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**Task Force for the Implementation of the Environmental Action Programme for Central and Eastern Europe, Caucasus and Central Asia  
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**INTRODUCTION TO MEDIUM-TERM EXPENDITURE FRAMEWORKS (MTEF)**

**Briefing Note**

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*This Briefing Note looks into the major (theoretical) premises of medium-term budgeting. It is based on a review of existing literature and analytical studies. It discusses the main elements of public finance reforms that have been taking place with the aim of improving the effectiveness and efficiency of the allocation of scarce resources across different sectors.*

*The Briefing Note is based on a recent OECD paper that discusses the use of Medium-term Expenditure Frameworks in a development cooperation context.*

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## 1. BACKGROUND

There is a growing recognition that strong national public finance management systems, including budgetary processes, are valuable public goods in and of themselves. One set of reforms designed in recent years to strengthen the budget process has been the introduction of a multi-year budgeting process, which most often takes the form of Medium-Term Expenditure Frameworks (MTEFs)<sup>1</sup>.

Originally pioneered in OECD countries such as Australia and New Zealand which began to develop a 'modern' approach to public finance management, MTEFs are now being adopted wholly or in part in many non-OECD countries too. They are seen as particularly useful as a means of mapping national priorities set out in Poverty Reduction Strategy Papers (PRSPs) into government budgets. This reflects a realisation that the annual approach to budget making actually undermines budgetary performance, contributing to fiscal instability and, perhaps even more fundamentally, to resource misallocation and the inefficient and ineffective use of resources.

In non-OECD countries the disintegration of the links between policy making, planning, budgeting and sector and agency management of policies and resources have been both a cause and a symptom of this focus in the short term. Policy making and planning (and, in fact, management) have been inadequately disciplined by the lack of any sense of a sustainable aggregate resource constraint (donor practices often contribute to this). Development impacts, which require a medium to longer-term perspective, have been all too frequently, and often unnecessarily, undermined by the short term imperatives of fiscal policy. In the meantime, it is only through being able to see how budgets are a time slice of medium to longer term priorities that the inevitable instability of the annual budget can be more effectively managed.

Until budgeting is required to take account of longer term resource realities and becomes more focused on policy priorities (taking account of the consequences of individual spending decisions over the longer term), the annual budget is likely to continue to lurch from crisis to crisis, with increasing recourse to quick fixes. Over the years, traditional, bottom-up budgeting, has been complemented by other approaches, such as top-down, medium-term expenditure frameworks and performance budgeting, which have been introduced to guide the annual budget process.

Where MTEFs were adopted to translate national policy objectives into public expenditure allocations within a multi-year macroeconomic and fiscal framework, one of the main concerns in this process has been the lack of capacity of sector agencies to prepare economically-sound, medium-term expenditure programmes which achieve their objectives in an effective and efficient manner. This is a particularly acute problem in ministries of environment and those involved in natural resource management. The cross-sectoral nature of many environmental issues, requiring coordinated action from a broad range of public sector institutions, presents a major challenge.

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<sup>1</sup> The MTEF concept was developed by the World Bank and promoted in non-OECD countries, particularly in the context of the Poverty Reduction Strategy Papers (PRSPs).

## 2. DEFINITION OF TERMS

There is no single, concise definition of the term ‘MTEF’. Rather, it represents a set of broad principles for sound budgeting that are implemented in different ways in different institutional settings. Indeed, this sensitivity to institutional setting is a crucial component of the design of a successful MTEF.

The term used in this paper for the specific instruments supporting a broad-based approach to medium-term budgeting is the Medium-Term Expenditure Framework (MTEF), but there are other terms. Some of these terms, used mostly in the OECD countries, include: multi-year expenditure framework, multi-year budget, forward budget, multi-year estimates, forward estimates.

At its heart, the MTEF approach seeks to link expenditure allocations to government policy priorities using a medium-term (i.e. three to five year time horizon) budget planning and preparation process. In addition, this methodology typically involves a number of common core elements:

- A **unified ‘whole-of-government’ approach** that encompasses all sectors. If it is to be a genuinely strategic resource allocation mechanism the MTEF cannot be partial in coverage and cannot be meaningfully piloted in a sub-set of sectors. This is very often undermined by sectoral access to external funds through bilateral relationships with donors in non-OECD countries and by the fragmentation created by earmarked donor funding – direct budget support helps to avoid these negative aid impacts.
- A **‘top-down’ hard budget constraint** consistent with macroeconomic sustainability that limits overall levels of spending over the medium-term. This should involve credible, realistic resource projections that are in turn based on explicit and carefully considered macroeconomic assumptions. It should ideally be backed by political commitment from the executive and legislative branches and set in coordination with the various levels of government involved in the conduct of fiscal policy. Aid unpredictability undermines this component in many non-OECD countries.
- A **‘top-down’ set of strategic policy priorities** that together with the hard budget constraint drive, and are reviewed during, the strategic ‘front-end’ phases of budget preparation. In turn, decisions during the strategic phase on policy or ceilings will then drive the detailed preparation of budget and MTEF estimates.
- **‘Bottom-up’ forward estimates** of the costs of existing policies, programmes and activities over the medium-term supported by expenditure reviews.
- A single **nationally owned political process at the centre of government** that reconciles the bottom-up and top-down components, forcing policy priorities to be established within the overall resource constraint through resource allocation decisions. This includes the reallocation of resources from one sector to another (on the basis of transparent rules) as well as the allocation of any additional money or ‘fiscal space’ that arises. This process should ideally promote early decisions and limit the number of key decision moments.

- **A strong and clear link between MTEF projections and the annual budget process**, so that multi-annual targets (duly updated for changes in the macroeconomic situation) set in the previous years should form the basis upon which the budget is prepared. Ideally, there should be no meaningful distinction between the MTEF and the budget process: they should be one and the same thing.
- **A focus on results** (i.e. outputs and outcomes) rather than on financial inputs both in the structure of the budget and in terms of accountability. This means that sector managers are given a more predictable flow of resources coupled with more discretion over detailed budget management (on the basis that they have an informational advantage as to how best to spend public money) and are held accountable for delivery of results. It also means that budgets are structured on a programme basis with strong contestability of allocations from year to year, rather than on a traditional 'line item' basis whereby sectors are 'entitled' to their previous year's allocation plus some small additional increment. Thus, "*policy priorities drive funding and not the other way around*" (Holmes and Evans, 2003).

Many of the elements of an MTEF are inseparable from good public finance management more generally. One of the key ways in which an MTEF approach adds value is to encourage a systematic overview of the public finance management system, focusing attention on the benefits of having key components of the process (e.g. macroeconomic and revenue forecasting, costing of policy options, the comprehensiveness and structure of the budget, monitoring and evaluation) working well together as a coherent whole.

In turn, the MTEF approach also highlights the considerable requirements of good public finance management for environment (donor alignment with government policies *and* systems, lack of non-OECD countries in terms of both capacity (human resources in particular) and enabling fragmentation, inclusion of all spending 'on-budget'). Delivering an MTEF in non-OECD countries is an enormous challenge that requires a realistic and properly sequenced reform process tailored to the institutional setting.

### 3. BUDGETARY REFORM

#### The annual budget

In essence, the budget is a document which, once approved by parliament, authorises the government to raise revenues, incur debts and effect expenditures in order to achieve certain goals. Since the budget determines the origin and application of public financial resources, it plays a central role in the process of government, fulfilling economic functions (the budget is the state's financial plan), political (the budget process ensures that the people's representatives scrutinise and approve the raising of taxes, the contracting of debts and the application of public funds by government), legal (the enactment of the budget in law by parliament limits the powers of government, since the government may not raise taxes that have not been approved by parliament and may not exceed parliament's expenditure appropriations) and managerial functions (the budget communicates government policy to public institutions by informing them how much may be spent for what purpose, thereby guiding policy implementation).

In order to adequately fulfil these functions, the budget should be comprehensive and transparent, following clear rules and procedures which establish the relationship between the key institutions in the budget process. In most OECD countries, and an increasing number of non-OECD countries, these goals are achieved by establishing budgetary principles and procedures in a budget framework law. Some of these principles include: annuality (the budget is prepared annually and executed over a period of one year), universality (all state revenues and expenditures should be presented in the budget), unity (all revenues and expenditures, and financing requirements, should be presented within the same budget), pooling of resources (revenues should be directed to the common fund for the financing of all expenditures rather than earmarked for the financing of a particular institution, programme or expenditure item), classification of financial operations (public financial operations are often discriminated by institutional, territorial, functional and economic classifiers).

#### Common problems with annual budgeting

Most budgets are prepared using an annual bidding system. This has the advantage of decentralising responsibility for budget preparation to the agency responsible for budget execution, while ensuring that the Ministry of Finance has the final say on the overall budget allocations, thereby ensuring their consistency with national expenditure targets. However, the bidding system has been criticised extensively on the following grounds:

- **Failure to review the base budget.** Departmental bids generally take the previous year's budget as the base and request additional increments, ideally on the basis of an expansion of the services to be provided, more often as a percentage increase. Negotiations with the Ministry of Finance focus on the increment, giving little consideration to the bulk of expenditure. Consequently, the bid system gives little scope to review the relevance, efficiency and effectiveness of existing programmes or administrative overheads.
- **Departmental rather than programme or output orientation.** Budgets are prepared by and for administrative units rather than on the basis of the Government's objectives, programmes and activities. Emphasis is placed on the inputs required to ensure that the administrative machinery operates smoothly, with little attempt to relate inputs to activities or performance as measured by the services provided (outputs) or their impact on the public (outcomes). In resource constrained

economies, this can result in divergence between the functions fulfilled by institutions on paper and reality. Where funds are scarce they will tend to be channelled into payroll expenses, leaving inadequate resources for activities, resulting in schools without books or incomplete wastewater treatment plants.

- **Inadequate timeframe for analysis of expenditure.** An annual time frame will not capture the long-term implications of expenditure decisions: for example, the recurrent cost implications of on-going capital expenditures. This is particularly true for infrastructure, including environmental infrastructure projects, such as wastewater treatment plants construction, whose costs will not be reflected in the budget until they become operational. Similarly, the short-term focus is likely to subordinate longer-term development priorities to immediate needs.
- **Encouragement of a cynical attitude.** Spending agencies will tend to bid high because they expect their proposals to be cut back. As a result, Ministries of Finance will be faced with overall spending proposals that greatly exceed the overall targets and, under pressure of time, impose arbitrary cuts on agency proposals. Since the spending agency does not feel directly responsible for the final budget figures it has little commitment to the limits imposed. There is, moreover, an incentive for the agency to fully spend its budget, since the Ministry of Finance will generally take execution rates into consideration when setting the following year's budget limit. To avoid under spending, there is often a surge in agency spending in the last quarter, often on frivolous items. Moreover, spending agencies have no incentive to make savings which they fear will be sent back to the centre, and hence continue to plan budgets which feature a range of activities, facilities and staff which cannot feasibly be funded at efficient levels of activity.

Awareness of these problems is nothing new. There is a long history of attempts at budgetary reform, most of which were initiated in the United States and Europe and subsequently filtered down to non-OECD countries (e.g. zero-based budgeting of the 1970s). These reforms met with little success, largely because they sought to address technical problems and failed to improve managerial capacity at operating levels.

More recent reforms have, in contrast, sought to combine technical innovation with managerial reform by increasing the autonomy and accountability of government agencies, giving them greater flexibility in the use of resources while holding them responsible for results. Some of these reforms include the introduction of MTEF and performance budgeting.

### **From bottom-up to top-down budgeting**

Introducing multi-year budgeting is not an end in itself. In most countries, the main reason for introducing a medium-term perspective to budgeting was strengthening fiscal discipline. In the late 1980s-early 1990s, many OECD countries suffered huge fiscal deficits, brought on by shrinking tax revenues and sustained increases in public expenditure. Policy measures that had been implemented to counter the growing fiscal deficits by controlling public expenditure did not prove effective against deteriorating fiscal situations. As public finance worsened, OECD governments decided to reform their existing budget formulation systems.

Until then, the bottom-up budgeting system was the main approach to budgeting. Budget formulation in the **bottom-up budgeting system** begins when all agencies and ministries send their requests for funding to the Finance Ministry. These requests typically far exceed what the agencies or ministries realistically expect to get. Starting from these requests, the Finance Ministry and line ministries will go through iterative rounds of negotiations until some common point is found. This is time-consuming and essentially a game between the finance ministry and line ministries. Most importantly, however, the negotiating process is bogged down in details and the ministry of finance loses track of the bigger picture.

In addition, given the annual perspective of the budget, expenditure which would accrue in the near future would remain hidden or disregarded by politicians whose political mandate might have terminated by then. As a result, in the late 1980s–early 1990s, fiscal deficit became a permanent feature of many OECD economies.

To overcome this unsustainable public expenditure and budget formulation practice, a number of OECD countries introduced **top-down budgeting**. The main feature of this new budgeting approach is that it allows the ministries of finance (or the respective government planning authority) to focus on setting aggregate limits and sector expenditure ceilings for line ministries, according to national objectives and priorities. This allows line ministries to decide on the allocation of resources across individual programmes within their assigned spending ceilings.

Thus, the ministry of finance does not need to intervene in detailed resource allocations made by line ministries. The main role of the ministries of finance is to monitor that allocations are conducted in accordance with set rules. As such, line ministries can use their best expertise to allocate resources internally in order to achieve their policy objectives. Therefore, the budget process started creating a sense of ownership in line ministries for the actions they take. Most importantly, to be effective, this process needed a longer-term perspective, so countries chose to design their fiscal and expenditure envelopes on a 3 to 5 year basis.

The credibility of this system lies in the first place in the capacity of the government to estimate total available resources for the public sector over a multi-year period, usually within a multi-year macroeconomic and fiscal policy framework. While the estimation and modelling process is mostly a technocratic exercise, there are a number of strategic and political decisions that depend on government choices which will shape the economy and thus the strength of the fiscal base of the country. Some of these include what structure of the economy will be supported by the government, the level of debt that will be incurred by the government or guaranteed by it and the overall taxation policy.

The development of sound conservative macroeconomic forecasts for budget formulation is crucial. Most governments identify at a minimum pessimistic and optimistic scenarios. Being optimistic, which serves primarily a political purpose, is likely to lead to excessive spending relative to likely revenues, as well as higher deficits and debt. Good practices show that comparing government estimates to estimates prepared by economic researchers from private sector institutions or non-governmental organisations (and using consumer confidence surveys) usually provide a more realistic picture.<sup>2</sup>

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<sup>2</sup> Countries use a variety of techniques to assure sound economic estimates, some during the budget development stage (*ex ante* to budget enactment) and some after budget passage. Among *ex ante* good practices are: comparison with private or academic forecasts during forecasts development, using the median forecasts of several reputable non-government organisations, economic updates prior to the budget enactment that allow for modifications to the budget proposals to fit emerging trends, inclusion in the budget of a table comparing the key economic variables of the government forecast with several reputable private or public forecasts with explanations for significant variation in median forecasts and having multiple government forecasts that could be the basis of budget development. Good practice also includes setting aside “reserves” during budget formulation to account for some variation in forecasts after budget passage, mid-fiscal year economic updates after budget passage combined with required proposals to bring the budget in line with emerging trends during the fiscal year, formal procedures for passing supplemental budgets during the fiscal year.

While top-down budgeting gained importance in many OECD countries in the 1990s, experience shows that this system needs to incorporate elements of the bottom-up approach as a complementary method in the budget process. In developing new initiatives, funding decisions should be made through a programme/project-based review (a typical element of a bottom-up approach), since the finance ministry will often lack information and data on the programme/project to judge the fiscal implications of the proposed initiative, such as performance data and total programme cost projections over the long term. Therefore, line ministries are usually required to submit detailed proposals to the finance ministry. In addition, individual programmes need to be reviewed in order for the finance ministry to monitor whether they are consistent with the fiscal rules.

**Box 1: Comparison between bottom-up and top-down approaches**

**Bottom-up**

- Ministry by ministry analysis that largely ignores economic forecasts
- Annual
- Time-consuming
- Ownership of proposals is more agency-specific
- Reactive

**Top-down**

- Aggregate fiscal analysis that takes into account economic forecasts
- Multi-year
- Delegated authority
- Creates joint ownership of proposals
- Proactive

**From top-down budgeting to medium-term expenditure framework**

Experience in OECD countries shows that the top-down budgeting system cannot work as expected without an effective medium-term expenditure framework. Most countries that employ top-down budgeting have also adopted MTEFs. The more ‘modern’ approach to public finance management with which the MTEF approach is associated seeks to structure the budget around broad programmes which are defined along government policy objectives and linked to specific outcomes. An example of a programme might be the ‘policy articles’ which comprise the Netherlands’ budget, with specific articles such as ‘Landscapes and Recreation’ in the Ministry of Agriculture, Nature and Food Quality’s budget. This makes it clearer what a given level of expenditure is intended to deliver and allows accountability to focus more on performance. In return, sector managers are granted more discretion over detailed budget management and empowered to use their greater informational advantage to deliver results.

The MTEF cycle can either be rolling or periodical. Rolling frameworks are drawn up during budget preparation every year or every two years. Year 1 in the previous year’s framework becomes the basis for the budget and a new year 3 is added (in case of 3-year frameworks). Thus, an MTEF cycle in a rolling framework will necessarily overlap with the previous and subsequent cycles by one or two years by design. By contrast, a periodical framework has cycles that run in sequence one after another. Specifically, a periodical MTEF is drawn up at the beginning of the period to which it applies and stays effective until that period has elapsed. Both rolling and periodical frameworks may be revised in the middle of their lifetime. The time span of an MTEF may run for two, three, four, or five years, including the upcoming fiscal year. The most commonly used period is three years.

#### 4. CHARACTERISTICS OF AN MTEF

According to the World Bank's *Public Expenditure Management Handbook* (1998), "The MTEF consists of a top-down resource envelope, a bottom-up estimation of the current and medium-term costs of existing policy and, ultimately, the matching of these costs with available resources...in the context of the annual budget process." The "top-down resource envelope" is fundamentally a macroeconomic model that indicates fiscal targets and estimates revenues and expenditures, including government financial obligations and high cost government-wide programmes such as civil service reform. To complement the macroeconomic model, the sectors engage in "bottom-up" reviews that begin by scrutinising sector policies and activities with the aim of optimising intra-sectoral allocations.

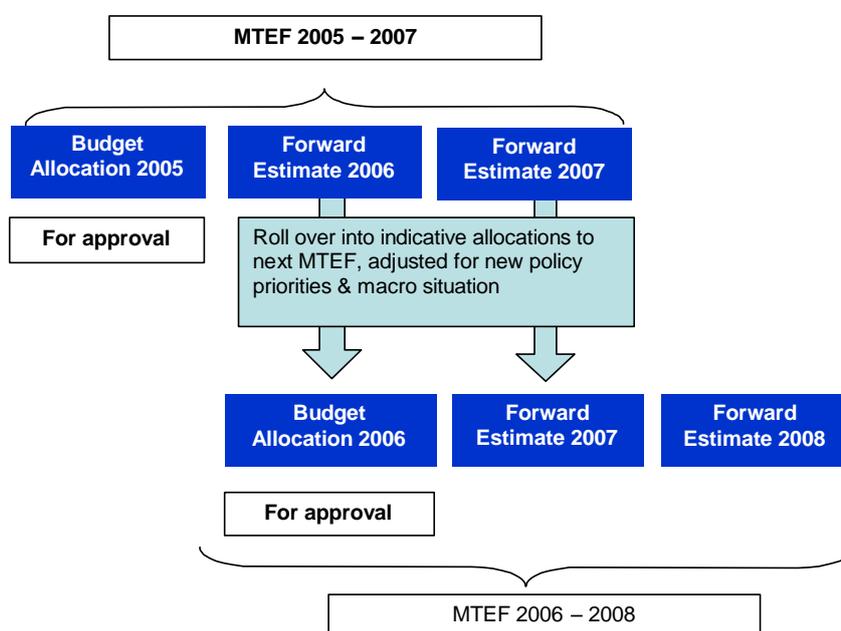
The value added of the MTEF approach comes from integrating the top-down resource envelope with the bottom-up sector programmes. These sector programmes are extensively discussed in the government as a result of which resource allocations by sector are agreed upon. It is at this stage of consensus building and negotiating inter- and intra-sectoral trade-offs (sectoral expenditure frameworks) that the policy making, planning, and budgeting processes are joined. Once the strategic expenditure framework is developed and the sectoral resource allocations defined, these are then used by the sectors to finalise their programmes and budgets.

Key to the sectoral review process is the notion that within the broad strategic expenditure framework, which reflects the resource constraint as well as government policy, sectors have autonomy to manage resources to maximise technical outcomes such as efficiency and effectiveness. Once the MTEF has been developed it is rolling in the sense that the first outward year's estimates become the basis for the subsequent year's budget, once changes in economic conditions and policies are taken into account. The integration of the top-down envelope with bottom-up sector programmes occurs by means of a formal decision making process.

As such, the main objectives of the MTEF are:

- Improved macroeconomic balance, especially fiscal discipline;
- Better inter- and intra-sectoral resource allocation through linking policy, planning and budgeting;
- Greater budgetary predictability for line ministries;
- More efficient use of public money through achieving performance and service delivery at least cost;
- Greater credibility of budgetary decision making (political restraint);
- Greater political accountability for public expenditure outcomes through more legitimate decision making processes.

Figure 1: Rolling baselines and MTEF



Source: ODI, Good Practice Guidance Note.

Central to the MTEF concept is the acknowledgement that the budget preparation phase is (and should be) fundamentally **political**, because it is about making real policy choices based on societal preferences and linking them to practical plans and resources. To make real policy choices the political process must be supported by certain **technical** elements, which include:

- a medium-term fiscal framework setting out the aggregates;
- estimates of the future costs of existing policy, and
- sector strategies setting out sector and sub-sector priorities for future spending.

Not all of these technical elements are going to be in place at the start of an MTEF process, but making progress towards them is a critical part of early MTEF development. While setting the medium-term fiscal targets and sector ceilings is usually a responsibility of the Ministries of Finance and/or Economy, estimating the costs of future policies and sector strategies and programmes lies with line ministries. This is the **entry point** for the sectoral ministries in the MTEF process and depending on the quality of the financing strategies and programmes prepared by these ministries, the programme cost estimates could be used as a basis for annual budget allocations. Often, unfortunately, one of the main problems in non-OECD is the lack of capacity and expertise to prepare credible programmes and strategies.

The most successful public finance reforms are those that have recognised the interdependence of these objectives. All these come together in the budget. A lesson from a number of non-OECD countries is that an MTEF can play a catalytic role in making the public sector more focused on achieving both fiscal discipline and results from government policies and spending. Implementing performance-based budgeting as part of the MTEF process could further strengthen the achievement of such results.

**Table 1: Comparison of single year budgeting and MTEF**

	<b>Traditional budget (at ministry level)</b>	<b>MTEF (3-year rolling programme at sector level)</b>
<b>Aggregate fiscal discipline</b> (To keep expenditure within the means)	Focused on short-term macro-economic concerns (with international agencies providing the discipline in many countries).	Situates short-term macro-economic concerns within a medium-term macro-economic and sector perspective. Involves building domestic macro-economic modelling capacity.
<b>Link between policy, planning and budgeting</b> (Reflecting the government's capacity and willingness to prioritise expenditure programmes)	Very weak because policy choices are made independent of resource realities. Thus, policy is not sustainable and spending patterns may not reflect the priorities articulated by government.	Policy-making tightly disciplined by resource realities. Thus, a much stronger link exists between policy-making, planning and budgeting. Spending reflects the stated priorities of government.
<b>Performance and service delivery</b> (Relating to operational performance of all resources both human and financial)	Incentives for results in terms of outputs and outcomes are generally low because emphasis is on input control. Little attention paid to the predictability of budget funding.	Emphasis is on the delivery of agreed outputs and outcomes with available resources. Incentives are structured to increase the demand for evidence of good performance (accountability of sector managers for results). Consequently, service delivery should improve.
<b>Autonomy of managers</b>	Generally low, because lack of discipline within the traditional budget framework is translated into detailed input controls.	Generally high because of greater discipline in setting and enforcing hard budget constraints plus accountability mechanisms that makes it possible for managers to be given more authority and autonomy to determine how agreed outputs and outcomes should be achieved.

Source: The World Bank and Korea Development Institute (2005).

Experience from OECD countries shows that **the success of the reform process depends on the budgetary basics** such as budget structure, scope and classification, accounting, information, evaluation and auditing. In many non-OECD countries, the budget structure is too complicated, its expenditure classification too subdivided, the coverage of the budget is too limited, excluding some important fiscal activities of the government. Current coverage of the budget is often not consistent with the Government Finance Statistics, an international standard for public expenditure statistics issued by the IMF. Another problem is the lack of well-developed information base and efficient channels to ensure sufficient information flows to facilitate strategic decision-making. Unless, these basics are well established, introducing MTEF may not generate anticipated benefits due to a weak public expenditure management environment<sup>3</sup>.

In all countries, a credible annual budget is the cornerstone of a successful MTEF. For medium-term expenditure projections to play a meaningful role in shaping future resource allocation decisions, they have to be rooted in a clear understanding of how much is being spent in the current financial year on a given activity. In addition, if an MTEF is to be more than a run of numbers in a document, they need to be supported by a set of rules and procedures that lend those numbers credibility. These procedures include an expenditure planning and arbitration process, accountability arrangements, rigorously enforced adjustment mechanisms, and medium-term commitment controls. A strong capable ministry of finance and a strong executive in parliament are crucial to ensuring that these "rules of the game" are both clearly defined and consistently enforced.

<sup>3</sup> Prof. Allen Schick, Look before You Leapfrog, 1998.

## 5. KEY LESSONS FROM THE OECD COUNTRIES

Experience of implementing medium term approaches to budgeting in OECD countries has provided a number of important lessons, including:

- The potentially damaging effects of over-optimistic assumptions about future economic growth. OECD experiences point to the importance of conservative estimates for economic growth, revenue and the resource envelope.
- A tendency for line agencies to view the out-year estimates as entitlements. A crucial lesson is to be clear about the status of out-year estimates and their binding nature (subject only to future policy change).
- Bottom-up budgeting alone does not fit well with a medium term approach. OECD countries have gradually moved to a more top-down approach to budget formulation, while agencies continue to prepare estimates within this framework 'bottom-up'.
- Political engagement is key with individual ministers engaging in decisions about allocating the top-down ceiling for their expenditure area, and much greater discipline in the parliamentary approval process.

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