Beyond the Annual Budget

Global Experience with Medium Term Expenditure Frameworks
Medium-term expenditure frameworks (MTEFs) constitute an approach to budgeting and public financial management (PFM) that addresses well-known shortcomings of annual budgeting, including short-sightedness, conservatism, and parochialism (Wildavsky 1986). Most public programs require funding and yield benefits over a period of years, but annual budgeting largely ignores future costs and benefits. Multiyear budget planning is the defining characteristic of MTEFs. Annual budgets typically start with the previous year’s budget and modify it in an incremental manner, making it difficult to reprioritize policies and spending.\(^1\) As a result, spending patterns become entrenched, even in the face of changing needs. MTEFs take a strategic forward-looking approach to establishing priorities and allocating resources, which allows the level and composition of public expenditure to be determined in light of emerging needs. MTEFs also require policy makers to look across sectors, programs, and projects to see how spending can be restructured to best serve established policy objectives. As a consequence, the opportunistic interests of spending agencies and beneficiaries that are a feature of annual budgeting should no longer dominate to the same degree. However, for these benefits to materialize, an MTEF cannot be regarded as separate from and only loosely related to the annual budget. MTEFs must eventually replace
the annual budget as the centerpiece of the budget process. Indeed, an MTEF requires budget preparation to go beyond the annual budget to take account of the medium term.

MTEFs translate macrofiscal objectives and constraints into broad budget aggregates and detailed expenditure plans, guided by strategic expenditure priorities. When an MTEF is implemented well, public expenditure is limited by the availability of resources, budget allocations reflect spending priorities, and public goods and services are delivered cost-effectively. MTEFs therefore offer the prospect of achieving the three high-level objectives of public expenditure management: aggregate fiscal discipline, allocative efficiency, and technical efficiency (level-one, -two, and -three budgetary objectives).² Traditional annual budgeting often falls short of meeting these objectives. Moreover, with macrofiscal policy increasingly being framed in a medium-term context, guided by debt sustainability analysis, multiyear fiscal targeting, and in some cases permanent fiscal rules, MTEFs establish a formal link between broad fiscal policy objectives and budgeting, which can strengthen the credibility of both. This can be particularly important when countries are implementing a medium-term fiscal adjustment program, since an MTEF can signal a government’s commitment to high-quality adjustment based on prioritization of spending and reduction of waste, which are often key to successful adjustment.

MTEFs can also leverage the fact that aggregate fiscal discipline, allocative efficiency, and technical efficiency are closely linked objectives. Governments can focus more on the microeconomic challenges of improving expenditure efficiency when they do not have to address the adverse macroeconomic consequences of persistent fiscal imbalances.³ Conversely, efficient public spending makes it easier to maintain fiscal discipline, since both allocative and technical efficiency reduce waste and thus alleviate the overall resource constraints. While the search for allocative efficiency does this by squeezing unproductive expenditure programs, technical efficiency requires pursuing objectives with fewer resources. Moreover, when the government is committed to fiscal discipline, new expenditure needs are more likely to be accommodated by reallocating spending than by providing additional funding. Finally, both fiscal discipline and expenditure efficiency create fiscal space that can support productive spending on economic and social infrastructure as well as on other high-priority areas. Fiscal space can also be used to respond to upcoming fiscal challenges (for example, population aging, climate change) as well as ever-present fiscal risks (for example, calls
on government guarantees, natural disasters). MTEFs provide a basis for considering these fiscal management challenges and the links between them within a consistent framework.

The power of MTEFs to generate good fiscal performance derives from their impact on the quality of budgeting and budget credibility. MTEFs help to reduce shortcomings of annual budgeting by achieving the following:

- **Budget realism.** The revenue that the government can reasonably expect to collect and the new borrowing that it can safely undertake should place an upper limit on spending. This contrasts with the fairly common situation where governments formulate ambitious annual spending plans based on unreasonable expectations about potential revenue and borrowing capacity.

- **Spending driven by medium-term sector strategies.** Rather than preparing an annual budget by making incremental changes to current programs, determining priorities based on the latest political imperative, budgeting separately for capital and current expenditures, ring-fencing chosen programs and projects, and building other rigidities into the budget, resource allocation should reflect an assessment of priorities within and between sectors based on agreed objectives and policies.

- **Spending agencies with a voice.** Instead of focusing primarily on compliance with expenditure controls, ministries, departments, and other spending agencies should have significant input into the design of sector strategies and some flexibility in managing their resources to pursue sector objectives and implement sector policies efficiently.

- **Budgets containing multiyear spending allocations.** To the extent possible, spending agencies should have a predictable resource envelope to ensure effective decision making, which is lacking when budgeting involves annual negotiations over incremental resources. With an MTEF, spending agencies have reasonable assurance about the resources they are likely to receive over the medium term. This not only makes it easier to plan multiyear expenditures, but also gives spending agencies the confidence to change policy direction.

- **Budget funding linked more closely to results.** A shift in focus from control of inputs to flexibility in the mix of inputs to produce specific
outputs and outcomes allows greater emphasis on allocating resources according to the results achieved by spending programs and provides more discretion over the choice of inputs used to achieve particular results.

- **Greater fiscal transparency and accountability.** MTEFs provide a clear-cut mechanism for monitoring government performance against approved plans, which makes it easier to hold governments accountable for their choice of fiscal policies.

**The Debate over MTEFs and the Role of the Bank**

MTEFs are not a recent innovation, but their spread around the world is a recent phenomenon. In one form or another, MTEFs have been around since at least the early 1980s, when Australia launched its forward estimates system. A few industrial countries followed suit in the 1980s and early 1990s (Denmark, New Zealand, the Netherlands, and Norway), but some African countries implemented MTEFs only in the late 1990s. The specific context in these countries (with the exception of South Africa) was the need to ensure a multiyear commitment of resources to policies included in poverty reduction strategy papers (PRSPs). Donors played an important role in encouraging the implementation of MTEFs. Part of their motivation was to improve public financial management as a means to ensure that external assistance and domestic resources would support development programs directed toward poverty alleviation.

Consequently, the World Bank built MTEFs into the standard budgeting toolkit that it was recommending to client countries at the time. This toolkit became an integral part of the *Public Expenditure Management Handbook*, which says that an MTEF “facilitates the management of policies and budget realities to reduce pressure throughout the whole budget cycle, … results in better control of expenditure and better value for money within a hard budget constraint, and resolves the tensions between what is affordable and what is demanded” (World Bank 1998, 9).

Over the period from 1991 to 2010, the Bank was directly involved with MTEF reform in 109 low- and middle-income countries in all six regions. Products focusing on MTEFs were mainly lending operations, analytical and advisory activities, and, to some extent, technical assistance. As figure 2.1 shows, the number of products has increased significantly over time, especially in the late 1990s and early 2000s, with the total number of products reaching 691 by 2010. The Bank provided advice on
MTEFs most actively in Africa (354 products) and in Europe and Central Asia (152 products), mainly in low-income countries. The spikes in the Bank’s engagement with MTEF reforms shown in figure 2.1 tend to be associated with broader Bank initiatives in the area of public financial management, such as publication of the *Public Expenditure Management Handbook* (World Bank 1998), the launch of the enhanced Heavily Indebted Poor Countries (HIPC) and PRSP Initiatives, and the introduction of the public expenditure and financial accountability (PEFA) framework or work at the country level, such as the preparation of a PRSP or a PEFA assessment. The objectives most commonly pursued in the context of MTEF reforms supported by the Bank are allocative efficiency, followed by aggregate fiscal discipline. Appendix A provides more detail on Bank operations focusing on MTEFs.

The Bank’s involvement with MTEFs picked up significantly despite early concerns that MTEFs might not be living up to expectations. Following some initial reviews that raised issues about MTEF implementation (see, for example, McNab, Martinez-Vazquez, and
Boex 2000; Oxford Policy Management 2000), two studies examined MTEFs in Africa. Le Houerou and Taliercio (2002), in a Bank study, draw lessons from MTEFs in 13 African countries, all but one of which were introduced with Bank support. Holmes and Evans (2003), for the Overseas Development Institute, review experience with MTEFs in the context of PRSPs in nine countries (eight of which are in Africa). Both studies identify similar shortcomings of the MTEF reforms:

- Initial country conditions, especially with regard to basic aspects of budget management, are not taken sufficiently into account.
- With the exception of a few cases, inadequate attention is paid to the political and institutional aspects of the reform process.
- Operational MTEFs do not resemble their textbook counterparts.

However, while Le Houerou and Taliercio (2002, 25) conclude, “MTEFs alone cannot deliver improved [public expenditure management] in countries in which other key aspects of budget management remain weak,” Holmes and Evans (2003, 31) conclude more optimistically, “MTEFs are progressing, albeit unevenly, and . . . in many cases they have both facilitated and are being strengthened by the current emphasis on implementing PRSPs.” These studies are summarized in more detail in appendix B.

The experience with MTEFs has also increasingly become a subject of other reviews. Oxford Policy Management (2008, 2009) has followed up on its 2000 assessment with suggestions on how to make MTEFs more effective. Filc and Scartascini (2010), Kasek and Webber (2009), and Oyugi (2008) examine the experience with MTEFs in Latin America, emerging Europe, and Southern Africa, respectively. These studies, which are summarized in appendix B, largely confirm the above observations about MTEF performance.

**Rationale for This Study**

On the basis of these studies, it may seem that there is little need for another assessment of the experience with MTEFs. Rather, the focus should now be on strengthening existing MTEFs as well as providing a blueprint for the successful implementation of new MTEFs. However, the available studies have significant limitations. First, their conclusions are derived mainly from country case studies, which lack empirical evidence supported by quantitative analysis. Second, they focus on a relatively
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small sample of countries. The emphasis to date has been on countries with MTEFs, especially in Africa and where the World Bank has supported their implementation. Third, MTEFs have become much more popular since the late 1990s, so studies undertaken in the early 2000s had relatively little experience to work with or time series to analyze.

This study aims to undertake a more comprehensive review of the experience with MTEFs and to address the limitations of the previous assessments. This is accomplished in the following way:

- **Methodological approach.** While it is not unusual to employ country case studies when reviewing the experience with policy reforms, there is scope to apply a wider range of analytical techniques to the available qualitative and quantitative information, with a view to identifying economic, political, institutional, and other (for example, regional) patterns that may be helpful in understanding differences in country experiences with MTEFs as well as in examining the effect of MTEFs on fiscal performance. Therefore, this study relies on multiple techniques, including event studies, econometric analysis, and case studies.

- **Country coverage.** This study looks at the experience of countries with and without MTEFs. Even if the goal is to improve World Bank advice on MTEFs to its clients, much can be learned from the experience of all countries that have introduced MTEFs and, for benchmarking purposes, of those that have not.

- **Timing.** MTEFs can take many years to implement in full, which means that having an additional five or more years of experience to examine is significant and can potentially yield meaningful insights.8

**Notes**

1. While incremental budgeting can work well in times of revenue growth, it comes under particular pressure when revenue falls, becomes more volatile, or reaches its natural limit, because this is when expenditure prioritization takes on increased importance.

2. These objectives cannot be viewed in isolation. Success in meeting them requires that budgetary and PFM systems function well, a subject discussed later in the book. There is also a link to broader economic developments (Campos and Pradhan 1996). Improved fiscal outcomes contribute to higher growth, lower inflation, and macroeconomic volatility. In addition, as the quality of spending improves, higher incomes should be accompanied by lower poverty rates, while better infrastructure should contribute to even higher growth and further poverty reduction.
3. Some argue that, in fact, large deficits prompt better expenditure prioritization; however, the lessons from fiscal adjustments around the world suggest that spending cuts are borne disproportionately by high-priority spending, especially public investment in infrastructure, with adverse consequences for future growth (see, for example, Easterly, Irwin, and Servén 2008). Lewis and Verhoeven (2010) report that the growth of public social spending has dipped as the global financial crisis has put fiscal positions under pressure and suggest that this “risks setting back achievement of human development goals.”

4. Australia replaced annually negotiated expenditure appropriations with policy-based medium-term allocations that were updated periodically to reflect new economic and programmatic developments. New policies were included as decisions were made (see Keating 2001). The United Kingdom had an embryonic MTEF system going back to the 1960s, when public expenditure survey committees were introduced, although the process was not called an MTEF in those days.

5. While recognizing the importance of multiyear planning, the International Monetary Fund (IMF) did not explicitly recommend MTEFs in its PFM guidelines (Potter and Diamond 1999). However, the IMF views MTEFs as good for fiscal transparency, for the same reasons that the Bank advocates them (see IMF 2007).

6. If products focusing on high-income countries are included, the total number of countries is 110. There are six such products and they comprise countries that reached high income level recently.

7. Out of this total, project documents are available for only 363 products.

8. On average, countries that take a gradual approach to implementation (as recommended later in this study) need about six years on average to put in place a full-fledged MTEF. Some countries have taken or will need much longer.

References


