic development and the formulation of medium-term or annual development plans, these new services were considered in an *ad hoc* manner. After the introduction of development planning, however, plans came to be viewed as the basic framework through which additional services were provided and additional expenditures incurred. But new activities or outlays may not always be 'developmental' in character. While all outlays are to be incurred only through one budget, the continuing outlays were analyzed within the realm of the annual budget process, and the developmental outlays came to be concluded through the 'plan' process. This brought about a separation between planning and budgeting, a feature that continues to be prevalent in several countries. With the decline of the importance of development plans during recent years, medium term expenditure planning on a rolling basis has come to be adopted as the new framework. Development plans were viewed as somewhat rigid, while the rolling expenditure plans

(considered in detail in the following section) were viewed as endowed with more flexibility. Both these approaches permit a detailed analysis of the problem, the desired policy response, and implementation of the proposed policy.

The conversion of the policy response into a budgetary package is dependent on the type of the budget system of the country. The line item or the conventional budget permits the use of all three types of expenditures but requires the packages be broken down into input items. They can also be processed through a performance type. Here the packages are converted into desired impact categories. The policy proposals, both existing and new, may need to be thoroughly reexamined when a country is passing through a fiscal crisis. In this context, zero-base budgeting may be used. These linkages are illustrated in [Table 2](#).

(iii) *Medium Term Fiscal Framework (MTFF)*: Expenditure forecasting beyond the fiscal year was undertaken, periodically, by some governments to illustrate the future financial implications of current and continuing policies. Since the early 1970s, however, medium term expenditure planning has come to be taken up by several governments in the industrial and developing worlds. Several reasons contributed to this practice. First, in those countries that formulated formal development plans there was a recognition that the scope of the plans was, in general, restricted to government investment outlays and that the estimates included in the plan were often treated as firm and inviolate. In reality, such rigidity contributed to several distortions. Second, there was recognition that expenditure adjustments and related implementation of fiscal policies could only be envisaged over the medium term. In addition to the massive capital projects whose implementation was spread over several fiscal years, there were areas such as poverty alleviation, modernization of defense forces, development of partnerships with the private sector, and adjustment for previous fiscal follies could only be envisaged over the medium term. Third, international financial institutions engaged in lending advocated the introduction of rolling public investment planning so that the investment program could be formally linked to the annual budget and the lending programs of the institutions. Finally, the medium term forecasts illustrated the continuing financial implications of existing policies, their draft on future resources, and thus illustrated the leeway available for further expansion or contraction. In due course, it was felt more appropriate to extend the exercise to cover all types of expenditures.

As more experience was gained with expenditure planning and forecasting, there was widespread recognition that the exercise had limited utility in the absence of an explicit recognition of the resource constraints. Thus, the medium term fiscal framework, covering resources and outlays and affording an annual opportunity to update the estimates on a rolling basis, came to the fore. Increasingly, it was felt that the sustainability, flexibility, and vulnerability of fiscal policy over the medium term were of paramount importance. The medium term fiscal framework (MTFF) is now viewed as a policy instrument that seeks to inform the public, the market agents, and government agencies and thus provides ample transparency, clarity, and to the extent possible, a stable environment for more detailed policymaking. In its endeavor to reduce uncertainty, it is assisting all economic agents to make their own decisions in the context of MTFF. The MTFF is different from the medium term expenditure framework (MTEF) in that the latter is a component of the former and is as vast, as fiscal policy itself.

The formulation of the estimates included in the MTFF may involve the use of extensive econometric methodology. In a simpler formatting, it could involve, in some cases base-line projections or formulation of estimates taking into account, the buoyancy and elasticity factors affecting revenues, and the past autonomous rates of growth of expenditures. Projections from a base year have limited usefulness and it is for this reason that this practice has yielded place to rolling estimates. Each year, estimates are made for the following two or three years and the formulation of annual budget provides an opportunity to revisit the estimates and to revise them in the light of changing economic variables. Both MTFF and MTEF are essentially auxiliary devices providing support to the formal, legal budgets approved by the legislature.

An important analytical component of the MTFF is the deficit or surplus emerging from the exercises. A surplus may imply a potential for reduction in future tax rates, while the persistence of deficits would imply the need for a comprehensive fiscal strategy aimed at reducing the levels over the medium term, thus improving the prospects of fiscal sustainability. The use of the concept of the deficit is not uniform, however, and much is dependent on the underlying intent of analytical use. There are at least fifteen concepts of deficit, each one illustrating a particular aspect. For example, a deficit calculated on the basis of intergenerational accounts, may illustrate the phase in a distant future that may not be of immediate relevance. Hence, sufficient care has to be extended in the choice of the analytical concept as the policy implications emerge from that. These aspects are of particular relevance to countries that are experiencing severe fiscal stress. It becomes important for them to formulate medium term policies toward moderating the rate of growth of current expenditure, clearance of accumulated arrears, and focus more on capital formulation.

*(iv.) Organizational Aspects:* The organizational aspects essentially cover three areas (illustrated in [Chart 5](#)): (i.) features of the MTEF; (ii.) linkages with the MTFF, and (iii.) the way in which the content of MTEF and MTFF is converted into day-to-day action. The MTEF should have a coverage that is comprehensive in that it should include the budget, extra-budgetary accounts, and should be perceived at a national level. The coverage would also include potential contingent liabilities as these have a tendency to shock the adjustment process. They should therefore be carefully estimated and internalized. Similarly, if the government is having a situation of accumulated arrears, the manner in which those arrears would be cleared, needs to be addressed as a part of the MTEF. Alternatively, if it is a stimulus package, that should be covered as well. The exercise should not be too aggregative, as may be done in an econometric model. Rather, the intent of MTEF is to analyze the medium term behavior of each program, how its internal expenditure dynamics is going to impact on the program and on the total expenditure. In contrast, the MTFF may be at an aggregate level as it is more concerned with the direction of fiscal policy. The program level analysis should explicitly include the continuing outlays on policies already approved, the new maintenance levels that will be needed on completed projects, and any major changes in policies expected to be made. As an integral part of this exercise, effort should also be made to formulate priorities, so that in the event of resource shortfall, alternative policies are available. The intent of MTEF is not to enumerate but to facilitate further intensive planning in the light of the total picture. It is important to recognize that if policies are not properly

formulated, then the implementation would be rendered considerably difficult and the whole intent of policy formulation is likely to be defeated.

The relationship between MTEF and MTFF is a reciprocal one, each influencing the other, and each strengthening the other. The MTFF needs to know the firm expenditure requirements, just as the MTEF has to have a firm estimate of the resource availability. The annual adjustments, which set the scenario for the formulation of the annual budget, are common to both. As such, the calendar of activities, such as the preliminary preparation of estimates by the spending agencies and central agencies needs to be specified with care. In some countries, (e.g., Australia), the forward estimates are prepared by the central agencies, viz., Finance, and the spending agencies are afforded an opportunity to comment on and to revise them. In other countries, MTEF may reflect a bottom-up exercise in that the rolling estimates are formulated by the spending agencies and then consolidated. Depending on the approach taken, the steps involved in the process of consultation needs to be specified and should be preferably transparent.

The eventual intent of MTEF and MTFF is to strengthen the policy formulation processes. Therefore, the information processed and the conclusions reached through these analytical devices have to be considered by the various policy making bodies in the countries. Thus, the extent of use of these techniques by the central agencies in the formulation of annual budgets, their consideration by the cabinet, and finally the deliberation and approval by the legislature, illustrate the effective utilization of these techniques. In some countries, these two techniques may go through all the above phases, while in others, the results of MTEF and MTFF may be presented as a part of the budget documents, more for information, than for effective use in decision making. These aspects, therefore, merit a judicious review.

(v.) *Issues:* Notwithstanding the inherent attractiveness of the above techniques, several issues have arisen in their implementation. In considering the next steps, it is essential that these issues are considered and the alternatives explored. First, experience shows that the formulation of forecasts has not been followed by the adoption of much needed risk management strategies. Inherently, some forecasts cover areas that tend to be volatile. Revenues tend to experience shortfalls: outlays on entitlement programs could be higher. Several transactions may be decided on considerations other than merits. Some categories of expenditures may not always reveal the true characteristics. For example, loans given by governments are renegotiated in several cases, to the point that they may be written off. Meanwhile, as they are shown as possible recoveries, they provide a misleading picture. In addition, the contingent liabilities arising from internal and external guarantees are generally ignored until it is too late. These aspects require a risk management strategy, which is in general, not available. Second, the forecasts are often restricted to the central government, and in several cases, too aggregative and mostly in the nature of baseline projections rather than reflecting the expenditure dynamics of the categories. These methodological shortcomings are not insurmountable and improvements can be undertaken with ease. In undertaking such improvements, it has to be recognized that preparation of a forecast by itself would be of little use, unless the end uses are explicitly recognized and those features are built into the system. Third, in countries that are mostly dependent on foreign aid, the forecasts have not proved to be very valuable as the final levels of outlays were dependent on the aid

received than on the needs. This illustrates the need for a more detailed dialogue with the donors. Fourth, the general experience reveals that once forecasts are made, the spending agencies tend to view them as floor levels for obtaining resources. In some cases, given the dependence of the central agencies on the estimates provided by the spending agencies, they had little opportunity to scrutinize the estimates in detail. Fifth, in some cases, the resource constraints were not internalized as the forecasts were limited to outlays and did not include revenue forecasts. And, finally, the forecasts did not explore the alternative approaches to service delivery (e.g. public-private financial partnerships). In view of these shortcomings, the legislatures and the public would not appear to view them as credible. In at least one case (e.g. India), the experiment of running medium term forecasts was abandoned, as it was felt that it was contributing to a lessened importance of the established developmental planning machinery.

These issues need to be addressed frontally and properly if the systems have to gain credibility. The point of review is to identify the gaps that need to be remedied.

## **2. Macroeconomic Framework and the Annual Budget**

Proceeding from a properly prepared MTFF, the formulation of an annual budget should be an easy and a normal step. In reality, however, the annual budget exercise could be different, not in nature, but in terms of the changes that have taken place or are likely to take place in the national economy. Adjustments from the MTFF could involve two steps: (i.) an evaluation of the changes that have taken place in the economy and the proposed policy responses; and (ii.) addressing the unresolved dilemmas in the MTFF. The former could involve, depending on the situation, a sudden reversal in the policy direction and revisiting the policy debates previously faced. Where no MTFF or MTEF are formulated, annual budget making would involve an assessment of the national economy, its likely impact on the budget categories and the desired influence proposed for the next year's budget.

The general framework of objectives, ranges of instruments available and their applicability are summarized, for facility of discussion, in [Table 3](#). The most important consideration relates to the determination of the size of the fiscal deficit (surplus) in the light of the estimated changes in the magnitudes of revenues and expenditures. Most of these are generally estimated in terms of the expected changes in the GDP. Notwithstanding a considerable amount of progress made in the computation of GDP, in several countries, they remain, for the most part, tentative and are revised, several times, during the year. The revisions reflect problems of coverage, and classification, both with profound impact on the budget categories. Further, the use of a GDP deflator may not fully reveal the likely changes in the expenditure magnitudes of some categories, e.g., defense. Each major category of government expenditure is likely to be more affected by the price index of that sector and to that extent, the calculations made on the basis of GDP deflator may prove to be underestimations.

The consideration of needed adjustments is undertaken simultaneously for revenues and expenditures (and debt). These aspects are illustrated in [Chart 6](#). It has to be noted, however, that in countries which are substantially dependent on foreign aid, much is dependent on the dialogue with donors. In both cases, it is of utmost importance to resist the impulse to engage in the formulation of a rosy scenario as optimism in the early stages could lead to a series of problems at a later stage. As for expenditures, a distinction is made between discretionary and non-discretionary types, but the distinction may actually be overstating the flexibility available to government, for what is available in

theory, may be constrained by political factors, e.g., wages and subsidies may not lend themselves to quick adjustment as the community's expectation may be in the opposite direction. The approaches of economists and finance managers tend to be different to expenditures. Economists view the situation, as illustrated in [Chart 6](#) in terms of objects of expenditure, while the latter view them in terms of programs and projects. From the point of delivery of services, it is the programs that are important. Ideally, expenditure adjustments are best viewed in terms of program costs and the possible approaches toward their reduction. In practice, however, many governments do not have cost data and where they are compiled, they reflect cash flows more than the accrued cost of resource use. Strategic choices required to be made are in terms of programs which also implies that all expenditures should not be treated as equal. For policy purposes, they are unequal and should be so considered. From the macroeconomic point of view, the total level of expenditure is an important policy variable. From the point of service delivery, it is the program which is the focal point and these macro and micro aspects are expected to be reconciled during the annual rite of policy making.

Another important area meriting recognition relates to the performance during the previous and current years. As noted above, between intent and reality, there are several shadows, some creeping and some that have become explicit. These administrative factors are important as the economic ones. Identification of these slippages and consideration of the factors contributing to the slippages, requires up-to-date reporting systems. Lags in reporting contribute to distortions in policy making.

### ***Areas for Review***

- (a.) Policy formulation: adequacy of structural, analytical and informational aspects.
- (b.) Economy and business cycle: Adequacy of existing mechanisms and their impact on budgets.
- (c.) Policy responses and adequacy of budgetary instruments
  - Types of expenditures
- (d.) Features of MTEF and MTTF
  - coverage
  - level of aggregation
  - price level
  - deficit
  - use of econometric methodology
  - use of MTEF and MTTF for decision making
- (e.) Adequacy of organizational process to internalize the results of MTEF and MTTF
- (f.) Attention paid to issues
  - Formulation of strategy
  - Assessment of risk
  - Consultations with donors
  - Dialogue between central and spending agencies
  - Exploration of service delivery

- (g.) Macroeconomic framework and annual budget
- Identification of linkages
  - Use of GDP deflator and other indices
  - Adjustments in revenue and expenditure items: different approaches and their usefulness
  - Formulation of policies and choice of instruments; issues in their effective use.

