



Greening Public Budgets in Eastern Europe, Caucasus and Central Asia: Highlights for Policy Makers

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Introduction

Public environmental expenditure remains crucial for addressing environmental problems and, more broadly, promoting a greener model of development in the countries of Eastern Europe, Caucasus and Central Asia (EECCA). Traditionally, however, the environmental sector in these countries has not been very effective in attracting domestic public financing. As the global economic and financial crisis imposes ever-tighter constraints on public budgets in the region, and as donors shift to new approaches of delivering aid via country systems, the environmental sector in the EECCA countries becomes increasingly vulnerable to underfunding.

In this context, the OECD/EAP Task Force analysed the opportunities for and obstacles to integrating environmental programmes into the medium-term expenditure frameworks (MTEFs) that a number of EECCA countries have introduced. To do that, the OECD/EAP Task Force undertook a regional survey, involving ten countries, namely: Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, the Russian Federation, Ukraine, and Uzbekistan. The key objective of this survey was to define whether the policy, legal, organisational and knowledge-related pre-conditions for achieving the financial sustainability of the environmental sector are in place in the participating countries.

The report, prepared on the basis of the results of the survey, aims to help EECCA environmental administrations to harness the potential benefits of on-going public finance reforms (PFM) in the region, with a focus on MTEFs, and their impact on the environmental sector. The purpose of this Policy Brief is to present some of the major findings and conclusions that emerged from the survey.

Experts from both EECCA ministries of environment and finance participated in the survey. The results of the analysis were discussed on several occasions, at expert workshops and official meetings organised in 2010-11.

The report was prepared with the financial support of the governments of the Netherlands and Switzerland. ■

What is a Medium-term expenditure framework (MTEF)?

At its heart, the MTEF approach seeks to link expenditure allocations to government policy priorities using a medium-term perspective (i.e. three to five year time horizon) to the budget planning process. Commonly viewed as a set of broad principles for sound budget planning, the MTEF-based budgeting is implemented in different ways in different institutional settings. This "institutional sensitivity" is crucial for the successful use of MTEFs.

Defined in more technical terms, a MTEF consists of: (i) a top-down allocation of the budget envelope; (ii) a bottom-up estimation of the current and medium-term costs of existing and new policies; and (iii) a process of matching costs with available resources in the context of the annual budget cycle.

In its most advanced form, the MTEF is a tool that helps public authorities to structure the budget around programmes that are developed in line with explicit policy objectives and linked to specific outcomes, thus aiming to integrate policy, activity planning and annual budgets. Although adopted from a wider public sector reform perspective, this new way of planning is particularly suited to the needs of the environmental sector. As OECD practice testifies, the long-term nature of some environmental policies and infrastructure development can benefit from the stability created by MTEFs. More generally, financially sound environmental programmes stand a better chance of obtaining adequate funding. Even when there is a need for budget cuts, such programmes will suffer less damage, particularly if their economic rationale and policy relevance is well-documented. ■

Major findings

The assumption, at the start of this work that the EECCA countries may have rudimentary systems in support to multi-year budget planning turned to be false. The major finding of this survey is that most of these countries adopted MTEFs within a rather short period of time and with a very comprehensive scope. In most cases, the policy and legal pre-conditions for functioning medium-term expenditure frameworks seem to be in place but the knowledge-based system to support their actual and successful implementation lags significantly behind. In other words, the devil is, as usual, in the details.

Greening the public budget does not imply a mere increase of the level of resources allocated for environmental activities; it also implies a more cost-effective use of the public resources which will never be sufficient to meet all public needs at the same time. From this perspective, the main results of the analysis conducted as part of the survey are summarised below.

Progress on enacting reforms of public finance management (PFM) in EECCA is significant...

On the whole, the national budgets in the EECCA countries have become more comprehensive, based on more realistic macroeconomic assumptions, owing to significant progress in the reforms in the public finance management that these countries put in place. Many of these reforms have been driven by international financing institutions but in some countries (e.g. the Russian Federation) they have been a result of a, more or less, genuine willingness of the government to strengthen fiscal discipline and

improve the management of public finances. Progress in consolidating various types of government resources (extra-budgetary funds, public investment programmes, and quasi-fiscal activities) into budget documentation going through legislative scrutiny and in introducing treasury systems and single treasury accounts is also visible. Most of the surveyed countries introduced a full classification of government revenues and expenditure by economic, functional, organisational and funding codes. This facilitates the analysis of social and economic effects of government revenue collection and spending policies (however, these classifications do not facilitate the programmatic approach to budgeting). These reforms were further consolidated in comprehensive Budget Codes, adopted by many of the countries, which also introduced a number of modern budgeting concepts and practices, such as MTEF and performance-oriented budgeting.

Most EECCA countries are in a process of implementing or considering to implement medium-term expenditure frameworks. Seven countries in the region have already introduced MTEFs, in one form or another. These include: Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, and the Russian Federation. The MTEFs in these countries (except in the Russian Federation) are rolling frameworks revised annually. Armenia has the longest experience with preparing MTEFs, as it launched its first one in 1999, and Kazakhstan - the shortest (since 2008). At the same time, Belarus is preparing its first medium-term framework which is being launched in 2011 and will cover the period 2011-13. Ukraine and Uzbekistan have not developed MTEFs but have introduced certain MTEF elements in their budgeting practices (two-year programme based budget

estimates in Ukraine and medium-term macroeconomic projections in Uzbekistan). In general, however, most EECCA countries still use in their MTEF and the

budget documents the Government Finance Statistics (GFS) budget classification rather than a genuine programme budget classification. ■

Table 1. Basic information on the MTEF status in the surveyed countries

Country	MTEF	Year of launching the MTEF	Number of years included in the MTEF	Number of programmes managed by environment ministries as part of the MTEF/annual budget process (2008)
Armenia	Yes	1999	3	38
Azerbaijan	Yes	2003	4	2
Belarus	No	Expected 2011	N/A	10
Georgia	Yes	2005	4	6
Kazakhstan	Yes	2008	3 (plans for a 5 year MTEF)	14
Kyrgyz Republic	Yes	2001	3	2
Moldova	Yes	2002	3	8
Russian Federation	Yes	2006	3	56
Ukraine	No, only certain elements	N/A	N/A	N/A
Uzbekistan	No	N/A	N/A	N/A

Note: N/A – non applicable.

The Russian Federation is a special case with not just a loose expenditure framework: the country has gone a step ahead and has introduced three-year budgets, the most recent one adopted by the Russian Duma in December 2010. Strictly speaking, very few of the OECD countries have ever worked with more than annual budgets, as legislatures are not constitutionally allowed to raise taxes or approve appropriations for a longer period than one year. In this context, it will be interesting to follow the Russian experiment and to learn from it.

In terms of MTEF coverage, five countries report full coverage (Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, and the Russian Federation) that is, all levels of government and all sectors are included in the MTEF, while Armenia and Azerbaijan report that MTEF applies to central government bodies only. The same five countries report that the ministries of environment were part of the MTEF process, since the MTEFs were first introduced.

Almost all countries in the region prepare some medium-term macroeconomic and fiscal projections, those who have International Monetary Fund (IMF)-supported programmes seem more likely to keep them regularly updated. To strengthen budget discipline, many countries have started introducing fiscal rules and top-down expenditure ceilings on initial ministries' allocations. Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Moldova report such fixed limitations or hard budget constraints for individual government bodies. These hard budget constraints seem to be working rather well and to have introduced a certain level of

stability and predictability in resource allocations. Most countries report that the MTEF/budget process has been increasingly made more policy oriented. Some countries (e.g. Armenia, Georgia, Moldova, the Kyrgyz Republic) have put in place institutional arrangements to guide and co-ordinate the process of MTEF preparation (sector working groups).

In addition, six countries (Azerbaijan, Belarus, Kazakhstan, Moldova, the Russian Federation, Ukraine (to a certain extent), have introduced programme budget classification, while Armenia is actively working towards introducing a fully-fledged programmatic MTEF. Obviously, programme as well as performance-based budgeting can be introduced independently from a MTEF process but, in reality, it makes little sense to prepare such a heavy exercise within the limits of one year only. Also, most countries have introduced some kind of performance indicators or targets but these are mostly related to financial information and serve little purpose in the resource allocation negotiations.

...but the adoption of MTEFs has hardly changed the political stance of budgetary processes

Legislative reforms have been conducted to mandate the use of MTEFs. The main issue however is how these reforms are translated into real (political) life. By and large, it seems that they have been implemented as a condition by donors and IFIs granting support to the countries. Policy makers and parliamentarians rarely use macro-economic projections or performance information in their

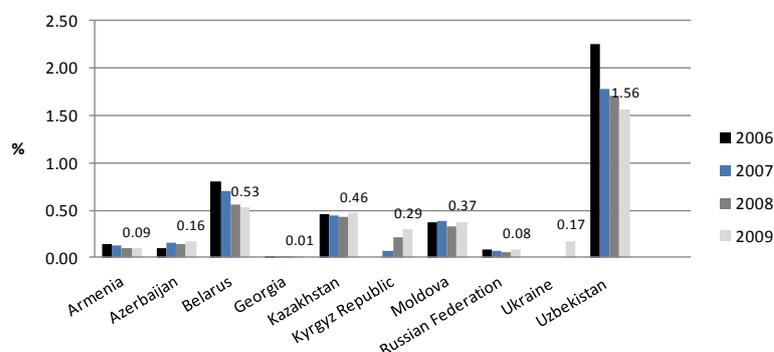
debates on policy priorities. The MTEFs are developed but not endorsed by parliaments. Often, there are no clear links between the MTEF and the annual budgets. In sum, there is little real demand for these modern budgeting practices on the part of politicians.

On the other hand, preparing a fully-fledged MTEF is a resource-consuming exercise and if the government is going to take a formalistic approach to its results, this will bring frustration and cynical attitude in staff and will be just a waste of money. There is some anecdotal evidence that this might be the case in some EECCA administrations. As long as parliaments and ministers do not seriously consider the medium-term costs of programmes in their policy and budget allocation debates, the MTEF will remain a technocratic exercise of little practical value.

Meanwhile, the financial sustainability of the environmental sector is further eroding...

The analysis of the survey data shows that public spending on the environment in the EECCA countries is rather low. The share of public environmentally-related expenditure in GDP, in 2009, varies across the countries, from 0.01% in Georgia to 1.56% of GDP in Uzbekistan. On a per capita basis, these expenditure are also small and in 2009 ranged from less than one USD per capita in Georgia to about 70 USD per capita in Belarus. For comparison, the public environmentally-related expenditure as a share of GDP, in the OECD countries, is on average between 1.5 and 2%. On the other hand, compared to what national budgets in the EECCA countries spend on other social sectors (e.g. health, education), environmental ministries' budgets are simply negligible. ■

Figure 1. Domestic public environmental expenditure as a share (%) of GDP, 2006-09



Source: EAP Task Force Secretariat own calculations.

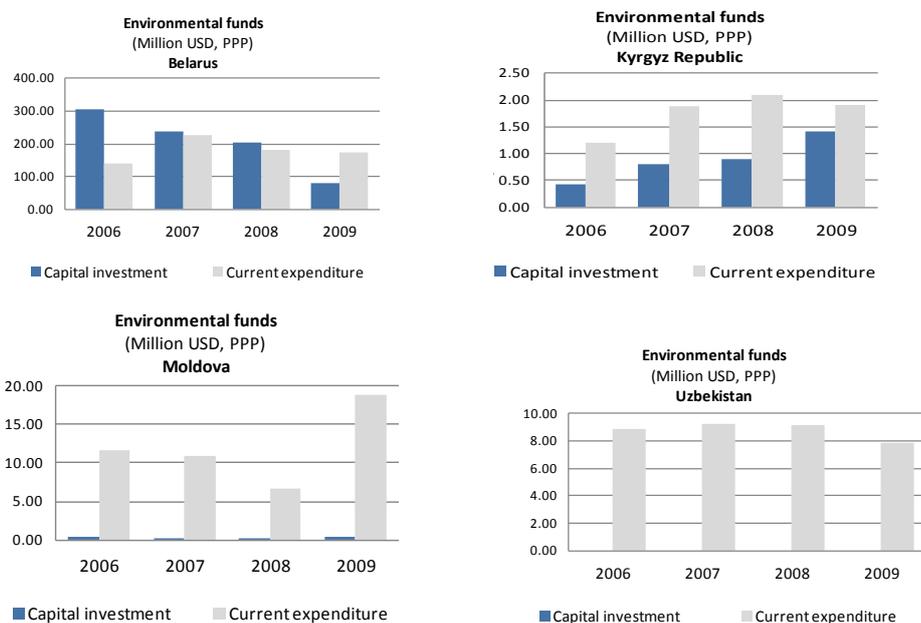
This picture may be more nuanced, however, since environmentally-related spending is spread over a large number of sectors. Further analysis, involving sectoral ministries, can shed light on the real picture of environmental expenditure. Together with the transition to the green growth model of development, this exercise can become even more complicated due to the lack of clear “borders” of green growth, on the one hand, and the traditional perception of environmental action as pollution abatement, on the other.

Most of the public resources of the EECCA environmental administrations, in 2009, go either to nature protection and conservation (Armenia and Kazakhstan) or water resources protection in Azerbaijan, Belarus, Moldova and the Russian Federation, followed by waste - in the Kyrgyz Republic, Ukraine and Uzbekistan. The countries (except Kazakhstan) spent most of the resources on supporting current expenditure rather than

investments. Georgia, for example, made almost no new public environmental investments in the period 2006-09.

In general, access to finance for environmental investments in EECCA is limited. Domestic capital and financial markets are weak and borrowing is expensive, hence the role of the domestic financial sector in environmental investments is negligible in most EECCA countries. Public support, including from (extra-budgetary) environmental funds (where these exist) and donor aid, remain significant sources of finance for environmental investments in some, though not all, EECCA countries. Carbon finance, for both mitigation and adaptation, is a potentially important source of finance for environmental expenditure that the EECCA countries need to exploit more consistently. ■

Figure 2. Capital investment *versus* current public environmental expenditure provided by environmental funds, 2006-09



Source: Country data.

One particular issue that needs special attention is the lack of (reliable) data. If aggregate data are more or less readily available, detailed information on spending by environmental media or types of expenditure are a challenge. Environmental data collection and reporting in line with internationally-recognised standards, such as those of the OECD and Eurostat, are still a weak point in EECCA policy making. A number of countries were not in a position to provide good quality public expenditure data and information and this raises concerns about the quality, sustainability and credibility of the environmental programmes prepared and supported by the environmental administrations. Without such basic data and understanding of what is generally financed at the national and local level, ministries of environment can hardly design programmes which will complement other funding sources. Problems like this become further magnified within the framework of medium-term expenditure planning where well-costed programmes are essential.

In the post-2012 global climate regime, donors and IFIs will be investing significant resources to support non-Annex I countries (most of the EECCA countries belong to this group). Future carbon finance mechanisms are likely to rely to a great extent on country-based systems for programme and project identification and implementation. Those countries that develop the necessary skills to prepare sound public expenditure programmes and identify cost-effective projects will be more competitive and will stand better chances of benefiting from international support. In order to be successful, such programmes need to be also integrated into the national

development strategies and medium-term budgetary processes. In addition, EECCA government administrations need to be willing to apply good practices in public expenditure management, such as accountability, transparency, and efficiency. Therefore, strengthening EECCA administration capacities in this area is key to access international carbon finance.

Because of limited capacity, the environmental sector benefits only marginally from PFM reforms

MTEFs have been introduced as a whole-of-government approach in most of the countries and the ministries of environment have been fully integrated in this process. While most of these ministries have extensive experience with preparing strategies and policies, their programmatic skills seem to be much lower. A lot of ministries' staff are involved in preparing programmes, including for inclusion in the MTEF process, but there is often little understanding of what this exactly implies. All countries have prepared numerous programmes, particularly the so-called targeted environmental programmes, but these are rarely properly costed or supported by specific implementation measures, such as financing strategies, market studies or feasibility analysis. Analytical tools, such as costing or cost-benefit and cost-effectiveness evaluation models, are rarely used in the programming process. Programme estimates are not sufficiently robust, the fiscal impact and economic implications of such programmes are not always clearly identified. Hence the habitually poor link of these estimates with the annual budget allocations.

In addition, programmes often lack clear and measurable environmental targets and benefits, performance indicators (particularly for the investment part) are not consistent across the years of programme implementation. Generally, only investment data are calculated, operation and maintenance costs are often not considered. Thus, environmental programmes often have little credibility.

Unfortunately, the reality is that even if other, more powerful, ministries are not particularly better in preparing programmes, because of political priorities, these other ministries are in a position to obtain more adequate level of resources. Therefore, the best way for the EECCA environmental authorities to overcome this obstacle is by developing their capacity to design, cost and defend their programmes on both environmental and economic terms and in line with good international practices. While it should be recognised that the budget process and resource allocation decisions are in large part of political nature, with or without a MTEF, the relatively low capacity of the environment ministries to prepare, cost and implement economically-sound multi-year programmes and finance cost-effective projects may have been one of the reasons for a low budget support for the environment. The absence of sound programming could contribute to a further marginalisation of environmental activities in the governments' agenda. At the same time, preparing a well-designed programme, consistent with MTEF requirements, is not a guarantee of increased financing: it is a necessary but not sufficient condition.

Procedural and organisational problems are likely to limit the finance absorption capacity of the environmental sector

Several ministries of environment report that they have not been able to spend even the little resources which they obtained from the budget. This may imply some problems with expenditure management practices. Only Armenia and Kazakhstan have dedicated staff responsible for working on MTEF preparation and co-ordination. In the rest of the countries, these functions are fulfilled by regular staff who do this work along with other routine responsibilities.

The management of investment projects is particularly weak in the EECCA countries. In general, there are no robust procedures, rules and criteria to support the investment project cycle. The appraisal and selection criteria are rather basic. Cost-effectiveness is not a prominent criterion in the appraisal of projects so it is not clear if the most cost-effective projects are selected to receive public support. The fact that most countries do not have dedicated staff to manage (appraise, select and monitor) investment programmes and projects on a daily, routine, basis prevents the creation of a critical mass of skills in the institutions as well as the development of project preparation capacity in the countries, for that matter. EECCA administrations' record with managing and capacity to implement

environmental investments is rather poor. This poor management of public environmental expenditure programmes leads to further dissipation of public funds, and weakens the claim of environment ministries for maintaining or increasing their budget allocation. This is particularly crucial when it comes to accessing international carbon funds where environmental ministries are often not the preferred partner. In consequence, there is a need to continue improving the programming, project preparation, and environmental expenditure management practices in the EECCA countries in line with good international standards.

The shift in donor financing approaches may bring new opportunities, but there is a risk of a further marginalisation of the environmental sector

In terms of donor financing, direct budget and/or sectoral support is being more widely used by donors and is replacing project financing. In most countries, however, all possible forms of donor support are co-existing (project and programme financing, sector wide and direct budget support). Therefore, it is difficult to make any strict conclusions on the basis of the limited data provided in the survey by the countries. It is important to note that data related to donor financing for the environmental sector are also sparse and difficult to obtain. However, OECD database on donor financing shows that over the past years donors like France, Germany, UK have started using this aid instrument on a regular basis. However, bringing all donor support on the budget in most of the countries still remains a challenge.

This shift in donor support practices imposes new challenges to the ministries of environment in the competition for public resources as they need to learn how to work with this new instrument. There is some evidence that countries are having difficulties in dealing, for example, with sector budget support. Experience from Moldova and Ukraine shows that the lack of sound strategies and financial plans for spending donor resources is a serious barrier to accessing donor funds. Unless ministries of environment improve their expenditure management practices, they risk to remain marginalised in this process and lose access to donor resources. Donors, on the other hand, can contribute to good public governance by supporting policy dialogues and actively participating in sector working groups which are responsible for the preparation of sectoral MTEFs.

Carbon financing, along with the budget and extra-budgetary environmental funds, is gaining place among the environmental funding sources. It has to be noted though that there will be a lot of competition for resources coming from carbon funds which also makes the case for improved financial planning, if the environment sector would want to get access to this source.

Developing technical expertise and promoting further transparency are crucial

Technical expertise in the preparation of programmes, setting targets and performance indicators and in improved project cycle management can equip ministries of environment with knowledge and skills that would make them more competitive. Donors have a crucial role to play in supporting such methodological and capacity building work in the countries.

The neutrality of the MTEF process with regard to individual sectors introduces a level-playing field that EECCA environmental ministries may be able to benefit from should they aim to change their traditional way of preparing their medium- and long-term programmes and annual budgets. Donors can be instrumental in supporting countries which are willing to improve their public environmental expenditure management practices.

A crisis period is often a good time to introduce and strengthen multi-year budgeting. This can help consolidate public budgets and better target policy actions as well as provide healthy public finance for the economy after the crisis is over. The governments and the legislatures need to create further demand for good practices in public expenditure management, including in the environmental sector, should the countries choose to improve their public finance systems and bring them closer to international standards.

Ministries of environment jointly with the ministries of finance and economy could prepare a government-wide methodology for multi-year environmental programmes for inclusion in the MTEF process, which will be prepared by different government agencies. They need to introduce clear rules and procedures for mid-term reviews of the programmes and possible ways for adjusting them as well as clear lines of responsibility for all actors involved in the implementation of such programmes. This may help overcome the fragmentation in the environment sector. ■

Major recommendations

To address some of the above challenges, the report makes the following major recommendations:

On the side of the EECCA ministries of environment:

Develop and/or review medium-term public environmental expenditure programmes, using state-of-the-art analytical tools for economic and financial evaluation, in order to ensure feasibility, affordability and cost-effectiveness of the programmes submitted for inclusion in the MTEF process.

Increase capacity for designing and costing medium-term programmes, for managing public environmental expenditure, and for appraisal and financing of investment projects.

Improve the information and data base for preparing medium-term environmental programmes; cooperate with national statistical services to use internationally-recognised methodologies and environmental expenditure classifications.

Increase the transparency of public environmental expenditure, and accountability for results; develop and maintain a database of all public environmental expenditure programmes.

On the side of the EECCA ministries of finance and governments as a whole:

Continue the alignment of legal frameworks for PFM with good international practice, particularly as concerns budget (programme) classification.

Make further procedural adjustments to ensure fiscal discipline and increased transparency of public expenditure, e.g. by improving overall reporting and information disclosure requirements as well as by strengthening internal control and external auditing.

Develop government-wide guidelines for the preparation and costing of environmental

programmes, and introduce cost-effectiveness as a criterion for project and programme appraisal, and for performance evaluation for all government agencies managing public expenditures for the environment.

On the side of donors:

Further implement the Paris Declaration on Aid Effectiveness, particularly concerning the provision of information on the amounts and timing of aid, and by aligning donors' priorities with the EECCA countries' priorities.

Support capacity development, e.g. the development of specific skills in EECCA ministries of environment related to analysing costs and benefits of environmental policies and programmes, the better integration of environmental programmes into MTEFs, and the development of appropriate analytical tools. ■

What is the EAP Task Force?

The EAP Task Force (Task Force for the Implementation of the Environmental Action Programme for Central and Eastern Europe) was established in 1993 within the Environment for Europe process. Secretariat support since then has been provided by OECD. The main objective was to establish a framework to support both national actions and international assistance for environmental reconstruction in the transition economies of Central and Eastern Europe. Sharing and adapting the experience of OECD countries was central to that task. During the 1990s, work was primarily focused on the countries of Central Europe, and was credited with helping to create a good basis for those countries to begin their accession dialogue with the European Union. The EAP Task Force also provided the model for a programme of regional environmental cooperation in South-East Europe following the break-up of the former Yugoslavia.

Towards the end of the 1990s, the work of the EAP Task Force shifted to Eastern Europe, Caucasus and Central Asia (EECCA). The new programme of work was implemented increasingly through demonstration projects that were designed to either develop or test tools that could support policy and institutional reform. The new approach helped secure important outcomes. For example, the preparation of finance strategies for water supply and sanitation has enabled some EECCA countries to provide more predictable and stable financing for this sector. Other activities have resulted in the adoption of integrated pollution prevention and control, the strengthening of environmental inspectorates and of public environmental expenditure management practices in these countries, and the establishment of schemes to rate industry's environmental performance. More attention has also been given to capacity development, including through training of civil servants. Activities were implemented in close cooperation with both aid agencies and environment ministries.

Following the 2011 "Environment for Europe" Ministerial Conference in Astana, Kazakhstan, the EAP Task Force's work will concentrate on financing water resources management, including adaptation to climate change, and on green growth.

For additional information

For more information about OECD's work on public environmental finance in the EECCA countries, please contact: Nelly Petkova, Tel: + 33 (1) 45 24 17 66, E-mail: nelly.petkova@oecd.org or see <http://www.oecd.org/env/eap>

For further reading

OECD (2011), Greening public budgets in Eastern Europe, Caucasus and Central Asia

OECD (2010), Medium-term Management of Green Budgets: The Case of Ukraine

OECD (2007), Handbook for Appraisal of Environmental Projects Financed from Public Funds

OECD (2006), Recommendation of the Council on Good Practices for Public Environmental Expenditure Management (C(2006)84)

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