Budget Reforms and the Medium-Term Expenditure Framework in Kenya

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Abstract

Many developing countries in Africa introduced planning systems after attaining independence but very little attention was given to budget systems as a tool for achieving plan targets. Recent recognition of the need to link budgets and plans has resulted in a wave of public expenditure management reforms. The latest effort has been the introduction of the Medium-Term Expenditure Framework (MTEF) process to re-orient annual budgets to a medium-term focus. This paper reviews various budget systems and evaluates the strengths of the MTEF process and the threats to its sustained implementation in the context of a developing country like Kenya. Previous reform efforts in Kenya are reviewed and it is observed that these reforms had objectives similar to those of the MTEF approach. The Programme Review and Forward Budget, for instance, was designed to link planning and budgeting and increase efficiency of public expenditure over a three-year horizon. The paper concludes that the MTEF is a powerful tool if fully implemented and adopted as the best practice. However, the MTEF process faces similar obstacles to those that contributed to the failure of past reform initiatives. In particular, the MTEF approach and associated public service reforms require total and sustained political commitment.

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Abbreviations

BNF	Budget Negotiation Framework
BPG	Budget Procedures Group
BRP	Budget Rationalization Programme
CBS	Central Bureau of Statistics
DPM	Directorate of Personnel Management
EWG	Estimates Working Group
FSP	Fiscal Strategy Paper
IPRSP	Interim Poverty Reduction Strategy Paper
KTMM	KIPPRA-Treasury Macroeconomic Model
MoFP	Ministry of Finance and Planning
MPER	Ministerial Public Expenditure Reviews
MTEF	Medium-Term Expenditure Framework
MWG	Macroeconomic Working Group
O&M	Operations and Maintenance
OP	Office of the President
PEM	Public Expenditure Management
PER	Public Expenditure Reviews
PIP	Public Investment Programme
PPBS	Programme and Performance Budgeting Systems
PR&FB	Programme Review and Forward Budget
PRSP	Poverty Reduction Strategy Paper
SPG	Sectoral Planning Group
SWAP	Sector-Wide Approach
SWGs	Sectoral Working Groups

1. INTRODUCTION

Many developing countries in Africa have engaged in detailed planning exercises of various types in the period after independence and this has resulted in a wide range of literature on planning. Little attention was paid to budget systems although this is generally recognised as the main instrument for allocating resources to specific recurrent and development activities. In recent years, however, budget systems have received more attention and literature on public expenditure management has become more common. The budget is increasingly recognised as the key tool for economic management. It is nevertheless also recognised that a country can have a sound budget and financial system and still fail to achieve its intended targets. This suggests that the rules of the game by which the budget is formulated and implemented are equally important and that they do influence outcomes (Schick, 1999). This recognition has led to a series of budget reform systems that have a broader focus on public expenditure management.

Budget reforms have been attempted in Kenya from as far back as the early 1970s but the results have not been encouraging. In recent years, a key recommendation has been to shift the focus from the annual budget to a Medium-Term Expenditure Framework approach to budgeting. Kenya adopted the MTEF approach in 1999 and implemented it for the first time in the budget presented in June 2000.

The purpose of this paper is to review budget reform initiatives with particular focus on the MTEF approach. The paper describes the budget system and reform efforts in Kenya prior to 2000 and discusses the introduction of the MTEF approach. The main historical approaches to budget preparation are described and their respective strengths and weaknesses evaluated. Although there has been increasing recognition of the need for budget systems to focus on outputs rather than merely to control inputs, major difficulties have been experienced in implementing and sustaining these systems, and also in budget management. The paper describes recent innovations in the MTEF process and outlines the main goals of the approach, the sequencing of the process, the strengths and threats of this approach in the context of a developing country. It reviews the budget system and reforms in Kenya before the introduction of the MTEF in 2000, describes previous reform efforts, notably the Programme Review and Forward Budget, the Budget Rationalization Programme and the Public Investment Programme, and then outlines the causes of failure and the outstanding problems. Finally, the paper reviews the introduction of the MTEF process in Kenya and the steps taken to achieve the goals of an MTEF. Measures that need to be taken if the MTEF approach is to achieve its objectives and be sustainable are outlined, based on the experience of previous reform efforts.

The paper recommends that for the MTEF to deliver a sustained improvement in public expenditure management, it is necessary to secure political commitment to a wide-ranging reform programme. Critical steps in institutionalizing the MTEF process include adhering to fiscal discipline, and developing a budget negotiation framework to ensure that inter-sectoral resource allocations reflect the full cost of ongoing programmes and the attainment of performance indicators. This implies a radical change in the culture of the civil service away from the traditional line-item budgeting towards a focus on delivery of outputs. Although decentralization and greater managerial autonomy are long-term objectives of the MTEF approach, they cannot be attained until effective control mechanisms are put in place.

2. BUDGETING

2.1 Budget Preparation

Budgeting is a set of procedures by which governments ration resources among claimants and control the amount each claimant spends. Within this context, the budget can be used for three purposes: as an instrument of economic policy; as a tool for economic management; and as an instrument for accountability. Budget systems can be evaluated either by the process (how budgets are prepared) or by the product (what is included in the expenditure estimates).

The budget is an allocation mechanism that attempts to maximize the contribution of public expenditure to national welfare. This can be achieved by ensuring that the budget process successfully allocates scarce resources so that the marginal unit of expenditure achieves the same marginal benefit in each category of expenditure.

In determining resource allocations, the budget should reflect the development agenda of a country through which it influences the attainment of national growth and investment targets. Despite this overall objective, it has been common to separate the planning and budget systems. The task of budget preparation is often seen as an accounting activity that concentrates on the annual recurrent budget while planning is seen as a medium-term activity. In this approach, the annual budget ensures control over aggregate expenditure and generates detailed financial statements on resource utilization but is not concerned with broad strategic development over the medium-term.

The budget format and classification depends on the system adopted in each country. The *IMF Manual of Government Financial Statistics* describes both the economic and functional categories of expenditure:

- *Economic classification* distinguishes between two broad categories: recurrent expenditure (including wages and salaries, other goods and services, interest payments, subsidies and transfers), and capital expenditure and net lending. This classification reflects the inherent difference between creation of capital assets and ongoing activities especially as projects give rise to additional recurrent expenditure (both to service and maintain the asset) once they are completed. Although a few countries have adopted a unitary budget, most developing countries recognize this distinction and prepare both recurrent and development annual budget estimates. However, the definition of recurrent and development expenditure is often unclear and it is common for expenditures that are recurrent in nature to be found in the development budget. This is partly because all long-term development assistance (either concessional loans or grants) from external financing agencies is channelled through the development budget.

- *Functional classification* is based on expenditures that are linked by the function or output that they are intended to achieve. Sectoral analysis is useful in determining trends in expenditure over time. In practice, however, most countries prefer to prepare budgets on the basis of their organizational structure and administrative units (usually ministries).

Although more sophisticated budget systems focussing on outputs and outcomes to be delivered have been developed, most budget systems concentrate on resource allocations using expenditure on inputs as the preferred method of control. Their main product is therefore the annual budget document that often reflects legal or even constitutional obligations to submit the annual estimates to a parliament for appropriation. This annual focus does not encourage reallocations that should be implemented over several years or even capital projects that take several years to design and implement. As a result, some systems usually associated with preparing the development budget allow multi-year budgets in which the appropriations are approved for several years. More recently, some systems have been introduced that allow rolling budgets in which the first year is identical to the annual estimates while the outer years provide indicative budget ceilings.

All budgets cover the activities of central government but some countries prepare comprehensive budgets that show the revenues and expenditures of other tiers of government, semi-autonomous government agencies and public enterprises. This approach is particularly helpful if there are transfers of resources between these agencies. Some budgets include information on appropriations in aid while others exclude it or only publish it in the annual accounts.

2.2 Budget Systems and Reform Initiatives

2.2.1 Line Item Budgeting

Budget systems evolved when government involvement in the economy was relatively limited and skilled manpower was scarce. It was natural then that these systems were designed to achieve control over inputs in a simple manner. Most budget systems focus on control of expenditure at item level and authority must be given before any purchases can be made. Under such systems, efficiency is defined in terms of economising on inputs rather than optimising outputs.

Many countries still adhere to this basic approach of listing the specific items that each spending agency intends to buy during the financial year. The approach encourages accountability since it separates authorizing of expenditure (with parliament being responsible for the annual appropriations) from the spending of the resources. It facilitates a uniform method of external control by the treasury while the focus on inputs makes the budget relatively easy to prepare and implement. It is also easy to impose strict reporting requirements that limit the scope for corruption and misuse of resources. To the extent that spending agencies are able to determine their own priorities by line item, the system allows a bottom-up resource allocation process and all the agencies have an opportunity to secure a fair share. However, spending agents do not have any incentives to economize and are not encouraged to relate their activities to the outputs they are intended to deliver. Instead, they learn ways of avoiding the controls and instead spend on favoured activities. This system of control retards operational efficiency and government expenditure is plagued with redundant and rising costs.

Line item budgeting also makes it difficult to impose central control on spending agencies. The disadvantages of this system become more apparent as the complexity of government activity increases. As spending agencies learn how to manipulate the "rules of the game", the control agency responds by introducing increasingly complex procedures that take up more administrative time. However, information asymmetry means that spending agencies always have more relevant information than the central agency and are therefore able to win arguments over specific resource allocations. Line ministries, for example, know more about the cost of programmes and projects than the ministry of finance. They can deliberately under-budget to ensure an item is included in the budget and then request for a supplementary allocation. They can also over-budget and half way through the budget declare a saving and ask for authority to reallocate to a preferred project.

A more substantive criticism of line item budgeting is that it only makes it possible to tell what the government is buying and not what the government is doing. Not only is the budget difficult to read (except for those who prepare it) but it is also difficult to monitor and evaluate performance or derive a development agenda. There is no scope for cost analysis and therefore this system does not encourage evaluation of alternative methods to provide the same service. Also, it does not improve operational efficiency. Line managers tend to develop a "compliance mentality" in which they follow the rules rather than improve the efficiency of their operations.

2.2.2 Incremental Budgeting

The starting point in this budget system is to determine aggregate expenditure ceilings. Any excess above total existing commitments becomes available for allocation between competing claimants. Incremental budgeting accepts the existing allocation of resources and concentrates on the allocation of any excess between spending agencies. Budget bids are assessed in the context of the additional sums rather than the base level of previously authorized expenditure. This system avoids internal conflict because it does not require any explicit trade-offs. It is relatively easy to apply in conjunction with line item budgets. The control over the increment tends to concentrate power in the hands of the ministry of finance.

The main weakness in this budget system is that, while there is a lot of haggling for the increment, the base is left intact and there is no evaluation of overall expenditure. Although awarding differential shares of the additional resources can be used to recognize relative priorities, in practice, budget officers typically assume that the existing budget had achieved allocative efficiency such that the marginal unit had the same value in each activity and that there was no need to reallocate resources. Since activities and programmes may not be clearly defined or prioritized, it is difficult to identify areas to reward when revenues increase or to cut when revenues are below target and when expenditure must be reduced to achieve the deficit target. Under these circumstances, it is easier to impose uniform increases or cuts and the allocation process tends to degenerate into across-the-board changes.

Incremental budgeting allows continuation of ongoing programmes even when policies and, by extension, priorities change. It creates a path dependency that militates against reallocations from low to high priority programmes across and within ministries. This makes the budget excessively rigid, leaving no scope for funding emerging priorities especially when aggregate budget constraints mean that the annual increment is small. This form of budgeting often results in redundant and rising programme/project implementation costs, encourages allocative and operational inefficiency, and leads to gradual enlargement of the public sector.

2.2.3 Target Based Budgeting

The application of specific budget targets is a limited response to the recognized shortcomings of cash management and incremental budgets. Once ceilings have been established for the deficit and aggregate revenue and expenditure, target-based budgets can be used to set expenditure ceilings for particular activities. This is a top-down resource rationing process. Special areas are identified and given preferential treatment in expenditure allocation. In order to protect these priorities, it is common for the sectors to be ring-fenced from expenditure cuts. This system of budgeting is rarely used alone but is normally combined with line item and/or incremental budgets that apply to all other activities. Targeting and ring-fencing are often used to protect poverty-reduction funds or funds for special programmes that are allocated earmarked sources of revenue. In Kenya, for instance, the Social Dimensions of Development programme was one type of target based budgeting. The main drawback with this system is that it breaches the principle of a consolidated budget. It means that when expenditure cuts are necessary the burden of budget adjustment must fall on the residual allocations, therefore distorting national priorities.

2.2.4 Programme Budgeting

Programme budgeting represents a significant change from line item budgeting because the classification system focuses on outputs (what government does with resources) rather than on inputs (what government buys with the resources). This is an important step in the evolution of official interest in management and efficiency values. The budget of each spending agency is classified into programmes and, if necessary, sub-programmes that reflect the end product. This is a suitable basis for planning and reviewing budget proposals. Within each programme, resources are allocated to the various activities through which the agency achieves its objectives. This approach is clearly an improvement on line item budgeting since it assists in identifying the priorities for public expenditure and discourages across-the-board allocations of additional resources.

Nonetheless, programme budgeting also has some weaknesses. Management is more complex and it therefore requires sound budgetary operations, financial discipline, skilled and responsible manpower and an efficient system of reporting on activities. It also fails to determine the level of service that will be provided and there are no in-built mechanisms to measure performance against agreed standards of quality and quantity.

One criticism of all these budget systems is that they leave little room for manoeuvre because the budget carries the burden of previous policy, budgetary and legislative decisions. A large amount of resources must be allocated to existing programmes and projects, therefore reducing the scope for funding new policies and priorities. The next two types of budget systems describe more substantial efforts to reform the budget process.

2.2.5 Zero Based Budgeting

In complete contrast to incremental budgets, zero based budget systems assume a zero base at the beginning of every budget cycle. The system is aptly summed up by a statement used to introduce this type of budget system in the US: "*all programs will be reviewed from the ground up and not merely in terms of the changes proposed for the budget year*" (Premchand, 1994). This implies that all line agencies are required to develop a fresh request for funding every year, based on a total cost analysis for each programme.

Although this approach is intended to encourage innovative thinking about priorities and operational efficiency, in practice it imposes an enormous administrative burden on budget departments. There is a risk that ongoing programmes are not guaranteed funds in future. Zero base discourages any comparison of the productivity and effectiveness of the service to be delivered. The system has not been widely adopted because it is highly labour intensive and involves a lot of paper work. It appears to be more effective as a management tool if it is applied to periodic assessment of specific activities rather than to all spending agencies in the annual budget.

2.2.6 Programme and Performance Budgeting Systems

The Programme and Performance Budgeting System (PPBS) is a three stage process. It starts by establishing budget classifications by purpose and function, it then applies a system of accounting appropriate for each category of expenditure, and finally it develops methods to measure physical performance.

This system shows both the activities to be undertaken and the level of service to be provided. It therefore represents a positive extension of the programme budget system by explicitly identifying the outputs of each programme and establishing mechanisms to assess performance against targets. An example is shown in Table 1 (UN, 1965).

Table 1: Sample PPBS Budget: Philippines

Function	*Organization*	*Programme*	*Project/Activity*	*Unit of Work Measurement*
Health	Field Operations	Field Health Services	1. Rural Health Units	Units operated
			2. Social Hygiene	Numbers of cases handled
			3. Dental Services	Patients attended

Most planning and budgeting systems are not effectively integrated. As a result, plans are prepared without realistic resource constraints while budgetary resource allocations do not address national development objectives. The PPBS partly resolves this problem by ensuring that budgeted activities reflect national priorities, and that they are designed to achieve their objectives through an efficient use of resources. It introduces effectiveness into public expenditure allocation through a thorough evaluation of relative social priorities that define the respective trade-offs (and, by extension, winners and losers). Successful implementation of this process therefore requires strong political and bureaucratic support. It then outlines the activities to be undertaken and the resources required to achieve the goals. This can be done through performance evaluation either through unit costs or if these cannot be generated, through physical measures of performance: cost benefit analysis, cost effectiveness analysis, a payoff matrix, or benefit incidence analysis. The choice depends on the capacity available to undertake the evaluation.

Although several countries have attempted to introduce the PPBS, there are few examples where it has proved possible to sustain this approach. The main drawback is that it requires a significant increase in administrative capacity in order to define appropriate indicators and to monitor performance over several years. Managers learn how to manipulate the system so that they are not held responsible for failures to achieve agreed targets.

2.3 Budget Management Issues

Although considerable attention has been paid to budget systems, there is general recognition that budget processes still encounter several constraints and that budget outcomes may be unsatisfactory even when the budget system is well-designed. A lot of literature on public expenditure management addresses problems of the practical aspects of managing the budget.

One concern is that revenue and expenditure follow different patterns over the financial year and aggregate revenue tends to be below the projections on which the budget is based. This is often the case in developing countries that face resource variability and have limited scope to smoothing consumption patterns. In order to conserve cash and to ensure that borrowing to finance revenue shortfall does not exceed annual targets, the ministry of finance may restrict the timing of expenditure by imposing cash management requirements. Even though all expenditure must still be based on authorized line items, spending agencies are also required to adhere to cash releases (which may be monthly or quarterly) based on actual receipts rather than on the appropriations contained in the budget estimates. When these releases are below commitments, managers are forced to cut expenditure. Personnel emoluments and statutory obligations such as debt payments are usually exempt from expenditure cuts. Agencies therefore concentrate cuts on items that can be deferred such as purchase of goods and services and implementation of development projects. Not only does this distort priorities, but it also reduces productivity since staff lack adequate resources for operations and maintenance. Imposition of cash management requirements weakens the credibility of the budget process and creates incentives for managers to engage in adaptive behaviour such as increasing informal debt through pending bills. In view of these defects, cash management should only be used as a temporary expedient when experiencing a fiscal crisis.

A variant of the cash-release system is to impose a hard expenditure ceiling by setting cash limits for each spending agency. Accounting officers are not allowed to exceed these limits. Since these ceilings are usually below the prevailing rate of inflation, it forces line managers to implement internal cuts on activities and preferably in ways that do not compromise productivity.

Other budget management issues are based on the recognition that public budgets often differ from the accounting systems used in the private sector. The main difference is that most governments operate a cash-based accounting system in which revenues and expenditures are recorded when funds actually change hands. This may create perverse incentives for accounting officers since it is possible to improve the finances in any one year by delaying payments or accelerating receipts. In order to reduce this type of problem, many countries have attempted to improve budget management by introducing features of private sector accounting systems.

A major reform in budget management is the adoption of accrual accounting in which a transaction is recorded at the time the commitment is made. The treatment of depreciation should also be reconsidered. For example, most governments show the full capital cost of an asset in the year in which it is purchased rather than showing the cost over the lifetime of the asset. New Zealand has taken this approach even further by assigning financing charges to cost centres according to their overall asset base. This requires the establishment of a comprehensive asset register that is adjusted for depreciation and net acquisition of capital assets. Spending departments will therefore maintain an operating account showing income and expenditure and a balance sheet showing physical and financial assets and liabilities.

Accrual accounting can also improve public sector accounting procedures with respect to:

- insurance (most governments act as a self-insurer so there are no resources available to replace assets that need to be replaced before their expected lifetime);
- contingent liabilities (governments accept potential obligations but fail to make the necessary budgetary provision); and
- pensions (most governments operate pay-as-you-go systems that have relatively low obligations while the civil service is growing but the financial commitments increase rapidly once employment stabilizes and after retrenchment programmes).

New Zealand has also introduced substantial reform of both the budget system and the financial management process. The key change was to introduce a performance-based system where political leadership enters into a contract with the executive arm of the government to provide specified goods and services. Ministers are required to define the overall objectives and specify the quantity and quality of outputs that they wish to “purchase” subject to agreed performance indicators. Within the approved budget ceilings, departmental managers are then given autonomy to manage resources in order to deliver these outputs.

Other areas that are the target of budget management reforms include the incentive system, discipline systems, procurement, contract management, transparency, contestability, and budget releases. It is common in developing countries, for example, for real wages to decline during periods of fiscal stress and this typically encourages a wide range of "adaptive behaviour" through which civil servants manipulate the system for their own benefit.

Even when a country is aware of the need for more effective budget systems and management, it will face capacity constraints that limit the choice of an appropriate budget system. The optimum system will depend on the availability of qualified personnel, policy objectives and the available technology.

Therefore, although there have been numerous attempts to address the weaknesses of incremental line item budgeting and to reconcile conflicts between the annual budget perspective and the longer-term planning horizon, successful implementation of budget reforms remains rare and there are frequent calls for further reforms. In recent years, the success of various OECD countries, notably Australia and New Zealand, in introducing and sustaining new approaches to the budget system and budget management has encouraged international financing institutions to recommend that developing countries should build an effective bridge between annual budgets and medium-term development plans. This has given rise to the introduction of the Medium-Term Expenditure Framework approach.

3. THE MEDIUM-TERM EXPENDITURE FRAMEWORK

3.1 The MTEF and Public Expenditure Management

It has become increasingly complex to manage public expenditure, both because the role of the state has expanded and because the number of citizens has increased. In addition, Schick (1999) avers that "when government is inefficient, public sector wages tend to be low, much public expenditure is absorbed by dead weight administrative costs and the government is robbed of resources needed for critical social development". The dead weight administrative costs are difficult to eliminate from the budget and this limits the range of executive and legislative discretion in any one year. Short of a crisis, it is only possible to deal with the margins of the budget. This development has resulted in a large and growing literature on the basic features of effective Public Expenditure Management (PEM). Premchand (1993) aptly summarises the main goal of PEM as being "work better, cost less". In order to provide a properly functioning planning and budget system, the core objectives of PEM are to:

(i) ensure that the process operates within realistic resource constraints and that scarce resources are utilized effectively and efficiently;

(ii) ensure that policy objectives and management capacity are in broad equilibrium;

(iii) create an efficient administrative system for implementation of authorized programmes;

(iv) create an institutional framework (if necessary, through civil service reform programmes) that increases the probability that intended outcomes will be achieved; and

(v) establish an information system that allows transparency and accountability in transactions.

In practice, there has been little success in persuading governments to adopt the principles of PEM on a sustainable basis. Premchand (1993) and Schick A. (1999) identify public expenditure management with the application of the Medium-Term Expenditure Framework (MTEF) approach to planning and budget systems. The MTEF approach is essentially an effective budget process and has similarities with the PPBS: meaningful classification of programmes and work; appropriate financial management practices oriented to those classifications; and suitable measures of performance under the substantive classifications. If properly implemented, an MTEF can impose discipline in planning and managing national resources and bridge the gap between planning and budgeting by addressing inadequacies in the links between programmes and policies and the resources allocated to their implementation.

3.2 The Goals of an MTEF

The goals of the MTEF can broadly be classified as:

- Fiscal discipline—expenditure by line agencies must adhere to hard budget ceilings in order to remain within aggregate resource constraints.
- Allocative efficiency—expenditure allocation should address national development priorities.
- Operational (technical) efficiency—public expenditure should achieve explicit outputs at minimum cost by applying performance targets of output relative to inputs.

3.2.1 Fiscal Discipline

The starting point in ensuring fiscal discipline through the MTEF is to determine the revenue and spending aggregates. This requires that the government make realistic forecasts of the resource envelope by estimating domestic revenue, external grants and concessional loans. The ceiling for aggregate expenditure is determined by applying a politically-endorsed deficit and financing strategy. Fiscal targets for the aggregates and the main components of revenue, expenditure, deficit and financing over the MTEF period are then specified. These targets may be expressed as real or nominal values or as ratios relative to GDP.

The aggregate amount of public spending must then be distributed to the main categories of expenditure. The first charge on the budget is for statutory obligations such as payments on interest, pensions, and payments to constitutional office holders. These must be accurately forecast, for example allowing for the impact of likely changes in domestic interest rates, and full provision made for. It is then necessary to establish an indicative allocation of discretionary resources between recurrent and development expenditure. The proper focus for expenditure control is the sustainable level of recurrent expenditure as indicated by the ability of recurrent revenue collections (i.e. excluding one-off receipts from the sale of assets) to cover the level of recurrent expenditure. Exceeding that level will create an additional debt burden that will adversely affect future development. However, most planning systems tend to focus on the level and distribution of capital resources rather than the resource requirements needed to maintain existing facilities and programmes. The recurrent budget should be allocated between wages and salaries, goods and services, and transfers and subsidies based on economic classification of the International Monetary Fund.

The aggregate expenditure ceiling must be split into hard budget ceilings for each sector and spending agency. Since agencies often generate revenues from the sale of goods and services, it is important to decide whether the ceilings are gross (showing the total expenditure appropriation excluding the revenues) or net (implying that the agency is allowed to apply revenue collections towards the cost of its activities). Specifying the sectoral spending limits over the medium-term enhances the credibility of the budget and avoids a hand-to-mouth approach to budgeting.

It is important to acknowledge that setting expenditure ceilings is a difficult task but ensuring adherence throughout the year poses an even greater challenge. It is difficult to maintain fiscal discipline if political or administrative decisions cause expenditure to increase without an equal commitment to introduce policy and/or administrative measures that will enhance revenue collection. The budget unit within the ministry of finance must have the capacity, and be empowered, to enforce the spending limits during budget preparation and during implementation. This may involve the sensitive responsibility of rejecting many requests that satisfy appraisal criteria but increase aggregate expenditure above the ceiling. In view of the information asymmetry problem and the tendency of spending agents to underestimate the cost of proposed programmes, the ministry of finance should have the capacity to estimate and project the standard cost of programmes to minimize cost overruns and re-evaluation of contracts. It should also have the capacity to develop a base line scenario that can measure the financial impact of proposed policy changes.

Table 2: Prerequisites for aggregate fiscal discipline

Schick (1999, 85-8) summarises the tasks of ensuring aggregate fiscal discipline as follows:

- Targets should reflect political commitments made by political leaders;
- Targets must be realistic and achievable;
- Budget aggregate targets should be set and enforced within a medium-term framework;
- Aggregate expenditure norms should be supported by sub-targets for major expenditure categories;
- The aggregate expenditure ceilings should be based on several indicators including sustainable revenue, the deficit, and total public debt;
- Expenditure targets should include mandatory expenditure;
- The budget system must include enforcement mechanisms, such as timely monitoring of outcomes;
- Hard budget constraints should allow some flexibility.

3.2.2 Allocative Efficiency

Although fiscal discipline is critical for macroeconomic management, it is important to remember that aggregate spending limits do not guarantee quality expenditure. Quality is achieved by concentrating resources on priority programmes (allocative efficiency) and by ensuring that the implementing agency utilizes resources productively (operational efficiency).

In most countries, the government structure is based on ministries. This often creates overlapping responsibility and duplication. The MTEF usually recommends the adoption of a sectoral approach to planning and budgeting in such situations. The IMF functional classification provides a starting point but each country should determine sectors according to its own economic and development priorities. Since these categories will not change over time, this approach provides continuity and allows consistent budget analysis, which becomes a starting point for monitoring and evaluation.

Allocative efficiency is improved when a government reallocates expenditure from low priority to high priority programmes and from less effective to more effective programmes. This approach is very different from incremental budgeting that locks in old programmes and locks out new ones even for emerging priorities. However, budget reallocations inevitably create winners and losers and therefore face severe opposition. Resource reallocations require government to:

- define national development priorities, usually by formulating a strategic plan that defines what the government intends to accomplish;
- evaluate the cost-effectiveness of existing policies and ongoing programmes to determine whether they achieve their objectives efficiently; and
- reallocate resources from low priority and ineffective activities on the basis of comprehensive information on programme costs and effectiveness.

In order to improve inter-sectoral allocative efficiency it is necessary to know the cost of existing policies in the medium term after making proper allowance for expanding demand. Education enrolments, for example, will need to grow in line with population. It is also important to know the benefits to be derived from these policies in terms of actual and projected outputs and outcomes, and also the recurrent and capital costs of implementing these policy proposals.

Allocative efficiency can also be improved by intra-sectoral reallocations that involve choices, for example between primary and tertiary education. These choices are best made by line ministries or by sectoral working groups. The MTEF approach therefore advocates greater managerial autonomy. The danger here is the tendency of line agencies to protect special programmes especially in cases where an impartial evaluation might recommend budget cuts. Spending agents must be accountable and responsible for the results. The ministry of finance may need to develop capacity to evaluate programmes but this creates the danger of information-overload as well as time-constraints for skilled staff. An alternative approach is to require line agencies to demonstrate that their expenditure programmes are achieving agreed development objectives in a

Table 3: Determining the appropriate role of government

The main reasons for intervention by the public sector are:

- to improve resource allocation: this includes the provision of public goods, externalities, exercise of monopoly powers and cases of market failure;
- to provide stabilisation: sound macroeconomic management (fiscal and monetary policy);
- to improve equity: progressive taxation and welfare support; and/or
- to ensure law and order: property rights and contract enforcement.

Choosing between the three main options for the most appropriate type and degree of intervention requires a combination of both political and technical choices:

- Direct market involvement is appropriate when public goods and services need to be supplied;
- Regulation is needed when markets do not operate freely; whereas
- No intervention is required in a competitive free market.

Even if it is desirable for the public sector to finance some form of intervention, this does not automatically mean that the optimal delivery mechanism requires the involvement of the public sector. The decision about the most suitable mechanisms to finance and deliver the intervention involves both political and technical choices:

- Direct expenditure of resources collected from taxpayers;
- Subsidies to other tiers of the public sector;
- Internal cross-subsidies by other public sector agents;
- Transfers to other providers;
- Vouchers to consumers; or
- Cost-sharing (i.e. costs are borne partly or in full by consumers).

Policy Options	**Institutional Options**	**Financing Options**
1. Don't Intervene	Free Market	None
	Subordinate Government	Budget Allocation and (or) Cost Sharing
2. Regulate	Specific Entity	Budget Allocation
	Government Department	Budget Allocation and (or) Cost Sharing
	Government Department	Budget Allocation
3. Provision of Goods and Services	Subordinate Government	Full Cost Recovery and or Transfers
	Specific Entity	
	Contract Out	Budget Allocation

cost-effective manner by providing monitoring and evaluation information as part of the budget preparation process.

Underpinning all resource allocation decisions is a judgement about the appropriate role of government in each sector. For this reason, the MTEF process emphasizes the need for an explicit consideration of relevant factors. Although this issue is not addressed exhaustively in this paper, the main decision points are identified in Table 3. The starting point is a review of the reasons for intervention by the public sector. This should produce a definition of the core functions of government, after which the appropriate level of intervention can be determined. The next step is the decentralization of power by conceding greater managerial autonomy and control over the utilization of resources. This will give implementing agencies more flexibility and allow them to explore alternative mechanisms for delivery of public goods and services.

3.2.3 Operational Efficiency

In practice, achieving sustained improvements in operational efficiency is likely to be the hardest step in reforming the budget process. The ministry of finance will not be able to implement inter-sectoral reallocations unless it has the capacity to assess the comparative worth of programmes. This will involve an iterative process based on an assessment of both allocative and operational efficiency since it would be wasteful to allocate resources to a high-priority activity if they are not being utilized efficiently.

This raises questions about both recurrent programmes and the public investment programme. Evaluation of benefits should reflect marginal efficiency and the fact that unit costs tend to rise as coverage increases. Also there is need to develop procedures that will ensure rigorous and appropriate project appraisal, selection and design.

Ensuring operational efficiency in the planning and budget system requires that the right incentives and institutional arrangements are in place. Managers must be given greater discretion in running their operations and determining what services to provide in-house and which ones to contract-out. In return, they must be held accountable for the results produced.

It is important that outputs or performance targets are specified in advance for ongoing programmes so that actual achievements can be compared to targets during implementation. Publication of annual reports highlighting all the achievements is one way of encouraging greater transparency and ensuring that managers are held accountable.

Managerial autonomy does not mean non-adherence to government procedures. Reliable control mechanisms are required before managers are given autonomy. Schick (1999, 113ff) recommends the following sequencing to avoid abuse of the system:

1. Establishing consensus on the principles of basic external controls.
2. Rationalizing internal controls to remove duplicative and dead weight controls.
3. Delegating internal control authority to well-managed departments that can handle greater responsibility.
4. Instilling a managerial ethic in the public service through skills-based and behavioural training and motivation through performance-related pay, and
5. Developing first generation performance measuring systems.

Sustainable development of management information systems will be expensive but is essential for the success of an MTEF in setting performance targets, calculating unit costs of producing budgeted outputs and physical and financial monitoring.

The following is a summary of institutional arrangements that will contribute to improved operational efficiency:

- Clarity of purpose (outcomes to be achieved);
- Clarity of task (outputs to be produced);
- Resources and systems commensurate with responsibilities (inputs to be utilized);
- Authority/flexibility to pursue the purpose and undertake the task;
- Accountability for use of authority; and
- Monitoring and evaluation.

3.3 The MTEF Process

The MTEF is an iterative process designed to improve financial resource allocations and achieve desired outputs through top-down and bottom-up information exchange. The pace at which the process is implemented depends on the capacity of each country. Some countries like Malawi and Pakistan have opted to start from the bottom-up by developing MTEFs for a few pilot sectors, an approach that is very similar to Sector-Wide Approaches (SWAPs). Other countries have started from the top by developing an overall macroeconomic framework while other countries like Ghana and South Africa have opted to introduce comprehensive reforms.

The MTEF has not yet evolved a formal set of procedures that describe the process. In particular, each administration must consider a number of critical issues affecting the operationalization of the MTEF approach in the light of local circumstances and make decisions concerning whether the MTEF will:

- be an annual exercise or will remain valid for several years;
- set rigid or indicative ceilings for the initial year and the outer years;
- set gross or net expenditure ceilings;
- adopt a comprehensive approach including public enterprises and other tiers of government, or will simply cover central government operations.

If the MTEF is fully and comprehensively implemented, it is expected to achieve the following improvements in the expenditure allocation process:

- improved macroeconomic balance by developing a consistent and realistic resource framework and determining aggregate expenditure ceilings and the split between economic and sectoral categories;
- commitment to increased predictability in resource allocations so that spending agencies can plan ahead;
- improved allocation of resources to strategic priorities both between and within sectors by developing an institutional mechanism for the evaluation of the trade-offs between activities and sectors; and
- increased incentives for more effective (better targeted) and more efficient utilization of resources by providing agencies with predictable funding levels and increased autonomy while encouraging improved accountability and transparency of managers.

Although the MTEF process will depend on the institutional arrangements in each country, the Public Expenditure Management handbook (1998, 47-52) identifies seven main stages:

1. Development of a macroeconomic framework for projection of revenues and expenditures over three years. The development of a forecasting model is useful in linking economic forecasts to fiscal targets and checking the policy framework for inconsistencies. The formation of a macroeconomic working group would complement and enhance the modeling effort.

Table 4: The MTEF process

2. Undertake sector review to provide a basis for allocating resources. If a civil service reform programme has, for example, been undertaken, it should provide a good foundation for this part of the MTEF process by defining the role and core functions, activities, services and programmes of government in each sector. The review would clarify ministerial mission statements to ensure they reflect national development goals, objectives, strategies and policies and generate proposals to enhance public sector productivity and quality in the delivery of public services. This is achieved by making organizational structures and processes more efficient and by eliminating areas of overlap and duplication.

   Based on this overall framework, all line agencies should identify services that should be discontinued, undertake cost analysis, and prioritise those functions that should continue to be provided by the government because of their nature as public goods.

3. At this stage, sector reviews are presented to the treasury to ensure that all programmes have been accurately costed and the objectives, outputs and activities fully specified.

4. Using the macroeconomic framework and the sectoral reviews, the ministry of finance prepares a strategic expenditure framework and undertakes a trade-off analysis to determine inter-sectoral allocations that maximize the expected contribution to the achievement of national development objectives.

5. The strategic framework and the sectoral ceilings are presented to the Cabinet for discussion and approval. The criteria for determining inter-sectoral shares should receive explicit consideration and political endorsement before each sector is informed of its resource envelope, which sets a firm ceiling for the budget year and an indicative ceiling for the subsequent years of the MTEF period.

6. Ministries prepare detailed three-year estimates based on the priorities and costs established in their sector review and consistent with their allocation of the sectoral ceilings.

7. The ministry of finance reviews the ministerial estimates, prepares the detailed budget and MTEF documents and presents them to parliament for approval.

3.4 Strengths of the MTEF

There is no doubt that the experience of several developed countries such as Australia demonstrates that a country that successfully implements the MTEF approach on a sustainable basis can achieve a significant improvement in its planning and budget system.

a) Medium-term planning

As noted earlier in this paper, the main weakness in traditional budget systems is that the annual budget carries the burden of past policy, budgetary and legislative decisions. Since an overwhelming amount of resources must be allocated to existing programmes and projects, the range of executive and legislative discretion in any one year is extremely limited. Short of a crisis, it is only possible to deal with the margins of the budget. However, the MTEF addresses this issue by providing a bridge between the need for a legally binding annual appropriation and by providing indicative ceilings for the outer-years.

The MTEF improves the link between planning and budgeting by placing greater emphasis on the medium-term. As Walker and Mengistu (1999, 27) note "The medium-term approach makes policy and funding choices in tandem, so that expenditures can be driven by priorities but choices are made from an affordable set of alternatives."

b) Forecasting

The MTEF is intended to improve the credibility of the budget process. This involves setting aggregate resource ceilings that are realistic and achievable over a range of macroeconomic outcomes and assuring spending agencies of the projected level of sectoral funding in order to plan ahead. The development of improved modeling and forecasting capacity is therefore an integral part of the MTEF process. To the extent that capacity is improved, MTEF improves the ability to predict resource allocations to organisations and sectors. This increases the credibility of the budget process, encourages budget honesty, reduces haggling during the annual cycle and improves efficiency.

c) Analytical budgeting

Unlike line item budgeting where the focus is on control of inputs, the MTEF emphasizes allocative efficiency. This encourages greater focus on strategic issues and improves the targeting of resource allocations on key priority activities. The MTEF framework also provides a mechanism for resolving conflicts between what is affordable (the top-down approach) and delivery needs (the bottom-up approach).

d) Improved service delivery

As a component of the new governance (or public expenditure management) paradigm, the MTEF is performance-oriented and results-focused. By shifting attention from what the government buys to what the government delivers, the MTEF improves resource utilization. This is achieved by increasing decentralization and giving line managers more autonomy and incentives for efficient performance. They are allowed to determine the optimal mix of inputs required to meet agreed output targets and can exploit alternative service delivery mechanisms. This focus on operational efficiency encourages detailed analysis of policy options, accurate costing of viable alternative policies, and an assessment of their expected impact on national development objectives. By establishing targets for performance (productivity) for direct service provision, the MTEF helps to establish an effective monitoring and evaluation system.

e) Political endorsement

All expenditure allocation decisions involve political choices that create winners and losers. However, by including several stages that require explicit political endorsement, the MTEF process builds commitment to the strategic and operational objectives of public expenditure.

3.5 Threats to the MTEF Process

Many developing countries are now in the process of introducing the MTEF approach to attain the substantial benefits that it can bring if successfully implemented. However, several proponents of the MTEF approach appear to overstate these potential advantages while ignoring the possibility that they could also be achieved by alternative reforms to planning and budget systems. They also tend to understate the many disadvantages and risks of the proposed reforms. In order to maximize the benefits and minimize these risks, it is important to anticipate the main threats to the design and sequence of introducing the MTEF.

a) Weak institutions

The critical question in implementing the MTEF is not what needs to be done but how to create an operating environment that will sustain the reforms. The success of the MTEF depends on introducing institutional arrangements that provide correct incentives and assist in balancing priorities with affordability. However, practical experience indicates that it is very difficult to establish suitable institutions and sustain them over time, especially when public sector remuneration is generally perceived to be low relative to market rates.

b) Capacity constraints

Introducing the MTEF approach imposes a substantial administrative burden on public service. The capacity constraints that afflict developing countries are often underestimated or ignored. The UN Manual on Programme Budgeting (1965, 89-90) notes that the introduction of budget reforms "should be adapted to conditions in the individual country, and should proceed at a rate consistent with the capabilities of the staff resources available for the job. Above all, it should be recognised that this is a long-range undertaking—one that will develop in an evolutionary fashion, and produce increasingly more effective results as experience is gained in operating the system." The risk that the MTEF will be introduced too quickly and that it may not be sustainable can be addressed by keeping the design of the process and the implementation procedures simple and robust.

The MTEF, by itself, will not ensure that the costs and benefits of policy options are accurately assessed. Experience with the PPBS shows that spending agencies lack the necessary skills and capacity to undertake this task. The difficulty of investigating complex policy issues on an across-the-board, annual basis makes success unlikely. "The MTEF budget prioritisation process as it stands, lacks the means to evaluate the cost of bids objectively, something that seriously undermines its ability to maximize the achievement of government objectives within the funds available" (Diamond et. al, 2000, 59). In addition, line agencies are reluctant to change existing polices and procedures. "It is extremely difficult, however, to devise a budgeting system which provides sufficient incentive for better analysis to be made by the technical agencies of government." (Allan and Hinchliffe, 1982, 148). One response that is not yet included in the MTEF toolkit is to concentrate limited analytical capacity in areas where it is more likely to be effective.

c) Sustainability of old and new systems

The MTEF is a new approach to budgeting and, like other reform initiatives, it comes with a new set of rules, procedures and guidelines. However, with time, the players master the rules of the game and learn how to outwit them. Line managers devise new ways of taking care of their self-interest. Equally, new systems can become a routine over time and as the willingness to enforce the rules wanes, they are likely to be abandoned. The Programme Review and Forward Budget in Kenya discussed later is a good example. This was designed as a medium-term programme review but although it covered three fiscal years instead of one, it rapidly degenerated into a routine incremental line item budgeting. To avoid this outcome, care must be taken to ensure that the guardians of the system remain in control and can enforce adherence. Transparency and accountability must be enshrined and the punishment for violating rules must be clearly defined.

There is a danger that introduction of a new budget system might mean that existing systems are dropped. In some cases, this may be premature and an essential fallback or complementary system may be lost. In Kenya, for instance, even though a comprehensive process of project selection and appraisal is intended to be an integral component of the MTEF, the institutional restructuring that followed the introduction of the MTEF resulted in the disbanding of the Project Management Division. The consequence was failure to apply PIP appraisal procedures and to produce the PIP outputs including the monitoring reports.

d) Credibility and prudent fiscal management

The introduction of the MTEF approach is likely to raise expectations in the delivery of government services. The credibility of the reform process will be damaged if these expectations are not fulfilled. However, the MTEF does not alter the underlying budget realities. Even though the MTEF should be based on realistic economic forecasts and the fiscal strategy component is intended to be robust under a range of outcomes, the annual budget is still prepared in an economically uncertain environment.

It is difficult for developing countries to generate accurate forecasts of resource availability, especially if they are dependent on mineral resources or primary export commodities. Economies with a shallow revenue base will rely on external funding and will not be able to respond to adverse shocks, such as a deterioration of the terms of trade. These can disrupt the attainment of targets, reduce accountability and damage the credibility of the MTEF process. Unexpected expenditure requirements, shortfalls in revenue outcomes, or withdrawal of donor support may force even the most committed government either to renege on its commitment to fiscal discipline or to cut back on programmed expenditure projects therefore threatening both allocative and operational efficiency. The lack of flexibility in responding to these threats may even force budget makers to resort to the traditional technique of imposing across-the-board cuts. The imposition of budget cuts during implementation and the continued operation of a “cash budget” system means that resource allocations in outer years will not achieve indicative MTEF ceilings and will preclude many of the presumed benefits of the MTEF approach.

e) Premature decentralization

The MTEF is expected to improve efficiency by empowering managers of spending agencies to exercise greater managerial autonomy. These benefits were achieved in developed countries because they had already established reliable internal and external control systems. However, it must be recognized that line managers have considerable potential to manipulate both their control over inputs and the payment of bonuses. This implies that implementing agencies should not be given autonomy before effective controls, an incentive system linked to performance targets, and a monitoring system are operational. Installation of an integrated financial system may resolve some fears but it may not address the incentive structure.

f) Securing political commitment

Although the MTEF process makes provision for political involvement, there is no guarantee that a political and technical consensus on optimal resource allocations will emerge. The technical solution may involve development of a budget negotiation framework that analyses trade-offs between marginal resource allocations and defines percentage shares going to each ministry/sector by economic/strategic categories. However, this approach may not be acceptable to politicians who wish to select policies and determine expenditure priorities for party political reasons such as allocating resources to projects in marginal constituencies.

g) Setting criteria for resource allocation

The MTEF principle of targeting expenditure at national development priorities appears straightforward. It is necessary to establish a clear strategic framework (for example poverty alleviation, rural welfare, basic social services, environmental protection, infrastructure, or production) that reflects national development objectives. In practice, however, it is extremely difficult to determine the various trade-offs between sectors, within sectors and over time. Even if choices are clear-cut, line agencies find it difficult and time-consuming to adjust their resource base, including skilled manpower, equipment, and facilities as quickly as central agencies would like.

It is equally hard to ensure that operational efficiency is improved. Experience with PPBS and other budget reforms has shown that it is extremely difficult to identify suitable output indicators and performance targets and to measure the annual attainment of targets. Central agencies in most developing countries do not have the enormous amounts of information and adequate analytical capability required for successful introduction of the MTEF. Relevant tasks include:

- ensuring that the MTEF applies to all categories of public expenditure, including central, provincial and local authorities, public enterprises and subvented organizations;
- setting ceilings by sector rather than by administrative category which is likely to create problems for resource allocation decisions because sectors typically cut across ministerial and departmental boundaries;
- defining expenditure targets clearly, for example by showing gross and net ceilings so that appropriations-in-aid are made explicit and their generation and application subjected to the same rigorous level of appraisal;
- developing capacity to ensure that all spending agencies apply the same criteria in evaluating their activities, for example performance targets, cost benefit analysis and cost-effectiveness analysis; and
- monitoring resource utilization by economic category to ensure that the budget achieves an appropriate balance between personnel and other recurrent costs and between recurrent and development expenditure.

In all budget systems, there are problems in addressing issues that cut across sectoral and ministerial boundaries, such as HIV/AIDS, environment, demography, regional development, gender, and disadvantaged groups. The MTEF approach has not yet developed any solution to this problem, although it may be possible to develop guidelines for sector working groups to ensure that adequate resources are allocated to these activities.

h) Complementary planning and budget initiatives

It is important to remember that the MTEF is not a stand-alone reform system and that it does not by itself address all of the outstanding issues affecting the quality of public expenditure management. Implementing a number of complementary planning and budget initiatives can only achieve the full benefits of reform. These include preparing of a long-term strategic planning framework, preparing of periodic medium-term operational documents, periodic sectoral reviews such as SWAPs, and a range of budget structure and management reforms. Achieving allocative efficiency, for example, requires a clear consensus on national development objectives, usually by preparing a long-term strategic vision that defines the main features of a pro-poor growth strategy. Improvements in public sector productivity depend on a wide range of reforms covering central and local government, the public service, and the legal system.

Gains in operational efficiency through introduction of performance targets will require major changes in the budget structure while many administrative constraints must be addressed through sustained improvements in budget management. The development of an accurate and timely monitoring and evaluation system is also an essential measure.

4. BUDGETING IN KENYA PRIOR TO YEAR 2000

4.1 The Budget System

The planning and budget system in Kenya before the introduction of the MTEF had seven main components:

- National Development Plans: these are fixed-period, medium-term indicative plans. The content varies considerably but generally includes a review of performance, a forecast of resource availability, and resource allocations by expenditure head and/or sector.
- District Development Plans: these are produced concurrently with National Development Plans. The content provides background information on the natural and human resource base, constraints to development and a priority listing of projects by sector.
- Development Strategy and Policies: the indicative plans are supplemented by Policy Framework Papers and Sessional Papers on specific sectors or topics.
- Programme Review and Forward Budget: this is an annual document providing rolling estimates for a three-year period with detailed indicative resource allocations.
- Public Investment Programme: this is an annual rolling three-year plan setting out indicative resource allocations to capital projects.
- Annual Budget: the relevant documents include the Budget Speech, Recurrent and Development Expenditure Estimates, and Revenue Estimates. Alterations during the year are contained in the Supplementary Estimates.
- Annual Appropriation Accounts: these are produced by the Auditor-General and contain expenditure details by vote and item.

A full annual budget cycle consisted of three elements:

(i) Three-year rolling forward budget in which the first year translates into the following year’s annual budget;

(ii) The annual budget setting out detailed appropriations by line item and project; and,

(iii) The revised budget that is a review of the annual budget prepared half way through the fiscal year to take account of any unforeseen expenditures or shortfalls in revenue.

The basic approach consisted of an incremental, line item system for separate recurrent and development budgets.

The budget process has five stages:

1. Reviewing and projecting of resources. This entails forecasting of revenues, local appropriations-in-aid and external resources in the form of loans and grants.

2. Determining the deficit (surplus). The deficit is not merely the difference between revenue and expenditure but is a government policy target that also takes into consideration net financing requirements and the appropriate balance between external and domestic borrowing.

3. Sharing resources. Once the broad aggregates have been agreed, the available resources are shared between constitutional obligations that have first call on revenue since they represent statutory commitments and discretionary expenditure that is allocated to line ministries.

4. Setting ceilings. Ceilings are then set by vote and communicated to ministries through Treasury circulars together with other policy guidelines for preparing the expenditure proposals. Votes are the major divisions of programmes between ministries on which parliament's voting procedure is based. Although this process tends to an incremental allocation of available resources, it is possible to take account of any policy changes when the ceilings are set. The allocation among ministries is weighted by three broad functions covering economic services (promotion of economic growth), public administration (including maintenance of law and order) and social services. In the development budget, the highest weight is attached to economic ministries whose basic function is promotion of economic growth.

5. Preparing expenditure proposals. Ministries then submit to the Treasury expenditure proposals within the ceilings already set. These are specified for each sub-vote, head and sub-head disaggregated at the line item level. A head in the estimates is formed by the organisational units or types of activities contributing to the accomplishment of the

objectives of the sub-vote. A sub-vote is a major objective or set of related objectives within a vote.

The proposals are sent to the Treasury for appraisal before they are included in the detailed draft Estimates appropriations for discussion and approval by Parliament.

4.2 Budget Reforms in Kenya

Policy makers in Kenya have always recognized the importance of the budget in the resource allocation process. There has been a clear consensus, for many years, over both the need for reform and the broad elements of that reform process. This is evidenced by the attention given to various policy guidelines. Three main initiatives towards implementing parts of the budget reform agenda need evaluation here. These are:

(i) The Programme Review and Forward Budget (PRFB) in the early 1970s intended to provide a link between planning and budgeting.

(ii) The Budget Rationalization Programme in the mid-1980s intended to revive that system and introduce reforms in financial management and accounting; and,

(iii) The Public Investment Programme in the early 1990s which attempted to impose a more clear criteria for selecting and appraising development projects in order to reduce the number of projects and prioritise scarce development resources.

4.2.1 Programme Review and Forward Budget

Recognition of emerging institutional weaknesses in the resource allocation process prompted the establishment of the Budgetary Procedures Group in 1972. This group reviewed existing budgeting procedures and recommended wide-ranging reforms in the budget process including the common classification system, a revised accounting manual, and the Programme Review and Forward Budget. Implementation began with the Treasury Circular No.12 of 1973 that initiated the Programme Review and Forward Budget for the financial year 1974/75.

The aim of the Programme Review and Forward Budget was to relate the annual development and recurrent budgets more closely with the five-year Development Plan. It was therefore conceived as an annual planning exercise and a rolling plan to be reviewed every year in order to provide the basis for the actual allocation of resources among sectors and within a sector. The PR&FB was defined as “a rolling plan for three years, to be updated and revised every year in the light of resources available and the actual implementation record and scheduling of development projects and programmes (Budget Rationalization Seminar, Vol. II, 1986).

The essential features of this approach were intended to introduce a medium-term perspective while preparing annual budget rollovers, link planning and budget systems, assess available resources, establish criteria against which performance of the ongoing programmes could be assessed, and apply appraisal techniques for the inclusion of new expenditure initiatives.

In practice, the PR&FB did not live up to these objectives. Indicative budget ceilings and expenditure programmes were included in the periodic national plans but these were based on optimistic targets rather than on realistic forecasts of resource availability. The approach therefore lost credibility at a time when the economy was coming under increasing pressure. Emerging fiscal constraints and macroeconomic imbalances forced a more serious concern in public expenditure planning. Fiscal discipline deteriorated to a point where deficit was 9.5 percent of GDP and the share of expenditure to GDP stood at 33 percent. An effort was made to revitalise the PR&FB in 1980 and the objectives were contained in Treasury Circular No. 5 of 1980. These were to:

- establish expenditure ceilings for three years;
- review current programmes and set revised priorities for the three-year period;
- establish internal guidelines to assist ministries in preparing expenditure proposals;
- assist ministries in identifying projects and programmes; and
- facilitate the preparation of detailed proposals for the next annual budget.

More detailed institutional arrangements were established in 1982 and disseminated to policy makers. Guidelines to be followed during the PR&FB process were also published. The emphasis was on an annual PR&FB cycle consisting of a programme review that reflects past performance and adjustments in response to new economic guidelines and a three-year forward budget covering both the recurrent and development budget. This would be prepared within the aggregate expenditure ceilings specified in the annual Treasury circular.

The core activity was to initiate and strengthen scheduling and monitoring of project implementation as a means of operationalizing the PR&FB. Among other things, the guidelines recommended better coordination of recurrent and development budgets, conservation of foreign exchange, development of performance and output criteria that would be used to evaluate projects and programmes, design of projects to focus on high-priority beneficiaries, and managerial autonomy to reallocate resources within portfolios.

The PR&FB was intended to be the only mechanism for introducing new projects and programmes that had no financial provision in the current annual estimates and for increases in the approved cost of ongoing activities. In order to undertake project-related activities, a comprehensive project registry was to be established and a Project Appraisal and Monitoring Division created. In 1984, the PR&FB was further strengthened to include public enterprises.

Two institutional mechanisms, the Estimates Working Groups (EWGs) and the Sectoral Planning Groups (SPGs). The key roles of the EWGs were to:

(i) function as a link between operating ministries and the Ministry of Finance and Planning in all budgeting matters;

(ii) update the recurrent and development estimates throughout the annual budget cycle and to make recommendations to the Budgetary Procedures Group to ensure that submissions remained within the ceilings; and

(iii) review, endorse or reject proposals for new programmes and projects and liaise with the external aid department to secure funding.

The SPGs were given a much wider scope in their terms of reference and were expected to play a significant role in expenditure planning and management by:

(i) ensuring consistency of ministry proposals with the national development plan;

(ii) prioritise development projects for ease in resource allocation;

(iii) ensuring recurrent cost requirements were adequately budgeted for;

(iv) monitoring progress in implementation of ongoing projects;

(v) ensuring proper implementation and scheduling;

(vi) reviewing new project ideas; and

(vii) assessing financing sources.

In practice, however, there was no evidence of serious application of implementation scheduling and monitoring procedures by 1989. Performance and output criteria had not been developed and no rigorous appraisal of projects had been undertaken. Forward budgets were included in the periodic national development plans but the annual programme review was less successful and the PR&FB suffered a credibility problem mainly because the annual budget ceilings were not derived from the forward budget. Although SPGs tended to be active when preparation of the PR&FB coincided with preparation of a national development plan, in practice, EWGs dominated the annual process and the forward budget degenerated into an incremental budget by line item.

4.2.2 Budget Rationalization Programme

Economic performance and prospects remained poor in the mid-1980s. There were five main concerns:

(i) The immediate budget pressure came from the poor performance of revenues that, with growing expenditure, necessitated an increase in public debt.

(ii) The resultant increase in debt service, which had reached 25 percent of total expenditure in 1985/86, meant a decline in the share allocated to discretionary expenditure.

(iii) The balance of expenditure between economic categories had become distorted because of declining shares for development expenditure and goods and services while an excessive share was allocated to personnel emoluments.

(iv) Because public expenditure consistently absorbed more than 30 percent of GDP, the private sector was crowded out and was unable to deliver sustained economic growth.

(v) The productivity of public expenditure was low, as exemplified by the poor completion rate of development projects, and had to be addressed by improving the utilization of existing assets.

These concerns prompted another reform initiative, the Budget Rationalization Programme (BRP). The BRP was launched in 1986 and was intended “to ensure that the limited funds at our disposal are spent on the most important and high priority areas which have an immediate impact on promoting growth prospects, increasing productivity, creating employment opportunities and in increasing the revenue base (Budget Rationalization Seminar, Vol. 1, p.1, 1986). The introductory paper stated that “The BRP seeks to rationalize and improve the present pattern of allocation of budgetary resources, in conjunction with a program of borrowing and other policy measures to bridge the gap between resources and requirements until the gap can be minimized...(Budget Rationalization Seminar, Vol. 1, p.3, 1986)

The two main objectives of the BRP were to:

(i) increase the productivity of scarce budgetary resources by allocating them in accordance with well-defined priorities; and

(ii) improve the planning and budgetary process in the treasury and in operating ministries so that the proposed improvements could be institutionalized and implemented through the annual cycle.

The PR&FB was seen as the main vehicle for achieving the intended results of the BRP. It was intended to be the link between medium-term strategic plans and the annual budget. Ministries were required to set clear and realistic priorities to improve allocative efficiency. A review of all ongoing projects and programmes in the development budget was intended to result in fewer, more productive projects by phasing out those that failed to address priorities. More rigorous appraisal procedures were to be applied to new project proposals and only those projects that contributed to increased production, created employment and income-generation opportunities, assisted the poorest population groups, conserved foreign exchange, and/or minimized the requirement for recurrent resources were to be selected. Allocations in the recurrent budget were to be increased to meet the operating costs of completed projects. Districts were to be fully involved in the annual budgetary process by providing relevant sections of district development plans to spending agencies and by commenting on the draft forward budget.

4.2.3 Public Investment Programme

Although there were a number of institutional and logistical improvements in the late 1980s, the PR&FB was still dominated by financial and accounting considerations and tended to duplicate the annual budget exercise. The main weakness was the failure of SPGs to provide an effective link between planning and budgeting. It had not been possible to reduce the number of ongoing projects or to concentrate development resources on a few priority areas. The government "had failed to produce either an accurate, annually updated list of public investments or to implement an effective system for preparing, appraising, approving and monitoring government projects and programs" (Wheeler and Cohen, 1994).

The challenge was to improve the quality of the development portfolio by reducing the aggregate level of development expenditure while redirecting that expenditure towards investment that contributed to economic growth more directly. The response was to introduce a public investment programme (PIP) that was intended to ensure that capital resources addressed national development priorities in an efficient manner.

A review of 15 African countries indicated that a successful planning system paradigm would have four essential instruments (J. P. Foirry, 1990):

1. A master plan that sets out the major lines of action based on the macroeconomic policy framework and the resultant projections, sector analysis and sector strategy. The growth of sustainable recurrent expenditure will determine the aggregate ceiling for development expenditure.

2. A primary PIP that lists priority public investments within the development expenditure ceiling. A supplementary pipeline of projects can be identified in case resource availability (both human and financial) improves.

3. A recurrent costs table that sets out the recurrent implications of proposed capital projects because it is necessary to ensure that adequate provision is available for recurrent costs arising from both service delivery and maintenance before making funding commitment.

4. A consolidated budget that shows the allocation of all national resources, both recurrent and capital. This is prepared annually and should be supplemented by relevant financial reports.

In line with this approach, “in 1990, with the encouragement of the World Bank, the Government launched the PIP exercise, with the intention to strengthen the planning, selection and management of public financed capital investments” (Wheeler and Cohen, 1994) and therefore to achieve the objectives of the Budget Rationalization Programme.

The PIP was designed to apply rigorous selection criteria through the project cycle, link sectoral strategies to capital formation, assist in coordination of external assistance, strengthen public expenditure management, monitor the investment plans of state corporations, and improve the forecasting of recurrent expenditure demands.

Wheeler and Cohen (1994) conclude that by 1994, the PIP had recorded genuine progress in preparing a project list, project briefs and ministerial policy statements including project and programme priority ratings. Formal responsibility for preparing the PIP had been transferred to the Ministry of Planning and National Development and the annual timetable had been changed to ensure that the PIP could influence the Development Estimates. Subsequent improvements included the introduction of a computerised project database and the design of standard forms to assist in the appraisal of new projects and in the monitoring of ongoing projects. In addition, a rationalized project inventory was produced in June 1998.

Despite this progress and the widely recognized need for an effective project selection and appraisal system, many projects were still included in the PIP for political reasons and without full transparency or accountability. Recurrent cost tables that should build a link between the PIP and the recurrent budget had not been developed. The monitoring of project implementation and evaluation of project impact remained weak.

4.3 Review of the Budget Reform Initiatives

Over the past 20 years, several reports have identified problems with the budget process in Kenya. These include the Working Party on Government Expenditures (1982), background papers for the Budget Rationalization Programme (1986), and various public expenditure reviews.

Despite the reform efforts, the 1997 Public Expenditure Review (PER) indicated that there are outstanding problems of macroeconomic management, the budget process has little credibility, and that public sector productivity is very low. Resources are poorly utilized and their contribution to achieving national development objectives is limited. Even though the PR&FB and the PIP were institutionalized to guide medium-term resource allocations, in practice the preparation process of the Forward Budget did not differ significantly from that of the annual budget. The programme review component was ignored and no evaluation of recurrent activities took place.

Table 5(a) shows the evolution of public expenditure from 1972/73 to 1996/97. Over the years, the development budget has included many items of recurrent expenditure. Expenditure reviews undertaken jointly by the World Bank and the government show that only 60 percent of development expenditure is investment. Based on this finding, spending on development was reduced to 60 percent to generate a new series of (dev 2) which is more representative of actual development expenditure. Conversely, rec. 2 includes expenditure on ongoing programmes that is budgeted through Development Estimates. The share of development in total expenditure, which was 10.5 percent in 1986/87, had fallen to 5.5 percent by 1996/97.

Table 5: Evolution of Public Expenditure in Kenya

Source: Table 6.1 of Economic Surveys, various editions; and authors' own calculations

Table 5(b) shows that the deficit has gradually reduced to manageable levels. However, this has been achieved at the expense of crowding out development expenditure. Indeed, Easterly (1998) cites Kenya as a typical case where fiscal adjustment was an illusion. The success in deficit reduction was a result of reduced spending in operations and maintenance, resulting in a rapid depreciation of public capital stock, and of crowding out new public investment. Easterly also found the negative trend in development expenditure as a proportion of GDP to be statistically significant.

Management reforms in Kenya therefore seem to have failed to improve the effectiveness and efficiency of public expenditure. Until this problem is addressed, additional injections of domestic or donor funding will have little or no impact on outcomes. The allocation of resources, both by economic category and by sector, contributes to the poor performance of public expenditure. During the period 1991/92 to 1999/2000, interest payments, wages and salaries averaged 54 percent of total expenditure and 66 percent of recurrent expenditure.

O'Brien and Ryan (2001) observe that adjustment in fiscal policy in Kenya has failed to create conditions for a sustained economic recovery, poverty has been increasing, and social indicators have shown negative trends in recent years. Kenya's problems are however not uncommon. When the economy was growing fast, the government was able to fund new priorities while retaining the old ones but once growth stagnated and donor funding petered out, resource allocations became fixed and priorities failed to change in line with circumstances. Instead, the government crowded out both private and government investment through expensive borrowing to finance the chronic deficits.

The overall conclusion is that the resource allocation process and implementation is flawed. The four critical problem areas are:

1. The failure to define strategic priorities. Despite the preparation of numerous planning documents, Kenya lacks a comprehensive development strategy that is based on realistic national resource constraints. There is no agreement on the appropriate role for the public sector and there are no criteria for determining inter-sectoral resource allocations. There is wide appreciation of the need to achieve national development objectives by concentrating resources on a narrow range of high-priority activities. This is evidenced by, for instance, "Each sector or operating ministry must develop a clear set of priorities for the allocation and the use of limited budgetary resources for the next three years" (Budget

Rationalization Seminar, Vol. 1, 1986). But there is no consensus on what these core priorities are or how to ensure they receive adequate resource allocations.

2. The excessive size of government. By comparison with most developing countries, the Kenyan government absorbs a very large share of gross domestic product (it has been around 33 percent in most years although it has recently been reduced to 25 percent). This has resulted from four main factors. First, government was seen as the “employer of last resort” in good years such as the coffee boom of the late 1970s but it failed to make staff reductions in bad years. Secondly, there has been continual pressure to expand the asset base for physical infrastructure, often as a result of donor funding. Thirdly, the government has made policy commitments that require a significant increase in recurrent budget allocations. Lastly, inefficient parastatal organizations have absorbed large subventions. This means that the public sector asset base exceeds the capacity to service and maintain it. As a result, public sector expenditure commitments exceed the sustainable level of long-run revenues and, in attempting to resolve the fiscal problem, the government has imposed a high tax burden that acts as a disincentive to private sector development and economic growth.

3. The failure to achieve aggregate fiscal discipline. Despite several attempts, some of which have been successful for a period, Kenya has failed to adhere to deficit targets. The resultant increase in non-concessional domestic debt has imposed a severe debt service burden on the budget and diverted resources from development and goods and services.

4. The poor quality of public expenditure. This shows up in the deteriorating condition of public assets, the declining quality of public services, and an increasing service deficit (that is failure to deliver services to the quantity and standard expected by the intended beneficiaries). In part, this is because the economic allocation of resources is inappropriate. Budget cuts have reduced the real level of public expenditure but the methods used, like reducing real wages but not the number of public servants, have distorted resource allocations. Salaries and debt service are for example allocated a high proportion of resources and very little is left for operations and maintenance, and for development.

A number of weaknesses in the planning and budget process have contributed to this poor performance. These include:

- Poor forecasting ability. There have been several efforts to create capacity to prepare economic forecasts. None of them were sustained and therefore budgets have been prepared without consistent and reliable forecasts of macroeconomic performance and analysis of the implications for the budget. This means that the Forward Budget has not been based on an accurate and reliable assessment of the aggregate resource envelope. The credibility of the budget process has been damaged because revenue forecasts have consistently exceeded actual collections, necessitating ‘across-the-board’ cuts in the appropriated Estimates.

- Lack of medium-term perspective. The budget process has been dominated by short-term stabilization concerns although optimal resource allocations can only be achieved by combining the different time perspectives of medium-term planning and annual budgeting. “A medium-term perspective of three or four years is essential in any planning and budgetary system for government expenditures” (Budget Rationalization Seminar, Vol. 2, 1986).

- Failure to cost future resource requirements. There is no systematic analysis of the resource implications of decisions to introduce new policies and programmes or to implement new legislation.

- Too many budgets. The preparation of three budgets in one year leaves little time to focus on medium- and long-term growth strategies or to monitor and evaluate ongoing programmes and project proposals.

- Excessive political interference in budgeting. It has not been possible to generate sustained political commitment to the budget process and product. There are numerous examples of “parachuted” projects introduced to the PIP without going through formal appraisal procedures.

- Separation of the planning and budget process. The budget and planning functions are currently combined within the Ministry of Finance and Planning although historically they have been separate activities. There has been a failure to ensure that recurrent and development activities contribute to the same strategic objectives although the dual budget approach of preparing separate recurrent and development estimates reflects a genuine difference between ongoing programmes and capital projects. Capital projects, by definition, should be discrete expenditures with defined outputs. This has been reinforced by planning and donor procedures that emphasise new initiatives as the engine of development and the prime mechanism to improve national welfare, with a corresponding lack of focus on recurrent programmes.

- Failure of Sectoral Planning Groups. Sectoral Planning Groups have not succeeded in integrating strategic planning concerns into the budget cycle. This has meant that budget officers who emphasise legality and fiscal discipline rather than efficiency in service delivery (i.e. compliance and control instead of managerial initiative and performance) take most resource allocation decisions. Since planning officers do not receive the training needed to become sectoral specialists, they do not become effective members of the planning team in line ministries and this makes the problem worse.

- Failure of expenditure control by line item. The budget system emphasizes accountability and transparency by controlling expenditure on inputs. This is not only time-consuming, especially because it has to be completed for all three budgets, but it also fails to ensure that intended outputs are delivered efficiently. Excessive detail in budget documents discourages analysis of resource allocations by activity and by economic category.

- Recurrent budgeting is incremental. The allocation of resources tends to be across-the-board rather than reflect strategic priorities. The budget has become rigid and sticks to the historical expenditure allocation path instead of adapting to changes in the dynamic environment. Ongoing programmes are continued even when circumstances are different, therefore preventing reallocations from low to high priority programmes across ministries. Low revenue collection means that available increment has been declining, leaving no scope for funding emerging priorities. This form of budgeting has resulted in redundant and rising programme/project implementation costs.

- Delays in issuing resources. The resources released throughout the financial year are frequently less than the appropriations in the annual Estimates. This is due to unforeseen changes in revenue, emergency expenditures and unplanned activities. Line ministries therefore incur pending bills, excess votes and delayed implementation of ongoing projects.

- Inadequate provision for the recurrent implications of development projects. Planning systems tend to focus on the level and distribution of capital resources while sound macroeconomic management requires that the size of the capital programme be determined by the long-term affordability of the recurrent implications of completed projects. Sustainability is demonstrated by the ability to meet the required level of recurrent expenditure with recurrent revenue collections, for example by excluding any one-off receipts from the sale of assets. Exceeding that level creates an additional debt burden. However, this criterion has been ignored and the resources needed to service and maintain the existing asset base exceed the sustainable recurrent budget ceiling. Although the application of rigorous project design, appraisal and selection procedures can minimize these implications, line agencies have ignored this issue and have failed to make adequate provision for the recurrent costs.

- Funding recurrent activities through the development budget. This occurs because many ongoing programmes attract donor funding but it adversely affects transparency and accountability. These activities are unlikely to be sustained once donor support ends.

- Discrepancies between Development Estimates and the PIP. Budget officers, and even the External Resources Department, failed to utilise the PIP approach when determining resource allocations although it was intended to strengthen project selection, appraisal and implementation. This contributed to the poor quality of capital expenditure.

- Poor quality of development projects. Public investment is expected to contribute efficiently to economic growth and poverty reduction. However, the incremental capital output ratio of capital projects is very low as a result of poor targeting. “The available budgetary resources for development have been spread too thinly across a large number of under-funded projects instead of being concentrated on the more important, productive and high priority ones which will have an immediate effect on the economy” (Budget Rationalization Seminar, Vol. 1, 1986). High unit costs and low completion rates also contribute to the low ratio.

- Weak accounting systems. Financial and budget monitoring reports are often late and inaccurate. Even the Annual Appropriation Accounts are often delayed and, in some respects, incorrect. This adversely affects the transparency and accountability of resource utilization.

- Inadequate monitoring and evaluation systems. There are no assessments of physical implementation and/or evaluations of outputs and outcomes.

- Failure to develop management information systems. Ministries fail to collect, analyse and utilise data even when there is considerable scope to improve productivity by comparing unit costs across a range of facilities and applying uniform standards of best practice. This approach can also indicate the scope to improve productivity by using private sector service providers on a contract basis.

5. INTRODUCTION OF THE MTEF IN KENYA

5.1 Background

Table 6 summarizes the main activities culminating in the introduction of the Medium-Term Expenditure Framework approach in Kenya. The starting point was the Public Expenditure Review (PER) in 1997. This was a joint initiative of the government of Kenya, the World Bank and other development partners.

The review concluded by adopting the terminology emerging from the international financing institutions and recommending the introduction of a Medium-Term Expenditure Framework. This was after identifying several systemic weaknesses of the planning and budget process. The Framework would have two main objectives:

- To create a macroeconomic environment that will attract both foreign and domestic private investment by supporting efficient production; and
- To ensure that public resources are utilised efficiently and effectively in supporting high growth of income and employment.

"The key element to a medium-term strategy is the efficient and equitable reduction in the share of public expenditure in GDP. This must be done in ways that concentrate Government activities on a focused range of functions, protect and better target the delivery of essential social services, and provides essential infrastructure that supports private sector growth. Far reaching reform of public sector management will be necessary in order to improve productivity while reducing the size of Government" (Public Expenditure Review, 1997).

Table 6: Chronology of introducing the MTEF Approach in Kenya

October 1997	1997 Public Expenditure Review recommends introduction of MTEF approach.
6 April 1998	Workshop of Permanent Secretaries and Authorised Officers on economic performance and public sector management endorses the main recommendations of the 1997 PER and agrees on the development of the MTEF approach and the preparation of ministerial expenditure reviews.
17 April 1998	Treasury Circular (CONF 51/03) confirms acceptance of the medium-term approach and indicates the need to prepare sector expenditure reviews.
29 April 1998	Treasury Circular (CONF 51/07) requires each Ministry to prepare a Ministerial Public Expenditure Review (MPER) and provides guidelines. Major tasks include definition of core functions, proposals for restructuring, identification of staffing reductions, and preparation of an indicative forward budget achieving a 20 percent reduction in budgetary requirements.
6 May 1998	H. E. the President chairs an Economic Consultative Meeting

	to discuss economic performance and public sector management. The participants conclude that Kenya needed to reduce the level of public expenditure and improve productivity through a medium-term expenditure framework.
12 May 1998	A workshop for those involved in the preparation of MPERs covers the main features of the MTEF approach and indicates how MPERs are expected to contribute to the overall achievement of improvements in public expenditure planning and management.
9 July 1998	A paper prepared for the PER Secretariat on "Introducing the Medium-Term Expenditure Framework" is presented to officials involved in the Ministerial Public Expenditure Review process.
Sept. 1998	Background papers on the MTEF approach are prepared by the Project Management Department and by the budget adviser.
October 1998	The draft report of the PER Secretariat on the MPERs and the MTEF is produced. The report notes the lack of political commitment to the definition of core functions, even in the Civil Service Reform Medium-Term Strategy 1998-2001, and recommends that the PER Secretariat be converted into an MTEF Secretariat, partly in order to enhance awareness of the MTEF approach among senior officials.
April 1999	The PER Secretariat organizes a workshop for Budget Supplies Officers at which the principles of the MTEF are presented and the appropriate organizational and institutional structures and the possible timetable for introducing the MTEF approach are discussed.
June 1999	The Budget Speech confirms the introduction of the MTEF approach.
October 1999	A workshop for senior officials agrees to the modalities of introducing MTEF.
Nov. 1999	The relevant MTEF institutions are established.
June 2000	The first MTEF budget is published.

The Public Expenditure Review was followed by considerable internal work mostly coordinated by the PER Secretariat. The aim was to understand the main components of the MTEF approach and agree on the appropriate organizational and institutional structure and the possible timetable for introducing the MTEF approach. The main components of the MTEF involve defining the aggregate resource envelope, determining inter-sectoral resource allocations by basing them on core functions, and then proposing intra-sectoral allocations based on intended outcomes, activities, inputs, outputs and operational efficiency.

The government made an explicit commitment to adopt the MTEF in the June 1999 Budget Speech: "This [Policy Framework for Economic Reform] outlines measures that can effectively translate long term strategies into medium term operational plans for effective implementation. As part of this framework, we will, during 1999/2000, embark on the formulation of the first phase of a three year Medium Term Expenditure Framework, which will outline: (i) priorities for allocation of public resources; and (ii) measures for more effective implementation of policies and expenditure programmes. Once such an integrative framework is established, annual budgets will be formulated within a long-term framework as outlined in the MTEF" (Budget Speech, 1999/2000).

Even so, no practical steps were taken to implement this approach until the MTEF process was officially endorsed in October 1999 following a workshop for senior government officials. The objectives of the workshop were to:

(i) Introduce senior government officers to the concepts, principles and basic objectives of the MTEF.

(ii) Demonstrate the linkage between MTEF and the broader public sector and governance reform programmes.

(iii) Provide an overview of experiences of selected African countries in implementing the MTEF.

(iv) Agree among senior government officers on an action plan that will enable the government to prepare the Fiscal Year 2000/01 budget using MTEF principles.

Immediately thereafter, the Ministry of Finance and Planning took steps to establish the institutional mechanism to operationalize the process. Three institutions were created in November 1999: the MTEF Secretariat, the Macroeconomic Working Group (MWG), and representatives of all ministries assigned to six Sectoral Working Groups based on identification of the following core sectors:

- Public Administration
- Public Safety, Law and Order
- Human Resource Development
- Physical Infrastructure
- Agriculture and Rural Development
- Trade, Tourism and Industry

Two additional sectors, the National Security, and Information Technology, were introduced in the MTEF2 cycle. This institutional structure has been used to prepare two annual budgets. MTEF1 was presented in June 2000 and MTEF2 in June 2001.

5.2 The MTEF Approach

The Medium-Term Expenditure Framework in Kenya is designed as a top-down and bottom-up resource allocation process intended to establish an explicit link between policy framework and planning and budget process by reviving the original concept of the Programme Review and Forward Budget.

There are three components in the MTEF:

(i) Fiscal discipline through a medium term macroeconomic framework;

(ii) Allocative efficiency (resource allocation in line with the development agenda) through a medium term budget framework; and

(iii) Operational efficiency (service provision at the least possible cost) through a budget that is based on medium term performance measurement.

5.2.1 Fiscal Discipline

The members of the Macroeconomic Working Group (MWG) included all the key agencies (departments of the MoFP, CBK, KRA, CBS and KIPPRA) involved in aspects of determining the aggregate level and composition of revenue and expenditure. The main task assigned to the Group was to prepare a Fiscal Strategy Paper (FSP) setting out the optimal levels of aggregate revenue and expenditure, a deficit strategy, and a financing strategy.

The success of a macroeconomic framework in imposing fiscal discipline presupposes the ability to make accurate and timely forecasts of likely economic outcomes. One weakness of the budget process prior to the introduction of the MTEF was the limited capacity to produce economic forecasts. For MTEF1, the MWG used RMSM-X (the Kenya version of the model was installed at the Ministry of Finance in early 1999) to assist in preparing a four-year government finance framework based on projections of the total resource basket. There were several shortcomings in this approach. The model can analyse the resource requirements of achieving specific policy targets but it requires detailed calibration to generate realistic forecasts of economic activity and the budgetary implications. Nonetheless, the MWG was able to use the model to produce some plausible economic forecasts by simplifying exogenous assumptions. However, these forecasts were considered too pessimistic to secure political endorsement although the basic principles contained in the Fiscal Strategy Paper were specifically intended to be relatively robust so that the government budget forecasts could be attained within a range of economic outcomes. Several drafts of the Fiscal Strategy Paper were prepared, including a scenario showing faster economic growth, but the Paper was not published together with the Budget documents.

A review of macroeconomic models that had been used in Kenya highlighted their strengths and weaknesses and identified a need for a more appropriate model (Karingi S. N. and N. S. Ndung'u, 2000). Work on the KIPPRA-Treasury Macro Model KTMM) therefore started in January 2000. The KTMM is designed to generate econometric forecasts through analysis of the main components of aggregate supply and demand. The first operational version was presented to senior government officials and other interested parties in August 2000. An early application of the model was to run a scenario showing the expected implications of the decline in agricultural production and electricity rationing as a result of drought.

The model was used to generate a consistent macroeconomic framework showing the expected growth of the economy and the implications for public revenue and expenditure in the MTEF2. In the light of anticipated private sector demand for resources, a central forecast was produced, which specified aggregate levels of expenditure and the deficit, assuming no change in current policy with respect to revenue. This base case was used to determine the main features of the public sector budget over the period 2000/01–2003/04. One key concern was to ensure consistency between estimates of public finances and the forecast of real economic activity. There were therefore several iterations between the draft fiscal strategy and the model. Fiscal and Monetary Affairs Division, for example, prepared revenue estimates on the basis of the GDP forecasts generated by the model and these were checked against the model forecasts. Though the model is still being improved, it has been a major milestone in operationalizing the medium-term macroeconomic framework and improving the quality of the economic forecast used in the annual budget cycle.

The MWG participated in preparing the base case of the model and the subsequent drafting of the Fiscal Strategy Paper. This was presented to a senior management team of the Ministry of Finance and Planning in January 2001. Some concerns were raised about the economic forecast and, through a consultative process, a number of model runs were prepared during which various errors were rectified. The MWG was not directly involved when the revised base case was finalized in March 2001 and the revised version of the FSP prepared. Further versions of the FSP were produced in April and May to incorporate alterations in the revenue and expenditure numbers that emerged as the budget was being finalized. The FSP was finalized in June 2001 and published as part of the budget documentation. The main features of the forecast and the recommended strategy were summarized for inclusion in the Poverty Reduction Strategy Paper (PRSP).

The model was used to prepare both pessimistic and optimistic scenarios between April and June 2001. An alternative Fiscal Strategy Paper was prepared based on the optimistic scenario. This set out the main reforms needed to shift to a faster growth path and indicated the resultant changes in the revenue and expenditure forecasts.

Several problems were experienced in achieving fiscal discipline during MTEF1 and MTEF2. These problems were:

- The base case model run came too late in MTEF2 to have the desired impact. Ideally, the model should generate the base case early in the annual process so that the Fiscal Strategy Paper can be prepared by October/November and can determine aggregate expenditure ceilings for inclusion in the Treasury call circular to sectoral working groups in December/January. A revised model run should be produced in March/April to confirm any modifications to the ceilings prior to finalizing the Budget in June. Additional runs would be prepared to analyse the likely impact of specific policy changes.

- The MTEF is expected to impose a “hard” budget ceiling and ensure that accounting officers adhere to this ceiling. This requires firm political commitment to the aggregate revenue and expenditure ceilings, the optimal deficit target and financing strategy, the broad development objectives, the appropriate role of government, the procedures for setting the expenditure framework, and the need for discipline in both macroeconomic management and line agency ceilings. Ideally, the ceilings should be published once they have received political endorsement but unfortunately, time constraints made it impractical to present the main features of the economic and fiscal forecast to Cabinet.

- The MTEF1 failed to achieve an improvement in aggregate fiscal discipline due to various factors. The most important factor was the necessity to implement substantial expenditure programmes intended to provide drought relief and resolve the energy crisis. Other contributory factors included the failure to ensure that accounting officers were fully committed to the budget ceilings, and continuing difficulties with budget management. Although the ceilings for MTEF2 appear achievable, adequate political commitment is needed to achieve them especially in the run-up to general elections in 2002.

- During MTEF2, a small team from KIPPRA and the Macroeconomics Planning Division finalized the KTMM baseline run of March 2001 and the subsequent revisions of the FSP under the direction of the senior management in the Ministry of Finance and Planning. Despite its nominal responsibility in this task, the MWG was not involved and the process failed to secure consensus from all key agencies.

- While project aid is only included in Estimates if agreements have been explicitly approved, programme aid was treated as an additional recurrent resource and the ceiling was based on the optimistic assumptions that the release of donor funds is certain. The failure to satisfy conditionalities of reform programmes caused delays in receiving aid. The provisional budget outturn figures for 2000/01 do not show much impact on the aggregate expenditure ceiling. However, attempts to identify budget cuts for some categories of expenditure in January 2001 as a result of increase in drought-related expenditures and the suspension of programme support disrupted the release of funds to spending ministries.

- The FSP attempts to set ceilings in line with the economic classification of expenditure. Since approximately half of the development budget is actually used to fund ongoing recurrent activities, there is considerable uncertainty about the optimal ratio of capital to recurrent expenditure and there are no guidelines to assess the recurrent budget implications of completed capital projects. This makes it difficult to determine the long-term sustainability of the expenditure programme.

- Both the FSP and the KTMM depend on receiving consistent, accurate and timely information on key parameters. In practice, there are frequent changes in for example revenue and expenditure data, inconsistencies in definitions used, inconsistencies between different sources (for example data from Debt Management Division and the Accountant General), and delays in receiving data. It is essential that the principal agencies involved in providing and utilizing information improve coordination, agree on core definitions and maintain the same format for presentation of data.

- There is considerable uncertainty about the proposed privatization programme and this has a significant impact on financing requirements. In the short-term, the MTEF should be based on a financing strategy that is not dependent on revenue from privatization while future MTEF cycles should ensure agreement on a realistic implementation schedule and an accurate assessment of net receipts from the sale of assets.

5.2.2 Allocative Efficiency

The objective of allocative efficiency can be expressed as “doing the right thing”. This means that the medium term budget framework should determine sectoral resource allocations in line with the national consensus about the development agenda, and should reflect national priorities as identified through a consultative process. Implementation of both MTEF1 and MTEF2 has been hindered by lack of a national strategic plan. There are several relevant policy documents that can be used but which do not provide adequate guidance to determine resource allocations (West G., 2000). These include sessional papers, the national development plans, the national poverty eradication plan, and the poverty reduction strategy paper. During the two MTEF cycles, planning efforts were concentrated on preparing the Interim PRSP and the full PRSP, which were published in June 2000 and June 2001 respectively. In October 2000, the government committed itself to prepare a National Development Plan covering the period 2002-2008. This was scheduled for publication in December 2001.

During MTEF1, the MWG prepared an historical analysis of expenditure to be used in determining sectoral allocations and the scope for appropriate reallocations. However, evaluation of trade-offs between sectors was not thorough. The MTEF was launched in October 1999 and a budget had to be produced by June 2000. Therefore, time to utilize data from the MPERs, to analyse public expenditure by economic and functional classification, and to make international comparisons was not adequate.

A more comprehensive approach was attempted in MTEF2 based on the national consultative process that was undertaken as part of the PRSP. The definition of national and local priorities was used to assess sectoral priorities and to set the sectoral ceilings for MTEF2. The procedure attempted to adjust for the distribution of activities between sectors and for the role of government. District priorities were weighted by frequency and by population. The proposals were based on existing resource allocations by sector and proposed gradual reallocations to achieve sectoral and district priorities. The methodology also recognized that, in the short-term, reallocations can only apply to discretionary expenditure and that some expenditure items such as salaries and asset based O&M expenditure must be provided in full. This methodology can be developed further in order to provide a foundation for future MTEF cycles.

Setting sectoral ceilings has been especially complicated because of the choice of sectors (six in MTEF1 and eight in MTEF2) and the peculiar division of activities between sectors that is based on the nature of the expenditure and ignores the purpose of the expenditure. Salaries are, for example, assigned to public administration, all construction to physical infrastructure, and sector specific training is assigned to human resource development. This has meant that a particular output may be dependent on successful bidding in several sectors. The allocation process is made extremely complex because all line agencies must submit bids to several sectors. The solution is to change the definition of sectors used in the PRSP/MTEF so that they are based on functions and outputs rather than inputs.

There are a number of problems that have been experienced during MTEF1 and MTEF2 in attaining allocative efficiency:

- The numerous practical and theoretical difficulties involved in setting criteria for allocative priorities have not been overcome.

- It has proved difficult to persuade ministries to incorporate national development priorities as determined by local communities and the pro-poor growth strategy into their expenditure programmes. The MTEF will need to address the political and bureaucratic reasons that make line agencies reluctant to reallocate resources away from ongoing programmes.

- The definition of the eight sectors in MTEF2 does not reflect an optimal functional classification for Kenya. Human resource development, for example, contains two very significant sub-sectors in education and health while information technology does not command any resource allocations. Certainly, the coverage of the sectors should be redefined so that they reflect functions and outputs rather than inputs.

- The MTEF cycle should include an explicit mechanism to deal with the complex bidding process between and within sectors. One possible approach is to develop a budget negotiation framework that sets out the main functional areas of expenditure and attempts to use output indicators to assess their contribution to national welfare.

- The time frame within which the MTEF budgets were produced did not allow for proper sequencing and adequate preparation. In particular, time for core activities such as bidding between sectors and line agencies and appraisal by SWGs and central agencies was inadequate. This implies that the annual cycle must start earlier with the publication of the Fiscal Strategy Paper and the call circular.

- The remit of SWGs is too narrow. Their terms of reference should be expanded so that they compile and maintain comprehensive sectoral databases and become the core institutions for preparing Sector-Wide Approaches.

- The sectoral action plans need to be more realistic and should take adequate account of resource and capacity constraints. Generally, both the MTEF and PRSP over-estimate institutional capacity and under-estimate financial costs, recurrent implications, and time required to introduce new policy directions and to implement programmes and projects.

- Existing commitments, resource constraints, and the time required to build appropriate institutional capacity mean that it will take several years to make effective reallocations. Additionally, donor pressure and the consultation process have created unrealistic expectations about government's ability to change priorities and the time frame.

5.2.3 Operational Efficiency

The objective of operational efficiency can be expressed as "doing the thing right", or maximizing the delivery of outputs while minimizing the inputs used. The Estimates have been simplified and the entire budget is now contained in only two volumes instead of the previous four volumes. However, the two MTEF budgets still emphasize detailed control over input allocations based on expenditure line items. They simply list all items to be purchased and this method of expenditure control remains so complex that it fails to achieve the intended purpose.

The Recurrent Estimates show Approved Estimates for the previous year, the Appropriations for the current year and the Indicative or "projected" estimates for the two following years. They also show the authorized establishment and the projected in-post numbers. The format of the current Estimates means that it is only possible to compare gross appropriations for the three years 2001/02 to 2003/04 (the 2000/01 information refers to net appropriations). However, an analysis of the financial allocations by vote clearly demonstrates that despite the addition of two outer years, the procedure remains that of incremental budgeting. After excluding some one-off expenditures (the early retirement scheme, house allowance adjustment, elections etc.), the ministerial recurrent estimates show a small nominal increase of 0.9 per cent over the three years. This represents a decline in real terms and is not consistent with the targets established in the Fiscal Strategy Paper. The Civil Service Reform Secretariat was not involved in setting the targets for personnel in-post. These are projected to increase by one percent from 467,305 in 2001/02 to 471,815 in 2003/04, with the only significant increase being for prison warders.

Incremental budgeting indicates not only the failure to implement resource reallocations (allocative efficiency) but also the failure to achieve improvements in productivity (operational efficiency). In particular, the absence of any change in manpower allocations suggests that the medium-term resource allocations have not been linked to the implementation of the Public Sector Reform Programme and to the attainment of the overall objectives of the strategy for performance improvement.

The Development Estimates show the approved estimates, the appropriations for the current year by head and item, and the indicative or “projected” estimates for the two following years. They also include the detailed source of finance (including external receipts) for the current year. Despite the politically endorsed intention to increase public sector investment in order to “crowd-in” private sector activity, the figures are heavily front-end-loaded, with estimates of KSh 41.6 billion in 2001/02 but only KSh 24.6 billion in 2002/03 and KSh 18.8 billion in 2003/04.

One of the main goals of the MTEF approach is to introduce an output orientation in place of the prevailing focus on control of inputs. Resource allocations should be based on the ability of each agency to deliver specified goods and services that address long-term development objectives while maintaining an acceptable standard at the lowest cost. This requires ministries to develop output indicators based on agreed development objectives and specifically selected for each activity (they must not be based on “one size fits all”). One approach is for all public enterprises and for most cost centres within ministries to develop performance contracts that clearly specify their respective rights and obligations.

This, however, is perhaps the most difficult stage to implement and has not yet been achieved. Both MTEF1 and MTEF2 were input based. Nonetheless, efforts were made during MTEF2 to introduce a focus on activities, outputs and outcomes. A workshop on activity-based budgeting was for example organized for budget officers in January 2001 but the MTEF Secretariat was unable to establish this performance-related approach. Moreover, no decisions have been taken on the appropriate format for the output budget.

Several problems were also experienced during MTEF1 and MTEF2 in attaining operational efficiency:

- The respective roles of SWGs and ministries in budget formulation were not clearly defined. Also, the limited time frame within which the MTEF budgets were produced, and the delays in circulating ceilings, discouraged line agencies from preparing their recurrent budget resource proposals in adequate detail. It limited the scope of SWGs and the central agencies in making adjustments in line with improvements in operational efficiency.

- The diversion of scarce planning capacity to preparing of the IPRSP and the PRSP meant that SWGs were unable to complete all elements of the MTEF budget process. They for example failed to convert expenditure concepts contained in the PRSP into adequately prepared project proposals.

- Neither SWGs nor the Ministry of Finance and Planning had adequate time or capacity to subject expenditure proposals to detailed appraisal and evaluation to ensure that the government provides value-for-money. This resulted in loss of quality control in the development budget. Following the closure of the Project Management Department in the Ministry of Finance and Planning which coincided with the introduction of the MTEF approach, no capacity was available to maintain the computerised PIP project listing and monitoring system.

- There has been no progress in the development of suitable indicators of operational efficiency that can be used to improve the design and performance of recurrent programmes and development projects.

- The continued increase in pending bills suggests that accounting officers lacked commitment to the ceilings set in MTEF1, and that it was not possible to guarantee the release of appropriated amounts throughout the financial year. Accounting officers must be held accountable for adhering to the hard budget ceiling, for example in ensuring that there is no increase in pending bills, and for delivery of the outputs on which allocations are based. Equally, the Ministry of Finance must enhance the credibility of the MTEF by ensuring that releases adhere to approved Estimates.

- The Ministry of Finance and Planning requires more time to exercise its control function in examining and appraising resource allocations proposed by line ministries. In practice, there was no opportunity to ensure that agencies had made adequate provision for ongoing commitments such as utility expenditures, pending bills and stalled projects.

- The addition of two indicative years was intended to encourage reallocation of resources to reflect improvements in both allocative and operational efficiency. Instead, the recurrent ceilings appear to be incremental while the development ceilings reflect the failure to identify suitable project proposals.

- The links between the MTEF process and the Public Service Reform Programme are weak. As a result, the recurrent expenditure ceilings do not appear to be consistent with likely manpower constraints. SWGs failed to contribute to the definition of appropriate core functions and optimal delivery mechanisms.

- There has been no progress in designing an optimal format for an output-oriented budget and in training budget officers for its introduction.

- No progress was made in the development of an effective monitoring and evaluation system, which is a pre-condition for the introduction of an output-budget.

5.3 Strengthening the MTEF Process in Kenya

The preceding analysis of the MTEF1 and MTEF2 budget cycles allows us to identify the main areas where strengthening of the MTEF process and the introduction of complementary efforts is necessary. This will ensure initial success, future sustainability of the process, and therefore realising of the potential benefits of improved public expenditure management.

Underpinning all these issues is the central concern that successful introduction of the Medium-Term Expenditure Framework will depend on sustained political commitment to the reform process. The government must develop the capacity, and demonstrate the political will, to improve the planning and budget system, to introduce complementary reforms, to restructure public expenditure and to improve the management of public expenditure.

It is also important that reform of the planning and budget system is not pursued in isolation but as part of broader reforms being implemented through the Public Sector Reform Programme. Personnel from DPM, MoFP and OP must therefore work together to ensure that the MTEF process adopts common goals and an integrated implementation plan.

5.3.1 Fiscal Discipline and Economic Forecasting

The first step in achieving fiscal discipline is to improve the quality of economic modeling and to use realistic forecasts in preparing the fiscal strategy. The MTEF2 process achieved significant improvements in the development of an econometric forecasting model and the utilization of the results in drafting the Fiscal Strategy Paper. The main outstanding challenge in this area is to ensure long-term sustainability of the model and its continued application in preparing the rolling fiscal strategy as part of the annual MTEF process. In particular, it is necessary to improve the availability, timeliness and reliability of data used in updating and calibrating the model runs. This requires a significant strengthening of coordination between the Central Bureau of Statistics, the Central Bank of Kenya, the Budget Monitoring Department and the KIPPRA-Treasury modeling team. All agencies involved in this exercise should use the same definitions of all categories of revenue and expenditure (or at least agree on a "bridge matrix" that allows easy reconciliation between the different concepts used in the planning and budget process. It is also necessary to ensure that the aggregate forecasts generated by the model are consistent with expected performance at the sectoral level and that public sector action plans address any constraints that would otherwise prevent attainment of the model outcomes.

The next step involves adhering to the recommendations contained in the fiscal strategy. The FSP should be prepared and distributed early in the annual cycle and there should be explicit political endorsement of the aggregate ceilings. These approved amounts should be disaggregated into sectoral ceilings and incorporated into the annual call circular that is issued to SWGs and line agencies. Spending agencies must have greater certainty that the ceilings will be translated into releases.

5.3.2 Sector Level Planning and Budgeting

Setting inter-sectoral ceilings is a very difficult and politically sensitive task, especially since the constraints on aggregate expenditure ceilings will inevitably mean that the recurrent and development allocations by sector will be less than spending agencies consider optimal. It is clear that the MTEF must achieve substantial resource reallocations since the current pattern of sectoral allocations has failed to deliver the outcomes expected from a pro-poor growth strategy. Nonetheless, the starting point for sectoral analysis must be current allocations and historical trends since, even if the present distribution of resources does not reflect long-term priorities, existing obligations mean there is little room for manoeuvre in the short-term. This exercise is especially complex because there are no standard criteria for determining sectoral resource shares. Ceilings depend not only on each sector's relevance to national development priorities (as defined in the various planning documents) but also on the operational efficiency of the sector's performance. Agencies that use existing resource allocations efficiently by adopting accepted standards of best practice are better able to justify an increased share in future. Ceilings also depend on the scope to use more efficient mechanisms for delivering public goods and services. This implies that in order to improve strategic inter-sectoral and intra-sectoral resource allocations, guidelines on optimal shares must be developed based on an iterative process that combines information generated from the central agencies (top-down) and from the spending agencies (bottom-up).

One tool that could be used in this process is the Budget Negotiation Framework (BNF). This would improve targeting of public expenditure because resource allocations would be based on a comprehensive assessment of the full cost of sectoral action plans and of their progress in meeting agreed performance targets. The BNF would require the development of benchmarks of effectiveness and efficiency—that is assessing the contribution that sectors can make to the achievement of national development objectives and how those sectors actually utilize resources. This would allow trade-offs between and within sectors to be made on a consistent, transparent and equitable basis by identifying those activities that deserve additional resources or those that should incur expenditure cuts.

Relevant factors in determining sectoral and sub-sectoral shares include:

- The extent to which lack of resources contributes to the failure to implement existing policies and ongoing programmes and to maintain existing assets.
- Expenditure commitments already made or in the pipeline as a result of approved policy changes and the recurrent implications of projects that are being implemented.
- Demographic and other social trends, such as increased school enrolments and prison expansion, which will influence the demand for public goods and services.
- The findings of a detailed sectoral situation analysis, which indicates the strengths and weaknesses of the present development status.
- The relevance of national development objectives to each sector and an analysis of the opportunities and threats that will influence their attainment.
- Agreement on the appropriate role for government agencies in contributing to national development objectives.
- Monitoring the implementation of recurrent programmes and development

projects and assessing their impact on the attainment of national development objectives.

- Ensuring that the costs arising from existing polices, proposed policies, and the recurrent implications of development projects have been accurately estimated and that they remain within the realistic budget ceilings of the implementing agency.

- Ensuring that each sectoral action plan identifies the scope to maximize revenue generation, including appropriations-in-aid and the probable levels of donor participation and funding.

Implementation of this approach, with the consequential improvement in allocative efficiency, will require several improvements in the sectoral structure of the MTEF process. There is little correlation between the activities of the eight sectors in MTEF2 and the portfolio responsibilities set by the current ministerial structure. A change in the definition of sectors is needed in order to align them more closely to the definitions used in international coding systems; and ensure that they reflect functions rather than inputs. This will ensure that each sector has full control over, and responsibility for, the manpower, recurrent resources and capital funding they need to deliver agreed outputs.

An initial step in setting sectoral ceilings would be to reach explicit agreement on the definition of core functions. This has been an objective of the Civil Service Reform Programme for several years and sustained political support is required to complete it successfully. The task should be undertaken jointly by the Civil Service Reform Secretariat, the MTEF Secretariat and the SWGs. Specific proposals should be based on:

(i) A comprehensive review of the policy framework (long-term national development objectives).

(ii) An assessment of the efficiency with which the public service can address these objectives.

(iii) Consideration of the expected fiscal constraints in order to strike an appropriate balance between aspirations and affordability.

(iv) Definition of the appropriate role for government in the sector following consultations with other stakeholders.

A detailed analysis and selection of the most efficient service delivery mechanisms should follow this consensus. Options include continued direct provision, privatization, decentralization to other tiers of government, use of semi-autonomous agencies, and regulatory units. It will then be necessary to undertake a costing exercise and ensure that the recommended activities are affordable within the expected expenditure ceilings. If necessary, the recommended activities will need to be redesigned or scaled down to ensure affordability.

It is anticipated that the size of the public service will be reduced to reflect the more limited functional scope of the public sector and, once these decisions have received political endorsement, agencies will ensure that they adopt the most appropriate organizational structure.

The terms of reference for SWGs should be widened so that the Group becomes the key institution in preparing the rolling MTEF and all other planning exercises (PRSP, medium-term indicative plans) and in coordinating the preparation of periodic Sector-Wide Approaches. This would be based on a clear policy framework and status analysis identifying those activities in which the public service has a comparative advantage and will provide the greatest returns on scarce resources. All donor agencies involved in preparing and funding of a SWAP should be in agreement that common implementation and accounting arrangements must apply to all resources.

The central agencies must ensure that aggregate sectoral ceilings remain consistent with the macroeconomic targets established through the Fiscal Strategy Paper. To the extent that this exercise generates recommendations for a real increase in the resource allocations to one sector, this may have to be offset by real reductions in allocations to other sectors.

The MTEF approach must also develop a procedure for addressing cross-sectoral issues including HIV/AIDS, environment, demography, regional development, gender and disadvantaged groups. These topics cut across sectoral and ministerial boundaries and it will be necessary to prepare guidelines to ensure that sector-working groups reflect policy concerns and allocate adequate resources to relevant activities.

5.3.3 Linking Budgets to Effectiveness, Efficiency and Outputs

National resource constraints mean that it is only possible to achieve expansion of public services through sustained improvement in the quality of public expenditure. The MTEF process must be linked to the Civil Service Reform Programme in pursuing the objective of Performance Improvement Strategy (DPM, 2001). This strategy is designed to exploit the considerable scope to make savings by:

(i) Enhancing effectiveness through reallocation of resources to core activities and by better design of programmes.

(ii) Improving efficiency both internally and through contracting out to more efficient private sector providers.

(iii) Changing the budget focus from allocation of inputs to delivery of agreed outputs.

The spending of money is not evidence of accomplishment. Instead, performance should be measured in terms of the outputs delivered and not by the expenditure of allocated resources. If resource envelopes remain input oriented, spending agencies may be encouraged to retain existing programmes without evaluating their impact on economic growth and poverty reduction. The introduction of an output-based budget process therefore appears to be a necessary pre-condition for the MTEF to be successful and the Secretariat should, in consultation with ministries, develop an output/outcome-based MTEF budget format. This will be the starting point in the shift from line item, input-based budgeting to output and outcome-based budgeting. Initially, it may not be possible to include all activities in this format. The appropriate criterion for public goods where prices are not market-related should be efficiency and the target should be a reduction in the real unit cost of delivering a specific service. This approach should be designed to contribute to greater transparency and accountability.

Even in areas where there are no significant demands for additional resources, there is likely to be scope to improve efficiency. Line agencies should explore the potential to raise productivity by introducing commercial discipline or by contracting out services. Inputs and outputs should be reviewed continuously and management information must be used to determine whether the least cost solution is being implemented. One approach is to require each agency to deliver an “efficiency dividend” that reduces the real cost of existing programmes by a fixed amount each year. A reduction by one percent each year, either through increasing output for the same inputs or reducing inputs for the same level of output, may for example be specified. The objectives must be specified in agreed performance targets and progress assessed through a monitoring and evaluation system.

The BNF will require benchmarks of operational efficiency that are likely to include:

(i) Staffing norms

Once it is agreed that a function will remain in the public sector, it will be necessary to develop rules-of-thumb that indicate how many people are required to undertake agreed tasks. The norms may be based on accepted ratios (such as the pupil:teacher ratio, number of police:population or number of warders:prisoners) or on explicit output targets (how many staff are required to process 5,000 passports each year). This is a major undertaking but these norms should incorporate information derived from the job evaluation and regrading exercise, the review of schemes of service, and the updating of job descriptions.

(ii) O&M expenditure norms

These will depend on the agreed delivery mechanism. The budget for a service that is contracted out is for example very different from that for direct provision. The O&M norms also depend on trade-offs between capital expenditure and recurrent costs (for example the technical specifications adopted in road construction have an impact on the optimal level of O&M). The two main guidelines are:

- Asset-based norms (the unit costs of maintaining and servicing existing assets, such as vehicles, buildings and equipment), and
- Activity-based norms (the unit costs of providing specified goods and services under conditions of acceptable best practice).

(iii) Capital expenditure norms

The aggregate capital ceiling should be determined by the sustainable increase in recurrent resources required to service and maintain the completed projects. Within this ceiling, allocations should depend on project appraisal. A major weakness related to the introduction of the MTEF process was the lack of the project planning and monitoring procedures associated with the Public Investment Programme. The MTEF should revive these procedures and ensure that they are rigorously applied by SWGs.

The MTEF approach anticipates that improvements in operational efficiency can be achieved through a significant increase in the autonomy of line managers to make decisions regarding the level and mix of resources. Line managers must for example have freedom to re-allocate resources within broad expenditure categories and in utilizing part of any revenue generated subject to sectoral priorities and efficiency criteria. It is likely that the quality of managerial performance will be enhanced by introducing appropriate incentive structures such as performance-related pay schemes as an integral part of the civil service reform process. The corollary of greater budget autonomy is that:

(i) Managers accept greater responsibility for the achievement of agreed goals; and

(ii) Central agencies provide adequate incentives and impose more rigorous discipline on managers who fail to adhere to the relevant budget and planning procedures.

In previous reform initiatives, the Ministry of Finance has not been willing to hold officers accountable for breaches of financial regulations. No action has for example been taken in response to the continued use by Accounting Officers of pending bills as an informal source of financing.

Schick (1999, 113) summarizes the appropriate sequence for increasing autonomy as: "a government must establish the rudiments of external control before it can safely switch to internal control, and it must have robust internal controls before it can entrust managers with broad flexibility and accountability for resources and outputs". Indeed, managerial discretion should only come after introduction of relevant external and internal controls, specification *of ex ante* output and performance indicators to ensure transparency and accountability, and completion of training and capacity building programmes. Central agencies need to develop a simple and robust monitoring system that generates timely and accurate information and can be used to assess performance and ensure full accountability. Components of this system would include an integrated financial management information system incorporating all functions of expenditure management and the Integrated Payroll and Personnel Database. These reforms will ensure that line ministries have effective managers who can demonstrate that programme objectives are being achieved cost-efficiently by providing management information on input use, outputs and outcomes. However, it should be noted that these objectives cannot be achieved in the short-term as they require a substantial change in the current culture of the public service and sustained implementation of the public service reform programme.

5.3.4 Strengthening of Institutions

Walker and Mengistu (1999, 39) identify institutional reform as a necessary pre-condition for success of the MTEF. The review of previous reform efforts in Kenya indicates that although reforms were well formulated, they were not sustained. It is important to understand why the institutions established under the PR&FB (notably the Budget Secretariat, SPGs and EWGs) were not successful in order to avoid similar mistakes since the arrangements are very similar to those adopted for the MTEF.

One reason for the failure of PR&FB as a medium-term resource allocation mechanism was the ineffectiveness of SPGs. The MTEF process is likely to suffer the same fate unless the SWGs take lead in linking line agency resource allocations to the sectoral level. In the earlier budget reforms, planners took a back seat and effective power was left with the budget department whose main concern was to ensure adherence to the approved ceiling even if this created problems for the implementation of recurrent programmes and projects.

Ensuring that manpower, recurrent and capital resource allocations are internally consistent requires a formal institutional arrangement (such as a Budget Priorities Committee) bringing together the financial, planning and manpower functions of the central agencies. It is also necessary that planning and budget reforms are fully integrated with the broader public sector reform programme and that there is explicit liaison with the Civil Service Reform Secretariat on all major aspects of the process.

One objective of the MTEF is to secure stronger political commitment to both the process (the annual budget and planning cycle) and the product (the aggregate ceilings and sectoral allocations). This support must be sustained even if the political landscape changes. This should be feasible because there is actually a broad consensus of the national development objectives of pro-poor economic growth and poverty reduction. However, the institutional mechanisms adopted as part of the MTEF approach can help to reinforce that commitment by ensuring involvement throughout the process.

Critical steps in institutionalizing the MTEF process include securing political commitment to a wide-ranging reform programme of the planning and budget system and the public service, local government and the legal sector. It also includes securing commitment to the core elements of the MTEF approach by intervening less in resource allocation decisions and by giving managers more autonomy to decide the most efficient way of achieving politically determined objectives. The threat is that politicians will not accept reduction in their discretionary powers and it may be necessary to provide incentives so that the beneficiaries of the existing system “buy-in” to a more demanding set of budget procedures.

It is important that politicians do not perceive the MTEF as a “black box” that is used by technocrats to provide “solutions” to a budget “problem”. Instead, it is vital to define a pro-active role for Parliament and civil society in setting the budget targets and monitoring progress and to build consensus both for the fiscal strategy and sectoral allocations. At a minimum, the process requires the formal involvement of the Ministers for Finance and Planning and the submission of briefs to Cabinet at key stages throughout the annual timetable.

Once the main features of the MTEF approach have been agreed over several repetitions of the annual cycle, it may be appropriate to consider incorporating the core procedures in relevant legislation.

The MTEF process was introduced on top of the existing budget institutions and without any reform of the organisational arrangements. In some areas, responsibility is not clearly assigned, for example between the MTEF Secretariat and the Budget Secretariat or between SWGs and the Estimates Working Groups. The MTEF Secretariat should be given a formal status within the organisational structure of the Ministry of Finance and Planning and, once its role has been fully defined, may require strengthening. The remit of the Secretariat should be broadened to include regular Public Expenditure Reviews so that topics of significance for the budget can be analysed in more depth and the findings incorporated into subsequent MTEF cycles. The Secretariat will also be responsible for the periodic consultation process to ensure that the MTEF reallocates resources in line with local and sectoral priorities.

The broader terms of reference for sector-level planning and budgeting mean that Sector Working Groups will need to ensure better integration of resource allocation decisions and consistent application of appraisal procedures. The core membership of SWGs should be based on the relevant sectoral units within MoFP and comprising both planners and budget officers, and equivalent personnel from line agencies.

The Macroeconomic Working Group has an appropriate membership but will need to be fully involved at all stages of the process, including during model runs, preparing of the Fiscal Strategy Paper, securing of political endorsement, and setting of sectoral ceilings.

5.3.5 Training

Successful implementation of the MTEF process will require capacity building in all agencies. This should be based on preparation of detailed action plans identifying training needs and programmes to be undertaken.

A successful activity organized as part of the PR&FB process was the annual workshop for all relevant officials. This was used to disseminate information about the call circular and to undertake training in budget procedures. The MTEF should introduce a similar initiative covering economic projections and the implications for aggregate budget ceilings as identified in the Fiscal Strategy Paper, application of the methodology for setting sectoral ceilings, deadlines for submitting sectoral and line agency budgets, and procedures for appraisal of draft recurrent and development budgets.

Regular workshops tend to be the basic form of in-service training but it is not possible to exhaust the details involved in budgeting through such a large forum. The additional processing and evaluation involved in switching from line item budgeting to a programme approach and to output-budgeting requires a lot of information and skills. The need to build capacity in operating the revised budget process requires the development of a specific training programme or the preparation of an MTEF module within an existing programme. The development of a manual for the MTEF would provide an essential tool for all those involved in budget formulation. This would close the knowledge gap for officials participating in the budget exercise for the first time and it could also be used in the curriculum for training finance and planning officers.

The efficiency of all institutional structures will be enhanced if training is provided to chairmen and convenors of working groups.

5.3.6 Sequencing of the MTEF Process

a) Sequencing of the reforms

Bruno (1988) has cited improper sequencing of reforms as one weakness of economic liberalization and opening up of developing countries. If the MTEF is to be successful, it needs to be properly sequenced. In describing the programme budget approach, the UN (1965, 89-90) recommends that introducing these budget reforms "should be adapted to conditions in the individual country, and should proceed at a rate consistent with the capabilities of the human resources available for the job. Above all, it should be recognized that this is a long-range undertaking—one that will develop in an evolutionary fashion, and produce increasingly more effective results as experience is gained in operating the system."

This is equally valid for the MTEF process. It is important for the MTEF Secretariat to formulate an achievable work-plan and assign roles and responsibilities to the various key players. This would cover the proposed evolution of the MTEF process and provide an indicative outline of the next steps which, taking into account the constraints the secretariat would face if the work-plan is too ambitious, would form a firm foundation for the institutionalization of the MTEF. One component would be to define the steps to managerial autonomy and the time frame for each step. This should be done in liaison with the Civil Service Reform Secretariat so that specific issues, such as the introduction of performance-related pay can be addressed effectively.

b) Sequencing of the annual budget cycle

An important aspect of sequencing is the annual cycle. It is essential that the process be based on a clear timetable that is circulated to all participants. The timetable should contain a logical sequence of tasks to be undertaken, set binding deadlines for each activity, identify the roles of all participants, and identify the officials responsible in line agencies, sectors and the central agencies. This document must address how priorities agreed through the consultation process are translated into specific programmes and projects, by whom and at what stage of the annual cycle. All participants in the MTEF process should receive guidelines describing the product expected at each stage of the process and explaining how each activity should be performed.

Although the objective is to apply MTEF procedures to improve the annual "product" of the planning and budget system, it is important to remember that the MTEF is a process and not an event. Each cycle provides an opportunity to ensure that those responsible manage the process better next time. It is therefore recommended that, at the start of each annual cycle, the MTEF Secretariat should organize a review of the previous cycle and enable participants to identify any problems they experienced and make proposals that would strengthen the process in future.

The MWG should produce the FSP early in the process. It will then be necessary to secure political endorsement of the aggregate revenue and expenditure ceilings in good time. Sectoral ceilings must be prepared in a transparent and consistent manner, using the proposed Budget Negotiation Framework approach. Once the ceilings have been agreed, the call circular and background information should be disseminated at an annual workshop that can also be used for training on the planning and budget procedures. SWGs must be allowed adequate time to resolve intra-sectoral ceilings. Line ministries and districts must be given enough time to prepare detailed cost estimates for their recurrent programmes, ongoing projects and new expenditure proposals for submission to SWGs. The SWGs and MoFP will require time to check that appraisal procedures have been adhered to and propose design changes and other ways of achieving additional efficiency savings. Towards the end of the annual cycle, a KTMM model run will be prepared to confirm the validity of the macroeconomic and fiscal assumptions. This will be used as the basis for checking final consistency, for example ensuring that sectoral and line agency budgets are in line with aggregate ceilings, and for preparing the budget speech and other budget documentation.

5.3.7 Budget Structure

Burkhead (1956), as quoted in Budgetmaking by E. Lehan (1984), states that the way in which revenue and expenditure are grouped for decision-making is the most important aspect of budgeting. Although this appears to exaggerate its importance, budget structure certainly has a significant impact on aspects of budget preparation and implementation.

The main change to the budget structure introduced by the two MTEF cycles has been the inclusion of ceilings for two additional indicative years. In assessing the effectiveness of the PR&FB in making adequate provision for operations and maintenance expenditure, Peterson (1996, 180) states that "the forward budget is primarily a 'forward draft' of the annual budget, and the two outlying budget years are virtually ignored". Unfortunately, the failure to use the two extra years to achieve significant resource reallocations means that the MTEF has not yet changed that perspective and increases the risk that it will repeat the failure of the PR&FB.

The recurrent budget format has not changed the line item budget process. This makes it very difficult to determine the development agenda the government is pursuing. Instead of focusing on what the government is buying, the MTEF must develop a new format that clearly shows what the government expects to deliver. Efforts need to be made to design an appropriate format for an output-budget. The budget structure should reflect the costing exercises described earlier by activity or cost centre. This involves establishing a consistent structure for setting performance targets for line agencies and entering into performance contracts with semi-autonomous government agencies.

The aggregate indicative totals contained in the Development Estimates decline rapidly in the two outer years and are substantially below the aggregate targets contained in the Fiscal Strategy Paper. This suggests that the Sector Working Groups were unable to identify suitable projects. More effort is required on project identification and appraisal. The Development Estimates should be supplemented by a more detailed publication similar to the Public Investment Programme documents:

(i) Containing a physical description of each project;

(ii) Setting the Total Estimated Cost (TEC) as the capital ceiling;

(iii) Specifying the intended date of completion and handover to the operating agency; and

(iv) Quantifying the recurrent resource implications.

This document should receive formal parliamentary approval in order to provide authority to incur expenditure up to the amount of the TEC. Any increase in this ceiling should receive explicit authorization from parliament before additional expenditure is incurred. The three-year MTEF does not provide an explicit mechanism for defining recurrent cost implications and their incorporation into the subsequent recurrent budgets. However, projects should only be approved if the agency can demonstrate that it can expect to accommodate these budget requirements within realistic forecasts of its recurrent budget ceiling.

One problem with the development budget has been the inclusion of numerous recurrent activities, principally because existing rules require all external assistance to be channelled through the Development Estimates. This approach prevents a proper assessment of total recurrent obligations and inhibits sustainability (Peterson, 1996). No action has been taken yet to rationalize the budget by transferring ongoing activities from the Development Estimates to the Recurrent Estimates, subject to agreement with donor agencies. Sound financial management requires the Ministry of Finance to avoid borrowing to meet recurrent expenditure but grant funds could be identified as Appropriation in Aid (A-I-A) in the recurrent budget.

The process of budget preparation must also ensure that development priorities of districts are reflected in the sectoral allocations while the budget structure must show the decentralized activities and outputs.

Changes in the budget structure must be designed to provide greater transparency and accountability, as this will contribute to sustaining improvements in operational efficiency and reassure the public and development partners that they are receiving value for money. Indeed, Sector-Wide Approaches are based on the concept that both implementing agencies and the relevant financing organizations will adopt common accounting and monitoring systems. However, the system must be simple enough otherwise line agencies and donors will not adhere to it.

Essential features of the proposed MTEF budget structure include:

- Preparation of departmental work programmes with specified targets for outputs and outcomes against which performance can be assessed. Recurrent programmes should be closed down if they fail to achieve their stated development objectives and their manpower and O&M resources reallocated to more productive programmes.

- Detailed cost estimates for core activities using standard cost norms and detailed costing of the resource implications of all new policy proposals before consideration by Cabinet.

- Submission of realistic capital cost estimates and implementation schedules. Experience from the PIP process shows that project proposals are often poorly defined, their costs are under-estimated and most cannot be implemented within the proposed time frame. This means that ongoing projects require allocations in excess of their original Total Estimated Cost and have to be included in the Estimates for many years before they are completed.

- Submission of realistic estimates of the recurrent budget requirements once projects are operational. Ministerial planners have no standard estimates of the likely recurrent budget implications that arise when capital projects become operational. These recurrent implications can be minimized by selecting projects with higher design standards (that is trading-off higher capital costs against lower maintenance costs), selecting projects from sectors with lower O&M implications, and increasing the proportion of rehabilitation projects in place of new construction.

- Accurate assessment of implementation capacity constraints. Emphasis has been on financial limits but there are also limits to construction capacity that can cause unrealistic estimates of the implementation schedule and of the availability of skilled manpower to service completed projects.

- Agreed procedures for the retention and utilization of revenue raised from departmental activities in accordance with sectoral development priorities and performance benchmarks.

- Implementation of management information systems that provide data on inputs, outputs and outcomes. The annual budget publications are readily available but their format discourages policy analysis. They should present a consistent time series of data and both inputs and activities (or outputs) identified by sector as well as by line agency. Research organizations should be given access to a "soft" copy of the budget documents for analytical work.

5.3.8 Budget Management and Analysis

The IMF (1999, p.6) notes that "the MTEF will not address the issue of budget management, particularly the need to enforce fiscal discipline *per se*. Moreover, improving public expenditure management procedures will be necessary to consolidate the progress made in fiscal adjustment". This indicates that a number of complementary improvements are required to strengthen budget management and analysis. These include:

(i) Stronger financial controls

Under the existing planning and budget system, the government has made excessive resource commitments. Recurrent programmes and capital projects have been approved even though domestic resource constraints mean that adequate funding is not available. In order to achieve fiscal discipline, the MTEF must ensure that the budget is consistent with hard budget ceilings in line with the agreed fiscal strategy and that activities are not included in the budget if resources are not available. Peterson (1996) argues that the failure to service and maintain existing assets implies that emphasis of public expenditure and donor funding over the next several years should be on capacity supporting activities rather than capacity expansion.

(ii) Strengthening the management of external assistance

An associated problem has been the excessive dependence on donor funding in the budget. Tranches of programme aid have been included as additional recurrent resources combined but the failure to satisfy the conditionalities of reform programmes has caused suspension of aid and disrupted the release of funds to spending ministries. This implies that the ceiling for the recurrent budget should be based on domestic resource availability while identifying supplementary activities that will only be undertaken subject to availability of programme finance. While project aid is only included in the Estimates if agreements have been explicitly approved, the planning of externally funded projects should be improved to ensure that we do not create "islands of excellence" that cannot be sustained once donor funds are exhausted. All projects that are dependent on uncommitted external finance should be treated as "pipeline" projects and should only be included in the outer years of the MTEF period.

(iii) Stronger cash-flow management

Achieving improved fiscal discipline will result in greater certainty that ceilings will be translated into releases and that line agencies will receive prompt and reliable issues. However, it will be necessary to improve cash flow management so that any emerging problems such as an increase in pending bills are quickly identified and addressed.

(iv) Improved debt management

This has two elements: First, it is essential to generate accurate and timely data on the current debt position and, secondly, the existing mix of financing instruments should minimize debt service obligations and encourage private sector access to the domestic capital market.

(v) Reducing the extent of appropriations-in-aid in the recurrent budget

The IMF (1999, p.60) has pointed out that "AIA has become so institutionalised and so extensive (around 16 percent of the Budget) that the benefits of the incentive to raise more revenue has been lost. Unfortunately, this approach to budgeting diminishes transparency, and consequently can be a source of abuse. Moreover, it has become a means, intentionally or otherwise, of avoiding the normal budget prioritization processes..." In this regard it is inconsistent with the objectives of the MTEF and works directly against the efficient and effective public expenditure management."

(vi) Ensuring consistency in the annual budget and the MTEF

The budget will show detailed appropriations for the Estimates' year and indicative figures for the two outer years of each MTEF period. These totals must be consistent with the aggregate ceilings and the ceilings disaggregated by sector and by economic classification as contained in the Fiscal Strategy Paper. The figures for personnel emoluments should be based on the approved establishment and must be reconciled with the Integrated Payroll and Personnel Database. It is also necessary to ensure that the allocations implement any agreed financial and manpower reallocations over the MTEF period.

(vii) Increasing budget analysis

The MTEF approach requires much more analysis using both budget documents and the monitoring and evaluation data. One task is the preparation of a "bridge matrix" showing the reconciliation between the Economic Classification (used in the FSP) and the Exchequer Classification (used in the Estimates).

(viii) Implementing pay and benefits reform

Successful management of the MTEF approach requires incentives for continued improvements in efficiency and effectiveness. In part, these should be provided through the pay and benefits reform which is a component of the broader public service reform programme.

(ix) Adhering to budget norms

The MTEF approach is intended to improve the reliability of budget releases.

This is vital in ensuring that once expenditure norms have been established, they are used in setting the appropriations and should not be subject to arbitrary cuts throughout the financial year. If cuts have to be imposed for unavoidable reasons, the agreed performance targets (whether for staff-related outputs, O&M or contracted services) should be reduced proportionately to the budget cuts. Norms should only be modified once evidence shows that standards of best practice allow efficiency reductions.

(x) Improve accounting systems

Government accounting procedures are increasingly recognized to be inappropriate and several private sector principles could usefully be adopted. These include:

(i) Changing to accrual accounting.

(ii) Requiring each line agency to compile a comprehensive asset register listing all physical infrastructure and all major items of equipment with a life of more than 12 months.

(iii) Making explicit provision for depreciation.

(iv) Establishing a public sector balance sheet, and

(v) Reflecting financing charges against the agency utilizing the resources.

5.3.9 Monitoring and Evaluation

The Poverty Reduction Strategy Paper (PRSP) proposes that the Central Bureau of Statistics should coordinate a comprehensive monitoring system based on the development of sample survey capability, supplemented by baseline data on specific output and performance indicator (for example generated from service delivery surveys). Implicit in this proposal is the assumption that there will be significant institutional reform of CBS, including the establishment of a National Statistics Committee bringing together users and producers of economic and social statistics. It should be noted that the cost of producing regular, timely and accurate data must be commensurate with the benefits derived from monitoring.

Most of this data is intended to show the impact of national policies on poverty but some of it can also be used by line agencies. SWGs and ministries will need to supplement this data by establishing management information systems and creating a sectoral database. Information from these sources should be used to set performance targets, introduce standards of best practice, and to monitor performance. The central agencies will also use this database to check proposed resource allocations against past performance.

The planning and budget officers in the Ministry of Finance and Planning who are responsible for the appraisal of expenditure proposals should also participate in performance monitoring. They should assist sector working groups and line agencies in defining appropriate indicators of outputs and operational efficiency and in developing accurate and timely management information systems so that resource allocations can be based on performance in delivering agreed outputs.

The MTEF should also revive the procedures developed for the Public Investment Programme for monitoring the financial and physical progress of all projects and should issue annual (or, if capacity permits, semi-annual) reports.

It is desirable to complement the MTEF by undertaking annual public expenditure reviews (PERs). Each review should assess overall macroeconomic performance and conduct in-depth studies of specific issues, for example debt management. The findings could then be used to fine-tune components of the fiscal strategy and improve the productivity of public expenditure.

An annual report on economic performance and prospects should be published as background documentation for the annual budget in June. This would be based on the latest run of the KIPPRA-Treasury Macroeconomic Model and would incorporate data generated by the Central Bureau of Statistics in the production of the annual Economic Survey.

The Budget Monitoring Department is responsible for publishing accurate and timely data on revenue, expenditure, financing and debt in the Quarterly Budget Review. Consideration should be given to providing monthly data, perhaps on the web site of the Ministry of Finance.

It is also necessary to utilize information from the monitoring and evaluation system to determine whether the MTEF has achieved its objectives and to assess its impact over time. The starting point will be a clear definition of the intended sequencing and expected outputs of the reform programme.

5.3.10 The Role of Development Partners

Given the extent of external financing requirements over the foreseeable future, it is important that Kenya maintains good terms with its development partners. The preparation of an MTEF budget demonstrates a commitment to achieving aggregate fiscal discipline, improving allocative efficiency and implementation of the performance improvement strategy, together with improved accountability and performance monitoring. This should provide an opportunity for the government to become increasingly proactive in its relations with development partners.

It seems unlikely that Kenya would have introduced the MTEF approach without direct engagement of development partners. Their support was critical for reforms such as the recruitment in 1999 of a team of non-bureaucrats to occupy key positions in the administration. Development partners also provided material and advice on the potential benefits of the MTEF, for example by providing funding and resource persons for the MTEF workshop in October 1999. They clearly have an important role to play in providing and releasing programme support and project funding and should be important collaborators in preparing Sector-Wide Approaches.

On the other hand, there is widespread opinion that external financing agencies have failed to be supportive in critical areas. The conditions imposed for release of programme assistance are generally considered to be excessively interventionist, with unrealistic deadlines. Moreover, rigid application of these conditionalities caused the suspension of disbursement of programme assistance early in 2001, therefore creating budgetary problems and contributing to the government's failure to achieve the PRSP targets that had been agreed with the donors. In setting their conditions, donors often fail to recognize that public sector reform is a process, rather than a product. Their programmes have often failed to address internal capacity constraints. Indeed, even the international financing institutions are increasingly concerned that a long list of conditionalities may be ineffective since it makes performance assessment extremely difficult. Is a country, for example, "on programme" if it has completed some conditions, partially completed others and not started some? Rigid conditionalities may also divert scarce implementation capacity away from core functions to the attainment of some peripheral conditions.

It is therefore important that financing institutions are persuaded to continue providing financial and technical assistance but in ways that support the MTEF process. Appropriate options might include:

(i) Converting expensive domestic debt into concessional external debt;

(ii) Providing programme-support subject to satisfactory performance on a limited range of macroeconomic indicators;

(iii) Establishing a reserve fund that could enhance budget credibility by using it (through mutual agreement) to smoothen out revenue shortfalls caused by exogenous shocks; and

(iv) Assisting SWGs in preparing and funding Sector-Wide Approaches.

Development partners should also be encouraged to adopt common procurement, implementation and monitoring arrangements.

6. CONCLUSION

"The MTEF is more than a technical tool or technique for achieving the deficit target; it represents a whole new way of doing business in government...but more than that the MTEF gives political decision makers the necessary information on which to base sound policy choices directed at creating a better life for all" (Walker and Mengistu, 1999, 27).

In their eagerness to promote the MTEF approach, Walker and Mengistu overlook the long history of initiatives to combine indicative planning and budget preparation in developed and developing countries over the past 50 years. They also under-estimate both the costs that it will impose and the threats to successful and sustained implementation. The costs are high because the MTEF process involves a complex set of planning and budget procedures and requires strong institutions and substantial capacity building. Kenya, having introduced the Programme Review and Forward Budget approach with very similar objectives nearly 30 years ago but having achieved little sustained improvement in budget outcomes, provides a very clear example of the threats to successful implementation of the MTEF.

The MTEF is the most recent attempt to shift the focus of resource allocation procedures away from a narrow concept of budgeting to a broader public expenditure management approach. It has significant advantages over traditional budget systems and provides a genuine opportunity to deliver sustained improvement in the productivity of public expenditure. The main goal of the MTEF approach is to improve the quality of public expenditure by focusing on:

(i) Aggregate fiscal discipline through medium-term economic forecasting and adherence to fiscal targets;

(ii) Targeting of public expenditure by reallocating resources from low priority programmes and projects to core functions that address high priorities; and

(iii) Delivering of core public goods and services at the least possible cost.

In essence, the MTEF is a medium-term implementation plan, concentrating on the financial resource allocations in the budget. Therefore, the MTEF is only one part of an integrated planning and budget system and does not address all aspects of the broader and more comprehensive PEM, although it offers a consistent and logical mechanism that encourages and supports the principles of public expenditure management.

To be effective, the MTEF must involve a radical change in the culture of the civil service and must be complemented by other planning and budget initiatives. Core features of the reform programme include:

- Setting an overall strategic framework based on the national consensus on development objectives.
- Developing effective tools for accurate revenue and expenditure forecasting.
- Ensuring that appropriated funds are actually released to line agencies, therefore enhancing the credibility of budget procedures and institutions.
- Establishing a budget negotiation framework that allows consistent and transparent assessment of the trade-offs between inter-sectoral and intra-sectoral resource allocations.
- Shifting away from the traditional system of line item expenditure controls to a system that focuses on delivery of specified outputs and outcomes.
- Improving the transparency of the budget system by presenting budget and accounting information in a format that is easy to interpret and analyse.
- Establishing an institutional structure that engages all parts of the public service and allows effective political involvement.
- Holding managers responsible and accountable for meeting agreed performance targets by developing an effective monitoring system.
- Introducing an incentive structure, the core of which will be a performance-related pay scheme, and enforcing disciplinary procedures.
- Ensuring adequate and appropriate support from development partners, such as a fund to cushion agreed expenditure plans from unanticipated shocks.

- Involving other stakeholders in designing sectoral strategies, perhaps through Sector-Wide Approaches.
- Improving budget management and accounting systems.

Sustained implementation of the MTEF approach and complementary reforms will be extremely complex but, the greater the challenge, the higher the potential dividend. If Kenya is to reap the dividend, then there is need to learn from past failures and recognize that successful and sustained implementation of the reform programme requires political and bureaucratic commitment to the design and introduction of new systems, to institutional strengthening, and to capacity building.

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