Tackling Budget Rigidity in Brazil

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Prepared by
Poliana Pereira, Master of Public Policy Candidate
Sanford School of Public Policy
Duke University

Faculty Advisor
Corinne Krupp, Ph.D.
Sanford School of Public Policy

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Executive Summary

With recurrent fiscal deficits since 2014, the government debt as a percentage of GDP reached a level much higher than expected for a developing country. Despite the government efforts to contain expenditures, the excessive rigidity of the Brazilian budget constrains the degree to which the government can promote fiscal adjustments. In this MP, I raise the question of whether the adoption of a Medium-Term Expenditure Framework (MTEF) by the central government would reduce budget rigidity and, therefore, promote fiscal discipline. MTEFs are not specifically designed to tackle budgetary rigidities. Still, the implementation of these frameworks can create an ex-ante constraint, which limits decisions that may result in more mandatory and continuous expenditures. The establishment of a causal relationship between medium-term frameworks and fiscal discipline is beyond the scope of this project. Instead, I focus on the normative merits of using MTEFs and on drawing lessons from the experiences of Peru, Colombia, and South Africa. The level of budget rigidity might pose several challenges to the introduction of an MTEF in Brazil. However, a medium-term perspective to the budget can be the starting point for the government to scrutinize current fiscal policy, and to draw a path that aligns fiscal sustainability and national priorities. The moment to implement an MTEF seems to be ideal, as Brazil can no longer postpone the adoption of measures to restore the country’s fiscal sustainability.

Who is the client?

The Brazilian National Treasury Secretariat (NT) – a branch of the Ministry of Economy – seeks to contribute to the national debate on fiscal policy and to foster staff to produce and discuss scientific knowledge through studies in public finance (STN, 2019j). Ultimately, the Treasury aspires to influence the law-making process in order to help fulfill its mission: to manage public accounts efficiently and transparently, ensuring both a balanced fiscal policy and good quality public expenditure for Brazil (STN, 2019c).

What is the policy question?

The Treasury acts in two broad areas: fiscal responsibility supervision and public debt management (STN, 2019b, and STN, 2019d). As a part of its core activities, the Treasury closely monitors the budget execution to ensure it is consistent with the debt management strategy. This analysis calibrates how much revenue to generate from bond issuances (Castro and Passos, 2010: 193).

The recurrent government budget deficits since 2014 have created challenges for debt management (SGS, 2020c). Despite the government efforts to contain expenditures, the rigid nature of the Brazilian budget – earmarked revenues, mandatory spending, and indexation – constrains the degree to which the government can promote fiscal adjustments (IMF, 2017d: 18). Consequently, the government has been resorting mainly to debt issuance to compensate for budget deficits. Having to manage increasing debt, the NT poses the question:
Would the adoption of a Medium-Term Expenditure Framework (MTEF) by the central government reduce budget rigidity and, therefore, promote fiscal discipline?

What has been the recent fiscal performance in Brazil?

The implementation in 1999 of the so-called “macroeconomic tripod” goals — inflation target, fiscal responsibility, and floating exchange rate — allowed Brazil to experience positive fiscal results, and to keep the government debt under control, at least until 2013 (Holland, 2019: 89). From 1999 to 2013, the primary fiscal balances — total revenues minus expenditures, excluding interest payments — presented surpluses, and the positive results were enough to maintain a stable government debt-to-GDP ratio (SGS, 2019a).

Although the first fiscal deficit only appeared in 2014, the roots of the fiscal deterioration date back to much earlier. Since the mid-1990s, primary spending — total expenditures minus interest payments on the debt — was growing faster than GDP. The good performance of tax revenues contributed to postpone any long-term fiscal adjustment project (Werneck, 2010:3). More than that, in 2006, the government opted for a more state-led macroeconomic policy through the expansion of public spending on infrastructure, on large national companies to help them compete globally, and on oil exploration (Ayres et al., 2018: 22).

This policy was pushed even further through countercyclical measures against the 2008 world economic crisis (Ayres et al., 2018: 22). The exhaustion of a public expenditure-driven and consumption-based growth model, coupled with a drop in commodity prices, led the country into a sharp recession in the 2014-2016 biennium (Ayres et al., 2018: 23). As the economic activity slowed down, revenues could no longer keep up with the level of expenditures. Figure 1 shows net revenues and total

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1 A fiscally responsible government adopts a fiscal policy that is sound and sustainable in the medium and long term. More specifically, the government uses a combination of taxes and borrowing to achieve an agreed set of medium-term fiscal targets, such as fiscal balance and debt level. Fiscal responsibility requires the government to be accountable and transparent before the parliament and the public, meaning the government needs to publish fiscal results. Moreover, the government needs to explain why deviations to the fiscal strategy happened and how to get back on track (Lienert, 2010: 4). After the enactment of the Fiscal Responsibility Law (FRL) in May 2000, there was a widespread belief that fiscal imbalances were in the past. FRL was expected to be able to ensure “a sound, permanent fiscal regime”, and the law would prevent governments from spending beyond their means (Goldfajn, 2003: 10).

2 A favorable international scenario, characterized by a commodity price boom from 2003 to 2008, significantly contributed to the positive results (Helbling, 2012). The period from 2004 to 2008 was particularly prosperous, not only economically, but also socially. During this period, the government increased social investments, such as the Bolsa Familia, a conditional cash transfer program (Ayres, 2018: 22).

3 Counter-cyclical measures are fiscal measures to counteract the impacts of the business cycle. For example, when the economy is growing, the government can save more. On the other hand, during an economic downturn, the government can either increase government spending or cut taxes to stimulate the economy.
expenditures for the central government – Central Bank, Treasury, and Social Security System – as a percentage of GDP.\footnote{Net revenues refers to the totality of tax revenues minus mandatory transfers.}

**Figure 1: Net Revenues and Expenditures (% of GDP)**

With the growing fiscal deficit, the government debt as a percentage of GDP also started to grow. Apart from the primary deficits, the hike in interest rates – to control inflation and compensate for higher risks – increased the debt service.\footnote{Primary deficit (surplus) is a negative (positive) primary balance.} Consecutive primary deficits and growing interest payments resulted in an increase of almost 30 percentage points in the government debt to GDP ratio since 2014 (IMF, 2019h). Not only did the debt increase quickly, but it also reached a level much higher than expected for a developing country: the Brazilian debt rose to 90 percent of GDP, while the average for developing countries is a little over 50 percent of GDP (IMF, 2019h). A direct result of this increase was the loss of the investment-grade rating for Brazilian government bonds in 2015, as the uncertainty about the sustainability of the debt also increased (STN, 2019: 13).

Fiscal imbalances and ballooning debt threaten the funding for public policies and create debt management challenges. On the one side, recurrent deficits limit the government's ability to meet demands and to provide public services. On the other side, due to increased market risk, the debt manager must focus on short-term strategies over the benchmark – the optimal debt structure in the long term (Alves and Silva, 2010: 135). Left with no other alternative, the government had to promote a fiscal adjustment. Past adjustments have focused on the revenue side. However, the already high tax burden in Brazil – more than 30 percent of GDP – forced the government to curb expenditures (Fernandes and Santana, 2018: 4, and Ayres et al., 2018: 23).
Figure 2 shows the decline in the primary balance (bars) and the concurrent rise in the debt-to-GDP ratio (line – axis on the right).  

**Figure 2: Primary Balance and Government Debt (% of GDP)**

![Figure 2: Primary Balance and Government Debt (% of GDP)](image)


The expenditure ceiling – established in 2016 – and the pension reform – enacted in November 2019 – deliver the two main measures to restore fiscal balance. The spending ceiling limits the growth of the federal government’s primary expenditures to the rate of inflation of the previous year (IMF, 2017d:30). The reform aims at reducing the burden of the pension system on the economy in the medium and long term. Despite being necessary, the pension reform will not be sufficient for fiscal sustainability, accounting “for only a third of the fiscal adjustment that is needed to comply with the expenditure ceiling by 2024” (IMF, 2019a:6). More than that, the budget rigidity will make compliance with the ceiling very challenging.

**Why can budget rigidity be a problem?**

“Budget rigidities are institutional, legal, contractual or other constraints that limit the ability of the government to change the size and structure of the public budget, at least in the short term” (Muñoz and Olaberria, 2019: 3). Rigidities are not intrinsically “bad”. They reflect public-policy priorities and can be the product of economic and social rights development, like social security (Muñoz and Olaberria, 2019: 8).

Excessive budget rigidities, however, negatively impact budget management. Budget rigidity prevents public spending from being easily reallocated (Muñoz and

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6 Primary deficit of the Consolidated Public Sector encompasses the Central Government – National Treasury, Central Bank, and Social Security System –, Regional Governments, and State-Owned Enterprises (BCB, 2016: 7). The General Government Gross Debt, used for of international comparison, “covers the total debt liability of the federal government (including Social Security System) with the private sector (public securities), the financial sector, the Brazilian Central Bank and the rest of the world (BCB, 2016: 13).
Olaberria, 2019: 3). In Brazil, it is not uncommon to have idle resources that are tied to one program, but cannot be reallocated to another program, even inside the same ministry. The total amount of idle money in 2019 reached BRL 17.4 billion and was one of the reasons behind the positive deviation from the fiscal balance target (STN, 2019f: 9). More than that, the government cannot easily reallocate resources as needs and priorities change over time.

Budget rigidities not only increase “the probability that countries get into financial distress,” but also constrain “successful fiscal consolidation” (Muñoz and Olaberria, 2019: 10). In the presence of excessive rigidity, fiscal adjustment gets compromised and tends to be done from the revenue side, weakening incentives to improve the efficiency of public spending. An adjustment through the revenue side means an increase in taxes, and the distortions that accompany that (Muñoz and Olaberria, 2019: 9). Austerity measures through tax increases, in opposition to expenditure cuts, tend to lead to recessions that are deep and prolonged (Alesina, Favero, and Giavazzi, 2019: 152). Furthermore, excess budget rigidity compromises the government’s ability to deal with fluctuations in the business cycle, and countercyclical fiscal policy becomes limited in scope (Muñoz and Olaberria, 2019: 9).

Figure 3: Central Government Expenditures – Past 12 Months (In billions of BRL – prices of December 2019)

The government cannot adjust mandatory expenditures. As the government tries to curb spending through cuts in discretionary expenditures, the provision of essential public services, public investments, and the execution of social policies get compromised (STN, 2019g: 5). Fiscal adjustments from the spending side, therefore, require a change in the structural dynamics of mandatory spending. Figure 3 presents the evolution of mandatory and discretionary expenditures of the central government. While

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7 Usually, there is idle money because the appropriation was authorized, but the resource disbursement depends on the execution of the project or program. If the execution goes slowly than initially expected, the authorized appropriation will be available, but will not be disbursed.
discretionary (vertical axis on the right) spending has been declining, mandatory expenditures (vertical axis on the left) keep increasing.

Wages, pensions, and debt service are naturally inflexible. However, other budget components can also be rigid due to legal provisions that establish revenue earmarking, define minimum spending requirements, or create triggers that automatically increase expenditures (Muñoz and Olaberria, 2019: 3). In Brazil, the rigidity of the budget results from excessive use of earmarked revenues, a high volume of mandatory spending, and indexation (IMF, 2017d: 18).

Embedded in the Brazilian Constitution, revenue earmarking determines automatic transfers from the federal government to sub-national governments, social sector spending as a percentage of current net revenue, and specific taxes for social security (IMF, 2017d: 18). Through the Federal Revenue De-Earmarking Mechanism (DRU), the central government can “de-earmark” up to 30 percent of the earmarked federal revenues. However, this mechanism has been proving to be insufficient (Brescianini, 2018: 8). Moreover, this mechanism is temporary and needs to be renewed by a qualified majority in Congress whenever it expires.8

Although earmarking guarantees minimum investments in specific areas, earmarking can create inefficiencies. Minimum spending – as a percentage of current net revenue – in education or health, for example, creates a pro-cyclical problem. During economic booms, the government has to increase expenditures on these areas because it is mandatory, and not necessarily because these areas need investment. Once the boom is over, depending on the type of expenditure – wages, for example – the government cannot easily cut expenditures. More than that, because of earmarking, the government does not have the flexibility to allocate the money to any other areas (Fernandes and Santana, 2018: 5).

Mandatory spending accounts for more than 90 percent of the total primary expenditures of the central government, and around 90 percent of mandatory spending is embedded in the Constitution (STN, 2019g:12; STN, 2017: 47).9 Almost 70 percent of primary expenditures are indexed, resulting in a steady increase in expenditures (STN, 2019h:3).10 For example, the government pays a minimum wage through the social security system, to more than 20 million people in Brazil. Every time the minimum wage increases, the expenditures with these benefits increase (Schymura, 2019).

As a result of the rigid nature of the Brazilian budget, the government needs to concentrate the fiscal effort on discretionary expenditures. However, given the relatively small size of discretionary expenditures – less than 10 percent of total spending – the overall impact on budget deficits is minimal. More than that, the government is close to the limit to which discretionary expenditures can be cut without a government

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8 The DRU in place was approved in 2016, and it is valid until 2023 (SF, 2016).
9 Any change to the Constitution needs to be approved by a qualified majority of three-fifths of both houses of the Congress in two rounds of voting in each house.
10 Primary expenditures are indexed to various indices, such as consumer price indices, minimum wage, and current net revenue.
shutdown (IFI, 2019: 29). Figure 4 shows the four types of expenditure that consume almost three-quarters of the primary budget: pensions, social assistance, wages, and unemployment benefits.\textsuperscript{11}

**Figure 4: Central Government Primary Expenditures – December 2019 – Past 12 Months (% of Primary Budget)**

![Diagram showing the four types of expenditure as a percentage of the primary budget.]

Source: STN, 2019i

The increase in budget rigidity is not an exclusively Brazilian problem. In the US, for instance, mandatory spending increased from 51 percent of the budget in 1997 to 63 percent in 2017 (GAO, 2017). Nor is budget rigidity in Brazil a recent phenomenon. Multiple studies have been pointing to the continuous loss of allocative flexibility in fiscal policy.\textsuperscript{12} However, since 2014, when the current sequence of fiscal deficits started, the problem became more evident, and finding a solution more pressing.

Since 2015, mandatory expenditures have drained the totality of the central government’s current net revenues. In the coming years, the challenge in controlling central government spending rests on controlling the growth of mandatory expenditures. In 2019, the level of discretionary expenditures reached, in real terms, the level of 2010. To reduce mandatory expenditures to the same 2010 level, when mandatory expenditures were equivalent to 75 percent of revenues, the government would need to decrease mandatory spending by BRL 283.7 billion (4.0 percent of GDP). Alternatively, the government would need to increase net revenues by BRL 384.4 billion (5.3 percent of GDP) (STN, 2019f: 16).

\textsuperscript{11} Primary budget refers to the totality of tax revenues minus mandatory transfers.

\textsuperscript{12} Budget rigidity is a recurrent topic in studies published by the Senate, the Lower House, the Institute of Applied Economic Research (IPEA), the Independent Fiscal Institution (IFI), etc.
There is not much room to increase the tax burden, and the government has been mostly relying on extraordinary revenues – early repayments from the National Development Bank, auction of oil fields, and an investment spending freeze – to reduce the fiscal deficit. On the other hand, in its debt sustainability analysis, the government relies, in great part, on the assumption that revenue will start growing again, as the economy recovers (SF, 2020; STN, 2020b: 15). However, by choosing not to face its budget rigidity problems, and therefore, to be able to reallocate and reduce expenditures, the government is leaving the country’s fiscal health at the mercy of the business cycle.

What are medium-term expenditure frameworks?

Annual budgets are, in essence, incremental, as the primary shifts of resources occur only at the margins (Schick, 2009:12). In an incremental budget, the current budget works as the baseline for the next year’s budget. To this baseline, the government adds a small percentage to account for inflation, and, sometimes, to promote a small real growth (World Bank, 1998: 102). Especially in times when revenues are growing faster than expenditures, due to the incremental nature of the budget, the government pays little attention to policy and spending priorities. However, when revenues can no longer keep up with the expenditures, prioritization becomes crucial. By focusing on the short-term, budget processes that cover only one year tend to disregard the fiscal impact of current decisions on subsequent years. This short-sightedness discourages fiscal discipline and can lead to overspending, as future years’ payments are neglected (Wildavsky, 2003: 39). The reconciliation of budget demands without an explicit constraint can result in high levels of public debt (Rosalky, 2012: 17).

A Medium-Term Expenditure Framework (MTEF) offers a mechanism for expanding the budgetary process over the traditional one-year timeframe, aligning the budget with medium-term fiscal policy objectives, priorities, and constraints (Pontes, 2018: 24). Moreover, MTEF can reconnect budgeting to planning, a connection which can be lost when the focus is on the annual budget. An MTEF is not a synonym for a multiyear budget, but rather "a set of institutional arrangements for prioritizing, presenting, and managing revenue and expenditure in a multiyear perspective" (Harris et al., 2013: 137). Integrated into the budget process, an MTEF provides the guidelines for the annual budget. Typically, appropriations continue to be annual, but are bounded by the medium-term fiscal strategy. 13

Depending on the level of complexity, the public finance literature classifies MTEFs as a Medium-Term Fiscal Framework (MTFF), Medium-Term Budget Framework (MTBF), and Medium-Term Performance Framework (MTPF).14 MTFF, the simplest form, focuses on fiscal discipline. At this level, aggregate fiscal targets and a spending cap are set, based on the availability of resources in the medium-term. As a step further in the level of complexity, in an MTBF, the focus rests on allocative

13 Appropriations refer to how much money is available to the government as a whole and each minister, agency, and program.
14 MTEF is used in this MP as an umbrella term and, therefore, can be an MTFF, an MTBF – the most common MTEF type –, or an MTPF.
efficiency, and expenditure is detailed by the administrative unit. Finally, an MTPF “links the budget with medium-term performance indicators, targets, and results,” aiming at technical efficiency (IMF, 2017d: 23).

As a sequential process, MTEFs follow a three-stage process. In the first stage, the top-down approach, the Ministry of Finance (MoF) – or its equivalent – forecasts a medium-term macroeconomic scenario and estimates the total available amount of resources – tax and borrowing – for the subsequent 3 to 5 years. A debt sustainability analysis evaluates the government’s borrowing needs and capacity. Besides determining the medium-term overall resource availability, the MoF may determine aggregate expenditure ceilings for ministries and agencies. The second stage follows a bottom-up approach. Spending agencies present their budget requests, trying to fit their medium-term strategies into the total amount of resources available. Finally, the MoF will reconcile resource availability with the units’ spending requests. To reconcile what the agencies want with the resources that are available, the MoF, ideally, relies on the national medium-term development strategy. Once the MoF finalizes it, the MTEF serves as a baseline for the budget.

In New Zealand, for example, from June to December, during the strategic phase, the Treasury develops an overall strategy for the budget. The strategy includes spending priorities and targets, revenue, fiscal balance forecasts, and public debt objectives. Spending agencies start developing their medium-term plans that will help inform decision-making regarding allocation. A Budget Policy Statement (BPS) is sent to Parliament no later than March 31st, reflecting the decisions made during this phase. The BPS is accompanied by the Half Year Economic and Fiscal Update. From January to April, in the decision phase, ministers submit their budget requests, and the Treasury decides which programs Ministers should carry forward. The cabinet makes the final decision on the strategic allocations. In the next stage, the budget production phase, the Treasury prepares the Estimate of Appropriations and submits it to the Parliament. The Parliament must then authorize, by May, the spending for the fiscal year ahead (The Treasury, 2018).

Although the features of MTEFs vary greatly, countries design their frameworks around common aspects such as timeframe, coverage, fiscal targets, level of detail, binding nature, and exclusions. Typically, an MTEF covers three years on a rolling basis: the next year’s annual budget plus two following years. The macro-fiscal scenarios become less precise as timeframes get elongated, but some MTEFs cover more than three years. Countries need to choose which levels of government would be covered. In a fiscally decentralized country, such as Brazil, the common choice is to restrict the framework to the central government. Moreover, the expenditure ceiling – the main

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15 MTFFs do not go beyond this first stage.
16 For example, Austria adopts a 4-year, and Canada adopts a 5-year horizon (OECD, 2019a: 157 and 163).
17 In a fiscally decentralized country, subnational governments (SNGs) hold fiscal autonomy. Therefore, the central government cannot impose an MTEF on them. The central government can suggest them to adopt a medium-term framework, in any case. One could argue that the central government may require SNGs to implement an MTEF as a counterpart in a bailout. At the end of the 1990s, the Brazilian central
fiscal target in place in Brazil and building block for a potential MTEF – only covers the central government.¹⁸

Countries commonly adopt expenditure ceilings as a tool to prevent government spending from growing without bound.¹⁹ These ceilings help to ensure consistency between spending and targets or rules for fiscal deficits and government debt (Brumby and Hemming, 2013: 226). Contrary to countries in which only the expenditure ceiling for the first-year annual budget is a hard limit, in Brazil, even for out-years, the rule limits primary expenditures in the current year to the expenditures of the previous year, adjusted for consumer inflation.²⁰

How strictly a country follows the ceiling and targets set out in the MTEF defines the binding feature of the framework. Countries choose different levels of restrictions to change the limits as determined by their MTEFs. For example, in Finland, changes to the expenditure ceiling are not allowed, yet in the UK, changes to the ceiling are discretionary, but they have a reputational cost (Sherwood, 2016: 29). The legislation in Brazil does not allow changes in the expenditure ceiling before 2036.²¹ Primary balance targets, on the other hand, are not binding, but merely indicative.

Fiscal rules in place usually, guide the level of detail of the medium-term framework (Sherwood, 2016: 13). Countries can have one overall expenditure ceiling, a ceiling for each spending agency, or even a limit to each program. The level of detail is inversely proportional to the level of flexibility, and it can compromise allocation. Within the global spending ceiling, in Brazil, for instance, each of the three branches of the government has its own ceiling (Presidência da República, 2016). Although MTEFs can determine expenditure ceilings for each ministry, sector, or even program, in a Brazilian MTEF, resource allocation would be more easily done through big areas. These areas – Health, Education, Transport, etc. – can remain unchanged when the government’s organizational structure changes. On the contrary, the number of ministries changes considerably from one government to the other, and the excessive number of programs would make it very complicated to establish ceilings for each one (Tollini, 2018:32).

The architects of an MTEF must decide which spending categories the framework will cover. In the European Union, for example, interest payments and spending that are heavily influenced by the business cycle – like unemployment benefits – are either excluded from the framework or receive a more lenient treatment under the expenditure ceiling. The rationale behind this choice is to exclude items that are out of the direct control of the government, such as the level of interest paid on the debt, or to grant

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¹⁸ The expenditure ceiling can be considered a building block for a potential MTEF.
¹⁹ As mentioned before, since the mid-1990s, the government’s primary spending was growing faster than GDP.
²⁰ The expenditure ceiling rule is valid until 2036. From 2027 on, the Congress can revise the adjustment factor every 4-year presidential term (Presidência da República, 2016).
²¹ The expenditure ceiling rule is valid for 20 years. (Presidência da República, 2016).
flexibility to deal with unforeseen events, such as the 2008 global crisis (Sherwood, 2015: 27). In Brazil, besides interest expenditures, the ceiling excludes transfers to SNGs that are mandated by the Constitution, and recapitalizations and bailouts to non-dependent state-owned enterprises. Moreover, the rule excludes extraordinary credits to cover unpredictable and urgent events, such as war, civil unrest, or catastrophic events (Presidência da República, 2016b).22 Allowing margins and contingency reserves in the framework design can provide a buffer in the face of an unexpected economic downturn.23

The promise of enhanced fiscal discipline makes medium-term frameworks attractive for countries to adopt, as the multi-year perspective can counterbalance the inherently short-term bias in public decision-making and help tackle the common pool problem.24 MTEFs can show the impacts over the medium-term of a new policy as well as the sustainability of current policies and establish a medium-term cap on expenditures. Furthermore, medium-term frameworks can foster a more efficient use of resources and improve public funds allocation (Sherwood, 2015: 13).

Had an MTEF been in place, would the Brazilian government have carried out its payroll tax exemption policy for six years – from 2011 to 2017? The exact answer is unknown, but a medium-term approach to the available fiscal space would have evaluated the impacts of the policy beforehand, and then its sustainability when in place.25 The payroll tax exemption policy was adopted in response to the economic downturn, but it cost BRL91.5 billion, and it did not help to sustain employment as intended (Receita Federal, 2020; Carvalho, Garcia, and Sachsida, 2018: 35). Ex-post, it is clear how the payroll tax exemption – which was just one out of multiple tax exemptions in place – proved to be inefficient to boost the economy, and how harmful the policy was to the already shaky fiscal accounts.26 Moreover, a spending cap would have helped to curb the volume of tax expenditures.

Despite the potential benefits, the implementation of a medium-term framework presents technical challenges, demands political support, and involves behavioral change. Without a reliable annual budget process, adopting an MTEF would hardly be recommended. The annual budget needs to be comprehensive, credible, and predictable, and must define clear and feasible fiscal targets.27 Moreover, MTEFs depend heavily on the quality and accuracy of macroeconomic and fiscal forecasts. The government cannot achieve fiscal discipline if revenue forecasts are consistently over-optimistic.

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22 Non-dependent state-owned enterprises do not receive funds from the government to cover personnel, overhead, or capital expenditures.
23 Contingency reserves are “an amount set aside, but not allocated in advance, to accommodate changes in the economic environment and to meet unforeseen spending pressures” (National Treasury, 2019: 74).
24 Regarding public resources, the common pool problem arises when few enjoy the benefits from a fiscal policy while the whole society bears the burden.
25 “Fiscal space captures the ability of a government to raise spending or lower taxes without endangering market access or debt sustainability” (Baum et al., 2017: 4).
26 For illustration purposes, payroll tax exemption peaked in 2015, when it amounted to BRL25.2 billion, while the central government posted a primary deficit of BRL116.7 billion in that year (Receita Federal, 2020; SGS, 2020b). The unemployment rate increased from 6.5% in 2014 to 8.9% in 2015 (SGS, 2020d).
27 A comprehensive budget means having a single budget instead of multiple budgets.
Conservative projections, on their turn, tend to underestimate revenue to restrict expenditure. When conservative projections are done systematically, spending agencies are likely to inflate their budget requests, which can compromise the allocation of public funds (World Bank, 2013: 23). Inefficient use of resources will result from both scenarios (Brumby and Hemming, 2013: 229).

The implementation of an MTEF in Brazil would require strengthening the budgetary process. Higher on the scale of priority, the MoF should improve the quality and credibility of the macroeconomic and fiscal projections. Changes in fiscal targets during the fiscal year have become prevalent, mostly due to over-optimistic revenue projections. The expenditure ceiling in place is already helping to constrain overoptimistic revenue forecasts. Moreover, the MoF can improve the credibility of the forecast through increased transparency regarding the underlying assumptions, and the reconciliation of forecast revisions (IMF, 2017a: 49). Figure 5 shows the initial target as defined by the budget guidelines for the central government, the target in place by the end of the fiscal year, and the outturns – actual year-end results, rather than those expected or forecasted.

Figure 5: Central Government Primary Balance Target x Outturns (BRL bn)\(^{28}\)

![Graph showing Central Government Primary Balance Target x Outturns (BRL bn)](image)


A positive development has been the implementation, in 2018, of a revamped and expanded fiscal risk section in the budget guidelines. In this section, there is an analysis of how changes in macroeconomic indicators – GDP, inflation, exchange rate, and interest rates – can impact the fiscal accounts – revenue, expenditure, and debt. For

\(^{28}\) The targets are already adjusted by the allowed deductions.
example, in the analysis for 2020, a one percentage point increase in real GDP would increase social security revenues by 0.13 percent, and the remaining revenues by 0.64 percent (Presidência da República, 2020: 6). The enhanced fiscal risks statement should bring more accuracy to the fiscal planning.

Political support is a *sine qua non* condition for the establishment of an MTEF. Besides a push from the president, changes in the budget process will require approval from the Brazilian Congress. Recent measures carried out by the Congress indicate that the adoption of more discipline in fiscal matters might not come easily. ²⁹ Moreover, the implementation of an MTEF would reduce Congress’s power over the budget. ³⁰ Finally, a new approach to budgeting would impose new responsibilities and require buy-in from the spending agencies. The recent decision to combine finance, planning, and budgeting under a single ministry, the Ministry of Economy, has the potential to make coordination among these areas more manageable, and, therefore, help the implementation of an MTEF. Moreover, the current government is supporting a bill to improve the budget process and strengthen fiscal responsibility, as well as a constitutional amendment to reform the fiscal framework. ³¹

**How can medium-term frameworks address budget rigidity?**

The combination of budget rigidity with a lack of medium-term fiscal planning has been preventing the Brazilian government from fulfilling an adequate primary fiscal balance – how much to save in order to stabilize or reduce the debt-to-GDP ratio. Changes in the target during the fiscal year due to weak fiscal performance became common in recent years, undermining the target’s credibility and generating time inconsistency issues – where the present moment is valued more than the future (Pontes, 2018: 126).

MTEFs create an ex-ante constraint, which limits decisions that may result in more mandatory and continuous expenditures, and, therefore, can contribute to tackling the source of budget rigidities (Pontes, 2018: 26). Grounded in a well-designed framework, the government can identify early on potential detrimental developments stemming from ongoing policies. Therefore, policymakers can curb or promote changes in policies before the consequences become too large and changes much harder to make. For example, the introduction of an indexation mechanism for social benefits that appears feasible in the short term might represent an unsustainable burden over the medium and long term (Harris et al., 2013: 137). An MTEF can provide the macro-fiscal scenarios to assist – even to compel – the government in making an informed decision. Besides looking into inter-temporal constraints, MTEFs also promote regular screening of expenditures across sectors, programs, and projects. Policymakers are encouraged to

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²⁹ The Brazilian Congress approved measures to take control of part of the already meager non-mandatory piece of the budget. The President vetoed them, but Congress might override the veto. In that case, the fulfillment of fiscal targets will not be possible without a government shutdown (IFI, 2020: 32).

³⁰ The Brazilian Congress is well known for increasing revenue estimates and adding an excessive number of amendments to the budget (IMF, 2014a: 18-19).

³¹ Bill 295/16 has been at a halt in Congress since 2016 (Câmara dos Deputados, 2016).
structure – and restructure – spending, focusing on the link between budgeting and planning (Harris et al., 2013: 137).

MTEFs are not specifically designed to tackle budgetary rigidities, but the implementation of these frameworks requires fiscal policymakers to look beyond the short-term. Therefore, an MTEF will force the government to look into current revenues and expenditures, and to discuss not only current fiscal impacts from rigidities, but also future fiscal impacts (Pontes, 2018: 121). Moreover, in the long term, the whole budget is flexible, as budget rigidity has a time component (Castillo, Cetrángolo, and Jiménez, 2010: 12). In the short-term, legal contracts, legislation, or even administrative or political inertia create mandatory expenditures. However, in the long run, opportunities for change arise: legislation can be changed, contracts can be renegotiated, and programs can be shut down (Harris et al., 2013, 141).

MTEFs are only one of the tools available to strengthen the budget process, but alone, they cannot promote fiscal sustainability, especially if the annual budget process remains weak (Le Houerou, and Taliercio, 2002: ii). Therefore, usually, MTEFs are implemented in the context of broader Public Financial Management (PFM) reforms (Filc and Scartascini, 67). Given the level and structure of current rigidities in the Brazilian budget, the introduction of an MTEF will need to be coupled with other tools – spending reviews and de-indexation, for example. MTEFs seem to be more effective to help with budget incrementalism, and to avoid rigidities in the future. A multiyear outlook on the public finances can grant the government a basis to push for needed reforms.

What can the experiences of other countries teach Brazil?

MTEFs have been around since the 1980s –Australia was the first adopter –, but their use became more frequent in the late 1990s. As of 2008, around 70% of the countries have adopted some version of MTEF. Low and middle-income countries adopted the framework as a part of donor requirements, while high-income countries implemented MTEFs to improve budget management and fiscal performance. The degree to which countries successfully carried out these frameworks varies. The experiences in Africa failed to deliver the expected benefits associated with MTEFs. Fundamentally, the low accuracy of macroeconomic and fiscal forecasts compromised the framework’s credibility (Allen and Chaponda, 2017). Several European and other OECD countries have adopted MTEFs successfully (EC, 2019, and OECD, 2013: 87).

Transplanting an MTEF model from another country to Brazil or adopting “international best practices” is unlikely to work. The introduction of an MTEF needs to be country-specific. The type of MTEF and the framework features should be aligned with the country’s policy objectives, its budget institutions and processes, and its administrative and technical capabilities (Boex, Martinez-Vazquez, and McNab, 2000: 22). Still, there is much to be learned from other countries’ experiences.

In a study that compared the experiences of 181 countries that either implemented MTEFs or did not adopt them from 1990 to 2008, the World Bank found
empirical evidence that MTEFs improved fiscal discipline (World Bank, 2013: 10 and 104). The study was based on questionnaires sent to the countries, and therefore, the reported positive correlation needs to be carefully evaluated (World Bank, 2013: 179). Evidence in Latin America suggests medium-term expenditure frameworks enhanced budget operations and outcomes by delimiting policy objectives, improving budget allocation, and increasing transparency in resource use (Filc and Scartascini, 2010: 56). Moreover, in Europe, increases in government debt seem to be negatively correlated with the strength of an MTBF (EC, 2014: 85).

Finding a country that is comparable to Brazil – level of economic development, type of budget institutions, nature of fiscal constraints – and, at the same time, has implemented an MTEF is not easy. Given the disparities between mature versus developing economies, frameworks in developed countries will be addressed in this work only from the viewpoint of “best practices.” Brazil’s Latin American peers can offer a reasonable starting point for comparisons. Among the largest 6 Latin American economies –the LA6 –, neither Chile nor Mexico has an MTEF in place (IMF, 2019h, OECD, 2019: 166 and 217). Although the Brazilian economy is much larger than the Peruvian or Colombian economy, the three countries are upper middle-income countries (World Bank, 2018). Therefore, Peru and Colombia were chosen.

In the late 1990s and early 2000s, these three countries experienced fiscal and balance of payments crises and needed the IMF help to promote the needed adjustment (Celasun, 2015: 9). As part of the adjustment process, Brazil, Colombia, and Peru went through fiscal and budgetary reforms. They introduced fiscal rules and fiscal responsibility laws, limited spending and sub-national borrowing, and adopted elements of an MTEF (Celasun, 2015: 24). In another point in common, the three countries follow a top-down budgeting style (Bas and Curristine, 2007: 17). The 2008 global economic crisis revealed weaknesses in the LA6 fiscal frameworks, and since then, these countries have been modernizing their frameworks.

As in Brazil, the Colombian budget is plagued with excessive rigidity (IMF, 2019b: 13; Moody’s, 2017: 4). Peru, on the other hand, enjoys a much more comfortable fiscal position, with much lower public debt and a more flexible budget (IMF, 2020a: 4; Moody’s, 2017: 4). The third country, South Africa, like Brazil, is a big emerging market country, an upper middle-income country, and a BRICS member. Similar to most Latin American countries, South Africa implemented a comprehensive reform of its budget and financial processes in the 1990s (Vyas-Doorgapersad and Waldt, 2016: 199). Moreover, South Africa has a full-fledged MTBF that works, in many aspects, like MTEFs in advanced economies (Allen et al., 2017: 33).

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32 According to the World Bank, the results seem to be exaggerated (World Bank, 2013: 179).
34 “Fiscal consolidation is a policy aimed at reducing government deficits and debt accumulation” (OECD, 2014).
35 BRICS stands for the association of Brazil, Russia, India, China, and South Africa.
Although there is no “perfect match,” the experiences of other countries in implementing an MTEF can offer valuable lessons when designing a framework for Brazil. This MP is concerned with the normative merits of using MTEFs, and their dynamics with budget rigidities. In the three cases chosen – Peru, Colombia, and South Africa –, the analysis focus rests on the overall structure of the adopted medium-term frameworks, how these frameworks align with best practices, and whether/how these MTEFs touch the budget rigidity issue. Moreover, other countries’ examples provide an opportunity to compare their budget practices with those in Brazil.

Peru

Peru offers a great example of how fiscal responsibility pays off. Peru experienced significant economic growth accompanied by macroeconomic and financial stability in recent years. On average, real GDP presented an annual growth rate of almost five percent in the last decade (IMF, 2019h). The Peruvian government expenditure as a percentage of GDP is low, and so is the debt-to-GDP ratio (IMF, 2019h) when compared with other Latin American countries. Moreover, Peru has a high degree of budget flexibility: only 53 percent of the total budget is mandatory. Peru, therefore, is the second-best positioned country in Latin America to reduce government spending if needed. Brazil, on the other hand, ranks last (Moody’s, 2017: 4). Figure 6 shows the Moody’s Investors Service Flexibility Index for selected Latin American countries and the percentage of the budget that is mandatory.

Figure 6: Flexibility Index Table

<table>
<thead>
<tr>
<th>Country</th>
<th>% of Budget that is Mandatory</th>
<th>Flexibility Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ecuador</td>
<td>49%</td>
<td>176</td>
</tr>
<tr>
<td>Peru</td>
<td>53%</td>
<td>161</td>
</tr>
<tr>
<td>Nicaragua</td>
<td>54%</td>
<td>158</td>
</tr>
<tr>
<td>Panama</td>
<td>55%</td>
<td>156</td>
</tr>
<tr>
<td>Honduras</td>
<td>65%</td>
<td>121</td>
</tr>
<tr>
<td>Mexico</td>
<td>70%</td>
<td>104</td>
</tr>
<tr>
<td>Guatemala</td>
<td>70%</td>
<td>103</td>
</tr>
<tr>
<td>Paraguay</td>
<td>70%</td>
<td>102</td>
</tr>
<tr>
<td>El Salvador</td>
<td>71%</td>
<td>99</td>
</tr>
<tr>
<td>Chile</td>
<td>74%</td>
<td>88</td>
</tr>
<tr>
<td>Bolivia</td>
<td>75%</td>
<td>85</td>
</tr>
<tr>
<td>Uruguay</td>
<td>78%</td>
<td>75</td>
</tr>
<tr>
<td>Argentina</td>
<td>85%</td>
<td>53</td>
</tr>
<tr>
<td>Colombia</td>
<td>85%</td>
<td>50</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>88%</td>
<td>43</td>
</tr>
<tr>
<td>Brazil</td>
<td>93%</td>
<td>24</td>
</tr>
</tbody>
</table>

For most Latin-American countries, the 1990s posed several macroeconomic and fiscal challenges. Successive crises in emerging markets – Asia (1997), Russia (1998), and Brazil (1999) – led to terms of trade deterioration and restrictions on capital mobility. Domestically, the crisis led to credit restrictions, real exchange rate depreciation, and loss of investor confidence. As a result, the market lost confidence in the country’s fiscal sustainability (Carranza, 2012). In 1999, to regain fiscal sustainability over the medium-term, the government enacted a fiscal responsibility and transparency law. This fiscal framework helped to reduce the public debt from almost 50 percent of GDP in 2003 to less than 20 percent of GDP in 2013 (IMF, 2019h).

Taking a step further, the Peruvian government adopted a new fiscal framework in 2016. The new framework introduced a medium-term perspective to the GDP and commodity prices in order to grant more predictability to the revenues, established counter-cyclical mechanisms, created a Fiscal Council, and better delimited the responsibilities of all levels of government in the context of fiscal decentralization (MEF, 2013). The new fiscal framework introduced a series of binding numerical fiscal rules, such as a debt-to-GDP ratio ceiling of 30 percent and a fiscal deficit limit of one percent of GDP (Presidencia de la República, 2016).

Peru introduced its four-year rolling basis Medium-Term Macroeconomic Framework (MTMF), an MTFF, in 2000 as a part of the first wave of fiscal reforms. The Ministry of Finance prepares the framework. Since 2017, the Peruvian Fiscal Council evaluates the methodologies and assumptions used in the macroeconomic projections contemplated in the MTMF. However, the opinions issued by the Council are not binding (Consejo Fiscal, 2017b).

In contrast with Brazil, Peru did not advance much on fiscal decentralization. Subnational governments (SNGs) in Peru do not have significant own-source revenue capacity and rely heavily on transfers from the central government. In Brazil, SNGs collect around 40 percent of total tax revenues, while in Peru, SNGs collect less than five percent of total revenues (IMF, 2019g: 10; World Bank, 2017b: x). Moreover, in Brazil, local governments have their own budgets, but in Peru, there is a budget for the whole public sector, including SNGs (MEF, 2020a). The Peruvian fiscal decentralization framework allows and requires an MTFF that covers all levels of government (MEF, 2020a: 6). Moreover, in May of each year, regional and local governments must submit to the MoF a Multiannual Fiscal Management Report as part of the budget process, following the forecasts in the MTMF. The report includes projections of SNGs’ public finances – revenues, expenditures, and financing – for the current year, and three more years. As mentioned before, the coverage of an MTEF in Brazil would likely to be limited to the central government because of SNGs’ fiscal autonomy.

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36 In Spanish, Marco Macroeconómico Multianual (MMM).
37 Initially, the MTMF had a three-year horizon. The timeframe was changed in 2013 with the new fiscal framework.
38 The Fiscal Council, created in 2013, is an autonomous commission linked to the MoF. The law grants the Council autonomy and independence to fulfill its purpose (Consejo Fiscal, 2017a).
39 The year for which the budget is being made and two out-years.
The MoF forecasts key macroeconomic and fiscal aggregates for the nonfinancial public sector, covering the current year and three years ahead.\textsuperscript{40} Despite relatively accurate one year-ahead forecasts, medium-term macroeconomic forecasts have a conservative bias, and the MoF must substantially revise some projections from one year to the next (IMF, 2017b: 39). The MTMF includes a debt sustainability analysis for a ten-year horizon. This analysis simulates shocks in key macro-fiscal variables to evaluate what would happen to the debt dynamics under different scenarios of exchange rates, interest rates, and fiscal deficits. It also takes into account the impact on the debt path if risks, such as contingent liabilities, materialize (MEF, 2020a: 146). The MTMF presents the priorities for economic policy, and reviews goals achieved. In all of its editions, the priority of the MTMF has been to promote sustainable economic growth in the medium and long term, and to improve social progress and economic stability (IPE, 2020).

Throughout the 20 years it has been in place, the framework evolved, inspired by international best practices. Besides incorporating the Fiscal Council opinion on economic forecasts, the MTFF now includes the underlying assumptions for the forecasts, and the revision of the medium-term forecasts (MEF, 2020a). In the MTMF 2020-2023, the MoF offers a comprehensive explanation for the differences between forecasts and outturns for the overall balance – revenues minus expenditures –, and for the public debt since 2004 (MEF, 2020a: 122). Moreover, the MTMF includes measures of macroeconomic and financial risks to the public finances, and a fiscal scenario that estimates mandatory expenditure in the medium term. This analysis aims at calculating the available fiscal space to “implement new public policies without compromising macroeconomic stability, fiscal sustainability, or market access” (MEF, 2020a: 81).

As a medium-term macroeconomic framework, the focus of the Peruvian MTFF rests on a multi-year macro-fiscal scenario. There is not, however, a clear link between the MTFF and the budget. The Multi-Year Budget Plan (MBP), the existing tool that gives a multi-year perspective to the budget, is prepared separately from the MTFF. Each presents the evolution of expenditures differently. The MBP uses an incremental approach to calculate expenditures, with a specific percentage added to the historical level of expenditures. The sectoral expenditure ceilings end up being seen as expenditure floors, with line ministries requesting allocations that are above their spending capacities. Therefore, the Peruvian government fails to deliver a medium-term strategic planning to the budget (IMF, 2017b: 42). Aiming to improve the link between fiscal discipline and planning, and pushing fiscal discipline even further, the Peruvian government gradually started to implement an MTBF since January of 2017. The MTBF is expected to align national and sector priorities, macroeconomic projections, and the budget (IMF, 2017c: 13 Peru; World Bank, 2017c: 21).

\textsuperscript{40} “The nonfinancial public sector includes the central government, the autonomous agencies, the local and regional governments, and the nonfinancial public enterprises” (IMF, 2007: 65).
Colombia

Like Brazil and Peru, in the aftermath of the economic crisis in the 1990s, Colombia implemented fiscal management reforms to regain fiscal sustainability. The core of the Colombian fiscal framework rests on the Fiscal Responsibility and Transparency Law (FRTL) introduced in 2003. The government carried out a second wave of reforms in 2011-12, in which, among other measures, it incorporated a fiscal sustainability principle and a structural balance rule for the central government (IMF, 2014a: 16).

The structural balance is the anchor of the Colombian fiscal strategy. The fiscal rule established decreasing structural deficit targets from 2011 to 2022, when the deficit is supposed to be one percent of GDP. This target was defined to be consistent with a level of debt-to-GDP ratio of 30 percent (López, and Lopez-Ghio, 2019: 18).

An MTFF was introduced in 2003 as part of the Colombian PFM reform, with the primary objective of guaranteeing a sustainable level of public debt (Filc and Scartascini, 2010: 64). Figure 7 shows that the Colombian government was successful in keeping the public debt at a low level until 2012, when the debt started to climb amid the oil price shock. Notwithstanding the increase, the public debt level is still moderate, and it is considered, with high probability, to be sustainable in the medium-term (IMF, 2019c: 12). Furthermore, the economic and social progress made over the last two decades granted Colombia an invitation in 2018 to join the OECD (OECD, 2019b).

Figure 7: General Government Gross Debt

Source: IMF, 2019d.

Determined by the fiscal responsibility law, every year, the central government must submit the MTFF to the Congress. The MoF prepares the medium-term

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41 A structural balance is a cyclically adjusted balance, which adjusts the fiscal balance based on the economic cycle. In Colombia, for example, the fiscal balance is adjusted based on revenue fluctuations caused by GDP growth and oil prices. This way, the rule curbs the tendency to overspend during economic booms or when the oil price is high. During recessions or during times when the oil price is low, the structural deficit allows the government to have an overall deficit – total revenue minus expenditures – higher than the structural deficit, which avoids abrupt adjustments (López, and Lopez-Ghio, 2019: 19).
framework with the collaboration of the National Planning Department (NPD), and the National Directorate of Taxes and Customs (NDTC). The MTFF must present the fiscal performance of the previous year and explain deviations – if any – from the structural balance fixed for the year. In case of deviations, the MTFF must indicate a corrective path because the structural balance is binding (IMF, 2014b: 17).

Given the level of fiscal decentralization in Colombia, the law requires SNGs to prepare their own MTFFs. Although not as fiscally independent as SNGs in Brazil, Colombian SNGs collect, on average, 18 percent of total tax revenues (Bousquet, Daude, and Maisonneuve, 2015: 5). SNGs in Colombia, contrary to Peruvian SNGs, have their budgets prepared independently from the central government budget. Therefore, the Colombian MTFF offers a 10-year forecast of key macroeconomic and fiscal aggregates for the central government.

The MoF updates the macro-fiscal scenarios in the second half of the year (IMF, 2018a: 41). Moreover, the MoF presents the forecasts and the underlying assumptions in a clear way. Despite the forecasts being relatively accurate, the IMF suggested improvements in the forecast methodology (IMF, 2018a: 58). The Colombian framework does not provide much explanation for revisions of medium-term forecasts for revenue, expenditure, and financing. Furthermore, the MTFF does not reconcile discrepancies between new and past forecasts (IMF, 2018a: 55). The MTFF includes a debt sustainability analysis based on the macroeconomic forecasts and the fiscal strategy. This analysis focuses on the fiscal balance that is needed to stabilize the debt-to-GDP ratio (MHCP, 2019: 305). Moreover, the MTFF establishes a spending ceiling for the following year and indicative spending ceilings for the nine subsequent fiscal periods. Based on the expenditure ceiling established by the MTFF, the MoF and the Planning Department set indicative ceilings for the spending agencies for the next four years in the MTBF (Bernal et al., 2017: 107).

Besides the 10-year MTFF, Colombia’s medium-term expenditure framework has a four-year MTBF. The Colombian MTBF — Marco de Gasto de Mediano Plazo — was introduced in 2005 (Conpes, 2019: 8). The structural balance rule, the National Development Plan, and the MTFF draw the boundaries for the MTBF. The Marco outlines the fiscal constraints in the medium-term, the macroeconomic framework, the fiscal strategy to be followed, forecasts for current and investment expenditures in the medium-term (4 years), and indicative sectoral spending ceilings for ministries and public institutions (Conpes, 2019: 4; and IMF, 2018a: 44).

When compared to more developed frameworks, the MTBF in Colombia falls short in some relevant features. First, in the Colombian framework, expenditures are only partially covered, as the focus is on investment spending, and they are not subdivided by economic category or program. Second, sectoral spending caps have been significantly amended from one MTBF to the next and fail to offer a valid basis for the medium-term expenditure planning. Third, the MTBF and the budget do not share

\[42\] The problem of expenditures not being fully covered results from the budget itself being separated in two: one for investment and one for current expenditures (IMF, 2018a: 57).
an integrated single preparation process. Fourth, changes in forecasts from one year to the next are not reconciled in the new document. Fifth, there are no planning margins or reserves. Besides, there is no carry-over mechanism, which would allow spending to be carried forward from one year to the next, respecting some clear rules (IMF, 2018a: 45).

Despite weaknesses in its MTEF, the Colombian government is in line with international best practices for using a policy-based fiscal strategy and concerning the quality of its budgeting processes. The government is able to support a sustainable fiscal strategy through the macroeconomic and fiscal forecasts and fiscal rules (World Bank, 2015: 119). In terms of implementation, the gradual approach allowed the actors to internalize medium-term budget constraints before deepening the MTEF (Filc and Scartascini, 2010: 73). The framework became a reference for fiscal discipline, added transparency to the budget debates, smoothed medium-term processes, and improved the accessibility to statistical data (Filc and Scartascini, 2010: 66-67).

Like the Brazilian budget, the Colombian budget is very inflexible. The sources of rigidities are also similar: an excess of earmarked revenues and expenditure rigidity (Bernal et al., 2017: 87). The success of the Colombian MTEF in reducing budget rigidity is mixed. The framework helped to make investment spending more flexible than before, but it did not help to deal with the overall inertial nature of the budget (Filc and Scartascini, 2010: 73). The Colombian MTFF contemplates actions to increase expenditure flexibility and efficiency and to decrease spending indexation. The strategy encompasses a comprehensive review of public spending and a clear establishment of priorities in the budget. The strategy also includes an evaluation of expenditure effectiveness from the perspective of public policy and target populations. However, such measures require a series of reforms and legislative changes in order to implement the recommended actions (MHCP, 2019: 328).

In another similarity with Brazil, in Colombia, the Congress has the power to include expenditures in the budget, which contributes to budget rigidity, as it compromises the ability of the Executive branch to control the spending dynamics and to respond appropriately in the face of macroeconomic conditions (Bernal et al., 2017: 90). Comparing the quality of fiscal forecasting and budgeting in Brazil and Colombia, the two countries are at a similar level. Nonetheless, Brazil has a longer way to go to catch up with best practices as established by the Fiscal Transparency Code (FTC).

For example, while Colombia ranks “advanced” – the highest score –, Brazil ranks “basic” – the second-lowest grade – on macroeconomic forecasting. Moreover, Colombia has been able to adhere to its fiscal rule, while Brazil, as stated before, has not. On the other hand, when it comes to budget unity, Colombia ranks “basic,” and Brazil, “good” (IMF, 2017a: 49; IMF, 2018a: 58). The fragmentation of the budget in Colombia makes it challenging to coordinate to achieve policy objectives, to identify future expenditures from current investment projects, and to fully evaluate the results from a policy or program (Bernal et al., 2017: 85).

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43 Fiscal forecasting and budgeting are one of the four pillars of the IMF’s Fiscal Transparency Code, “the international standard for disclosure of information about public finances” (IMF, 2019e).
South Africa

After the end of apartheid in the late 1990s, South Africa embarked on a series of PFM reforms. In 1999, the Parliament approved the Public Finance Management Act (PFMA), the anchor for the South African fiscal policy. The PFMA intended to “promote financial transparency, a cost-effective manner of service delivery, and efficient utilization of financial resources proposal” (Vyas-Doorgapersad, and Waldt, 2016: 200). Even before the enactment of the PFMA, in 1998, South Africa introduced a budgetary framework, the Medium-Term Budget Policy Statement (MTBPS), an MTBF. In 2002, the government converted the MTBF into a performance framework (MTPF). The introduction of a performance element into the medium-term framework proved to be premature, as most of the information produced was not used to inform spending decisions, and the MTPF works as an MTBF (World Bank, 2013: 225). The implementation of an MTEF in South Africa was concurrent with fiscal and macroeconomic improvements, including spending restructuring, lower government debt, and positive fiscal balances (World Bank, 2013: 229).

The MTEF is in place at the central government and provincial levels. The MTPF for the central government presents all expenditure categories at both national and provincial levels (World Bank, 2013: 225). SNGs have their budgets, as South Africa has a high degree of fiscal and political decentralization. The South African Constitution establishes a clear division of powers and functions to the three government levels – central, provincial, and municipal. Although provinces do not possess high fiscal autonomy, municipalities can raise almost the totality of their revenues (Dell’Erba, 2018: 41). Provincial governments must prepare their MTBPSs and municipalities must submit their Medium Term Revenue and Expenditure Framework (MTREF) to the National Treasury and the relevant provincial treasury (Provincial Treasury, 2019; National Treasury, 2018).

South Africa’s framework rests on a three-year rolling budgetary structure. In contrast with Peru and Colombia, South Africa does not have a numerical fiscal rule. Therefore, the MTBPS establishes guidelines, not a numerical rule. The framework establishes a non-binding expenditure ceiling for the succeeding fiscal years with a medium-term objective to stabilize the debt-to-GDP ratio. Despite the expenditure ceiling being non-binding, parliament or provincial legislatures need to approve changes in the cap (National Treasury, 2015: 30).

As a full-fledged MTBF, the South African framework encompasses the three-stage process: top-down, bottom-up, and reconciliation. The framework foresees a contingency reserve to provide flexibility and stability to the budgeting process. In the three-year medium-term framework, the contingency reserve is larger for outer years, because the level of uncertainty increases as projections move further into the future (Fölscher, 2007: 516). The medium-term framework and the budget process are fully

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44 “An amount set aside, but not allocated in advance, to accommodate changes in the economic environment and to meet unforeseen spending pressures” (National Treasury, 2019: 74).
integrated, creating an active link between policy and planning (Fölscher, 2007: 511). In South Africa, the National Development Plan establishes the long-term priority areas and guides the budget. In Brazil, the Multi-Annual Plan (PPA) works similar to a national development plan, and should be used to allocate public spending in the medium-term. However, the PPA has never fulfilled such a purpose. Since it is not integrated into the annual budget, the PPA resembles a wish list rather than a planning tool.

The National Treasury provides the macroeconomic and fiscal forecasts. Despite improvements in the quality of the projections, the macro-fiscal framework still faces imprecision issues. In the budget year, the accuracy of the expenditures forecast is similar to forecasts in developed economies. In the medium-term, however, South Africa tends to overspend when compared to the projections (Allen et al., 2017: 12-14). On the MTBPS, the Treasury discusses the assumptions used in the economic and fiscal forecasts and explains revisions in the projections.

In the MTBPS fiscal risk statement, the risks are categorized in macroeconomic risks, expenditure risks, contingent and accrued liabilities, and long-term and fiscal risks. In the macroeconomic risks subsection, the Treasury offers two alternative scenarios to the baseline economic forecast. It also presents a sensitivity analysis of the “debt portfolio to changes in interest-rate, exchange-rate, and inflation assumptions” (National Treasury, 2019: 49). The long-term fiscal sustainability focus is on social spending. The National Treasury evaluates the sustainability of current expenditures and the cost of new social policies. This evaluation is based on economic and demographic growth assumptions (National Treasury, 2019: 53).

Besides communicating the government’s policy stance, the MTBPS intends to foster the discussion surrounding the economy and the public finances with the Parliament and with the public (National Treasury, 2019: 1). For instance, the 2019 MTBPS acknowledges the widening of the fiscal deficits and the growing debt-to-GDP ratio, and “proposes a path to restore the public finances to a sustainable position” (National Treasury, 2019: iii).

South Africa experienced almost a decade of positive fiscal balances and declining government debt-to-GDP ratio. However, since 2009, the course was reversed. Like Brazil, South Africa witnessed growth in the gap between revenues and expenditures in the past decade. The government expects the fiscal deficit to worsen as revenues underperform due to weak economic growth, and expenditures remain rigid. Consequently, upward pressure on the government debt is also expected: “the combination of lower revenue and increased spending widens the budget deficit to an average of 6.2 percent over the next three years. Debt and debt-service costs will continue to increase” (National Treasury, 2019: 1). Figure 8 shows the evolution of the primary balance (bars) and the gross debt as a percentage of GDP (line – axis on the right).
Despite facing fiscal imbalances since the global financial crisis, the introduction of comprehensive budget reform, in which the MTEF played a pivotal role, increased budget credibility. In the 2014 PEFA, South Africa scored an A in several PEFA indicators that need to be in place for an effective MTBF (Allen et al., 2017: 19). The indicators that received the highest scores include aggregate expenditure and revenue outturn compared to the original approved budget, comprehensiveness of the budget documentation, and a multi-year perspective in fiscal planning, expenditure policy and budgeting (South Africa, 2014). Moreover, the performance of the South African MTBF and budget institutions compare favorably to the performance in advanced economies in many aspects (Allen et al., 2017: 33).

The South African framework offers a helpful example of how to implement an MTEF. Instead of starting from the implementation of a refined technical structure, South Africa focused on committing to realistic macroeconomic and fiscal forecasts, robust accounting procedures, and transparency through regular budget reporting. In Brazil, the starting point should be to improve the MTBF building blocks already in place, like strengthening the link between the budget guidelines and the annual budget. The establishment of the National Treasury as the single body responsible for the budget process strengthened the implementation of both the MTEF and the PFMA (Fölscher, 2007: 532) in South Africa. In Brazil, the departments responsible for the budget, the public debt, the macroeconomic forecasts, and the tax department are all already under a single Ministry.

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Apart from technical challenges, such as the necessary accuracy of the macro-fiscal forecasts, other factors come into play to help or hinder the MTEF performance. Despite its many potential benefits, MTEFs alone do not seem to be enough to guarantee the sustainability of public fiscal accounts, nor prevent or reduce budget rigidities. In the Peruvian macro-fiscal framework, the MTEF is one of the pillars of the fiscal framework in place. Fiscal rules, countercyclical tools, and surveillance and enforcement build the other three pillars to promote fiscal sustainability (MEF, 2020a: 67). In South Africa, the introduction of an MTEF helped promote aggregate fiscal discipline, and, at the central level, the government made significant progress regarding allocative efficiency. However, such advances were not a result of the MTEF by itself, but a result from multiple factors. Strong political support for the fiscal reforms and consensus-building played a substantial role in achieving fiscal discipline. Moreover, political stability influenced the way resources were allocated (Jogo, and Wilderman: 2012: 2).

Governments do not make budget decisions only in terms of efficiency and effectiveness, and ultimately, budget decisions are political decisions. Despite having an MTBF in place in South Africa, the increase in expenditures set in motion to counteract the effects of the 2008 global financial crisis continued, even when the economy started to bounce back. Based on the assumption that the economy would rebound soon, the macro-fiscal scenarios led the government to set nominal expenditure ceilings that later proved to be too high. Moreover, the most significant part of the increase in total expenditure came from an increase in the wage bill, which added inflexibility to the budget (IMF, 2018b: 6).

The budget reflects the power dynamics between the Executive and Legislative branches, as well the ability that citizens, interest groups, and political parties have to influence the budget process (Rubin, 2000: 2). These power dynamics affect the success of an MTEF. In Colombia, the Executive branch, through the MTFF, has advocated the need to decrease budget rigidity and to improve spending efficiency. Until there is a buy-in from the Congress that reforms are necessary, the MTEF cannot accomplish much in fighting rigidities. Similarly, in Brazil, any change to the mandatory expenditures depends on the Congress. The Congress members know that touching entitlements – a significant source of rigidities – is not a popular move.

How could this framework be applied to Brazil?

Brazil does not have a formal MTEF, but the Multi-Annual Plan (PPA) and the Budget Guidelines Law (LDO) offer some aspects of a medium-term framework. As some of the building blocks of an MTEF are already in place, the introduction of an MTBF seems feasible and appropriate. For the PPA to have an active role in a medium-term framework, the government would have to introduce a rolling plan with periodical updates to the macro-fiscal scenarios (Fortis and Gasparini, 2017: 80).
MTBF, like in South Africa, during the reconciliation stage, the MoF should be able to rely on the PPA to reconcile resource availability with the units’ spending requests.

For the LDO to work as the link between the PPA and the budget, and as a guide to the medium-term fiscal strategy, the LDO’s Fiscal Targets Section needs to be transformed into a real medium-term fiscal framework (Tollini, 2018:29). This transformation would require the Economic Policy Secretariat (SPE) – a branch of the MoF responsible for producing the macroeconomic forecasts for all budget documents – to improve the quality and credibility of the macroeconomic projections, and to provide the underlying assumptions. As mentioned before, forecasts have traditionally been upwardly biased, and the projections for the outer years are nothing more than an extrapolation of the forecasts for year one. Therefore, the forecasting model needs to be updated, and SPE should make the reconciliation of forecast revisions public. Transparency on the assumptions underlying the forecasts and reconciliation between forecasts and outturns will enhance the credibility of the forecasts (IMF, 2017d: 25).

All of the bodies involved in macro-fiscal forecasting are currently under a single Ministry, which should facilitate the exchange of information and expertise among them. The Treasury is responsible for producing part of the fiscal forecasts – mainly related to the public debt – along with the Federal Budget Office (SOF), and the Federal Revenue Secretariat (RFB) – revenue projection. Moreover, there is suggestive evidence that fiscal councils tend to help with the accuracy of budgetary forecasts and improve compliance with fiscal rules. Therefore, the accuracy of the macro-fiscal projections can be improved through the independent macro-fiscal forecasts published by the fiscal council (Beetsma et al., 2018: 23).

The introduction of a medium-term fiscal framework would also require strengthening medium-term fiscal objectives. The targets established in the LDO would need to be in consonance with the long-term fiscal policy objectives, as established in the fiscal rules. For example, the estimated overall amount of resources needs to respect the spending ceiling. Moreover, the country’s medium-term fiscal sustainability would likely benefit from a debt ceiling with automatic triggers, and from a new primary balance rule. Currently, as the primary balance target is set just for one year, the connection with long-term fiscal sustainability is lost. Furthermore, the government sets the target based on forecasts of revenues and expenditures rather than based on what primary balance should be met to reduce the debt level or to guarantee fiscal sustainability (Brochado, 2019: 20). Finally, the LDO could be used to foster the discussion surrounding the economy and the public finances, including allocation priorities, like in South Africa.

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46 Inspired by the Office for Budget Responsibility in the UK, the Brazilian fiscal council, the Independent Fiscal Institution (IFI), was established in 2016 to improve the transparency of public accounts. The council has four legal mandates. The IFI must publish its macro-fiscal forecasts for the budget, analyze the fit between fiscal and budgetary indicators and their targets, measure the impact of relevant fiscal events, including the evaluation of the costs of monetary, credit, and exchange rate policies, and forecast fiscal variable that are crucial for the long-term balance of the economy (IFI, 2016).

47 Automatic triggers mean that, if the debt reaches a pre-determined level, several measures would be automatically put in place to bring the debt back to its desired path.
Once the MTFF is established, the next step would be aligning the budget to the medium-term fiscal trajectory, through an MTBF. Besides a reliable forecast of revenues and the establishment of an aggregate expenditure ceiling, the implementation of an MTBF requires the government to distinguish the medium-term fiscal impact of current policies from available fiscal space to introduce new policies. The integration of the MTBF with the budget will come from the rolling nature of the medium-term framework: year one of the MTBF will be the baseline budget. Following the MTEFs sequential process, after the MoF determines the medium-term overall resource availability, spending agencies present their budget requests. The bottom-up approach will likely be the biggest challenge in the whole process as it involves coordination among several line ministries and agencies. For a smoother transition, the government can introduce a pilot MTBF and restrict the framework to line ministries with higher capacity like Ministries of Health and Education (IMF, 2017d: 25).

The main features of the Brazilian MTBF – timeframe, coverage, fiscal targets, binding nature, exclusions, and level of detail – have already been covered throughout the paper. In sum, a three-year rolling framework seems to be appropriate, as the LDO macro-fiscal scenarios cover three years, and the framework should be restricted to the central government. As mentioned before, the framework is bounded by a binding expenditures ceiling. Moreover, a debt ceiling and a new rule for the primary balance would help promote fiscal sustainability. For consistency, the framework should cover the same spending categories that are under the spending ceiling. Finally, in the level of detail, resource allocation should be done through thematic areas.

The level of budget rigidity might pose several challenges to the introduction of an MTEF. However, a medium-term perspective to the budget can be a starting point for the government to scrutinize current fiscal policy, and to draw a path that aligns fiscal sustainability and national priorities. Alternatively, the introduction of an MTEF can be coupled with other PFM tools when it is initially introduced. An MTEF and periodic spending reviews, for example, can strengthen the medium-term strategic prioritization and allocation of resources. In both scenarios, the government needs to address the sources of budget rigidity: earmarked revenues, mandatory spending, and indexation. The moment to implement an MTEF seems to be ideal, as the central government is inclined to promote fiscal reforms. Furthermore, the struggling public finances are about to be struck again amid the Coronavirus pandemic, and Brazil can no longer postpone the adoption of measures to restore the country’s fiscal sustainability.

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48 In November 2019, the central government sent Congress a draft of a constitutional amendment to contain the growth of mandatory expenditures, reduce earmarking and indexation practices (SF, 2019).
**Glossary**

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
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<tbody>
<tr>
<td>BPS</td>
<td>Budget Policy Statement – New Zealand</td>
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<tr>
<td>DRU</td>
<td>Federal Revenue de-earmarking mechanism</td>
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<tr>
<td>FRL</td>
<td>Fiscal Responsibility Law</td>
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<td>FRTL</td>
<td>Fiscal Responsibility and Transparency Law – Colombia</td>
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<tr>
<td>FTC</td>
<td>Fiscal Transparency Code</td>
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<td>MF</td>
<td>Ministry of Finance</td>
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<td>MTBF</td>
<td>Medium-Term Budget Framework</td>
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<td>MTEN</td>
<td>Medium-Term Business Environment</td>
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<tr>
<td>MTNS</td>
<td>Medium-Term Budget Policy Statement – South Africa</td>
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<td>MTF</td>
<td>Medium-Term Fiscal Framework</td>
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<tr>
<td>MTMF</td>
<td>Medium-Term Macroeconomic Framework – Peru</td>
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<td>MTPF</td>
<td>Medium-Term Performance Framework</td>
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<tr>
<td>MTREF</td>
<td>Medium Term Revenue and Expenditure Framework – South Africa</td>
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<td>NDTC</td>
<td>National Directorate of Taxes and Customs – Colombia</td>
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<td>NPD</td>
<td>National Planning Department – Colombia</td>
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<td>PFM</td>
<td>Public Financial Management</td>
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<td>PFMA</td>
<td>Public Finance Management Act – South Africa</td>
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<td>PPA</td>
<td>Multi-Annual Plan – Brazil</td>
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<td>SNG</td>
<td>Subnational government</td>
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<td>SOF</td>
<td>Federal Budget Office – Brazil</td>
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<td>SPE</td>
<td>Economic Policy Secretariat – Brazil</td>
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<tr>
<td>RFB</td>
<td>Federal Revenue Secretariat – Brazil</td>
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Works Cited


