Improving Fiscal Management in Brazil: Introducing the Medium-Term Expenditure Framework (MTEF)

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Acknowledgements: To my family for the unconditional love. To Mariana, for all strength, love, support and peace that she gave to me in this important achievement. To my friends from the Secretariat of Finance for the support, and to my friend Victor Hugo for the several economics thoughts that I learned with him. For all of them, my sincere and deeply thank you!
Abstract

This paper seeks to contribute in various ways to the study of public finance and proper fiscal management of public entities in Brazil. To accomplish this objective, the paper: (i) presents, in a summary form, the state’s role in the economy, the financial activity developed by the state and the budget process applied in Brazilian federalism; (ii) questions the real existence of a medium-long planning and its applicability via annual budget; (iii) introduces and contextualizes a new methodology used by more developed countries and heavily disseminated by international organizations as a way to achieve better results in the fiscal management of the public sector, the Medium-Term Expenditure Framework (MTEF); and (iv) demonstrates the process of developing the first model of a MTEF in a subnational government in Brazil, namely the State of Rio de Janeiro.

Key words: Brazilian Budgetary System, Plano Plurianual (PPA, Multiyear Plan), Lei de Diretrizes Orçamentárias (LDO, the Budget Guidelines Law), Lei Orçamentária Anual (LOA, the Annual Budget), Fiscal Planning, Public Finance, Fiscal Sustainability, Fiscal Control, Medium-Term Expenditure Frameworks (MTEF).
**Abbreviation**

BPA – Brazilian Public Administration.

CBO – Congressional Budget Office.

DCL – Dívida Consolidada Líquida (Net Consolidated Debt).

GDP – Gross Domestic Product.

IMF – International Monetary Fund.

LDO – Lei de Diretrizes Orçamentárias (Brazilian Budget Guidelines Law).

LOA – Lei Orçamentária Anual (Brazilian Annual Budget).

LRF – Lei de Responsabilidade Fiscal (Brazilian Fiscal Responsibility Law).

MTEF – Medium-Term Expenditure Frameworks.

MTFF – Medium-Term Fiscal Framework.

NPS – The National Planning System (Brazilian budget system).

ODI – Overseas Development Institute London.

OECD – Organization for Economic Co-operation and Development.

PAF – Programa de Reestruturação e Ajuste Fiscal (Program of Restructure and Fiscal Adjustment for the subnational governments in Brazil).


PPA – Plano Plurianual (Brazilian Multiyear Plan).

PRSPs – Poverty Reduction Strategy Papers.

RCL – Receita Corrente Líquida (Net Current Revenue).

SRJ – State of Rio de Janeiro (subnational government in Brazil).

WB – World Bank.
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1. **INTRODUCTION**

In a country such as Brazil with continued economic development, public management faces numerous managerial obstacles.

The numerous social demands, as well as the need to ensure the continued growth of the productive capacity of the country, represents, sometimes, a serious risk to the fiscal equilibrium of the government, either in the short or long-term, resulting in large losses of financial capacity. With a tax burden close to 40% of the GDP\(^1\), the discussions in the field of public finances become a priority in the Brazilian society.

With a distinguished federal system, composed of three different levels of government (central government, state government, and municipal government), the country presents a complex tax system as a direct result of this institutional architecture. In certain circumstances, this financial flow occurs through the central government, and, in other moments, through the local levels.

Unlike the American tax model, in which the collection of tax can be determined by both levels - by the central and by the local government - the Brazilian Constitution defines the powers of each level of government.\(^2\)

On the other side of the equation, the public expenditure, there has been a weak coordination between the three levels on the public spending, resulting in actions (public policies) of low quality and not directed to the intended audience.

Far from the Golden Decade\(^3\) (The Brazilian Miracle), a time of the national history in which the country had exceptional economic growth, the society now demands for higher spending and real results.

For many years, the main instrument used by the Brazilian state to ensure meeting the demands of society and making the necessary investments to economic growth, was made on the basis of the expansion of the tax burden and borrowing in the market (public inflows denominated lending operations or loans which results in the generation of a medium to long run liability).

There has been increased attention to the short-term planning, mainly due to the need to harmonize legal instruments and public policies with the temporality of governments. The abandonment of central planning as the guiding instrument for government actions (budget formulation) is clear. A plan which once was extremely necessary and important in the process of building a better future for the country is no longer applied.

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The reflection proposed here is intended to show that the outputs generated by the decision making process, when done without proper technical study, can pose serious risks to fiscal sustainability to governments in the medium and long-run.

The paper is divided into six sections. The first one takes the academic debate about the role of government in the economy to introduce the term Public Finance, a field oriented to analyze the ability of governments to influence local economic development.

In the second section, the financial activity of the state and its relationship with the public budget is presented. That section also starts to discuss certain important points of the budget model applied in Brazil by the central and by the subnational governments: The tools that were developed to assist in the budget process, their strengths and their weaknesses.

The intention is to show the loss of the link between planning and budgeting, partly generated by the difficulty of an elaborate technical budget rather than a political one, which can cause a great impact on the ability to draw up a tool for medium and long term planning.

The third section brings together a qualitative and quantitative analysis of the importance of fiscal management to strengthen the role of the state and maintain its ability to make tax policies. The legal framework created in Brazil to ensure the good fiscal management and the current criticism about their effective functioning is presented.

The fourth section discusses the importance of making decisions today by analyzing the effects in the future. Also this section presents the Medium-Term Expenditure Framework (MTEF), a new methodology that tries to assist in the implementation of good governance. The MTEF concept and its logical structure are introduced. This methodology is able to assist in the process of public accountability not only in the short but also in long-term through an intelligent fiscal management based in macroeconomic scenarios.

In the fifth section, the case of the State of Rio de Janeiro (SRJ) is presented, which is the first state in the Brazilian federation to draw up the MTEF to assist the process of managerial decision making. Finally, the sixth section presents the main findings of this study.

This paper describes the current Brazilian budgetary system and analyzes its integration with the government planning. The main goal of the paper is to highlight the importance of keeping the link between the budget and the central plan to ensure the fiscal sustainability in the long-run. A new methodology, globally known among more developed countries which has been replicated in developing countries, is presented.
2. PUBLIC FINANCE

2.1 Defining the idea

Public Finance is the branch of economics that studies the taxing and spending activities of a government. In a simplistic definition, the expression tries to explain the methods, the principles and the financial processes through which governments perform their roles into the society. For some authors:

_"Public Finance is nothing else than a sophisticated discussion of the relationship between the individual and the state. (Former Czech Prime Minister Vaclav Klaus)."_

_"The core of public finance depends on spending someone else’s money by some people. In democratic countries, this process has been constructed by the voters to whom they have given the public force elected by themselves (Shah, 2007)."

According to Rosen and Gayer (2014), the term does not reflect the goals of science, but is related to the study and application of resources.

_"The term is sometimes of a misnomer, because the fundamental issues are not financial, in other words, is not relating only with money. Rather, the key problems relate to the use of real resources. For this reason, some practitioners prefer the label public sector economics or simply public economics."

Thus, some actors prefer to characterize public finance as an economic public sector, or simply, public economics.

Conceptually, the field of study focuses on the effect of the presence of the state in the economy; when it taxes and spends resources in several areas. However, this paper will not be limited to just that arena. The study of the discipline also seeks to determine what should be the activities of the state in the market.

Ideologically, this science, of how governments should operate in the economic sphere, is strongly influenced by economic theories.

It is vital to make clear that the limits of the field, at certain times, are not so clear. Certain desired economic policies can be reached by public expenditures or simply through tax collection. However, other desired effects may be produced by other means, such as the use of regulatory activity.

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2.2 Economic theories: just a short overview

Several economic theories seek to define what would be the ideal size of the state and in what way and to what degree it should participate in economic activity.

Despite the disparities, one point remains in common between economics theories: all of them, from the most conservative to the most interventionist, recognize, even if minimally, the role played by the state in the economic system.

Whether controlling important macroeconomic variables (essential elements to growth and market stability) the state is actively participating in the production process; filling the existing gaps for the growth of the economy; seeking greater vertical equalization in society; or simply providing the public needs. It is clear that today the state has more presence in the economic cycle. However, the state’s participation in this process was not always viewed as a constructive intervention.

In the eighteenth century, theorists believed and spread the idea of an economic model with free markets; markets operating without any restrictions or interference from the state. Basically, economists and philosophers of the time were opposed to state intervention in the economic process, because, for them, the state should only provide the basic conditions for the market to take its course naturally.

The Economic Liberalism proposed by Adam Smith framed this conceptual row. For the father of classical economics, it was important that the state grant full freedom to private initiative, which would allow the continuous development of economic relations. In his classic book, *The Wealth of Nations*, Smith proposed the concept of the “invisible hand.”

The ideology of Smith preached that state intervention in the market would be disastrous for the progress of the economic system because it would directly interfere in the natural balance that exists between market agents (players), i.e producers and consumers.

In Smith's view, the economy should be organized into individual lines of action. His studies led him to believe that free competition among entrepreneurs naturally would regulate the market, leading to falling prices and bringing new technological innovations, which are important to improve the quality of products as well to increase the pace of production. For this, it was vital that the largest possible number of economic decisions were taken by individuals, not by institutions or collectives.

Smith defended free competition, the law of supply and demand, strongly fighting the regulatory role of the welfare state. The role of free market forces (the invisible hand) would lead both demand and production to a perfect balance point.

According to Abel, Bernanke and Croushore (2014):

> The idea of the invisible hand is that, if there are free markets and individuals conduct their economic affairs in their own best interests, the overall economy will work well. As Smith put it, in a market economy, individuals pursuing their own self-interests seem to be led by an invisible hand to maximize the general
welfare of everyone in the economy. (...) The classical approach to
macroeconomics builds on Smith's basic assumptions that people pursue their
own economic self-interests and that prices adjust reasonably quickly to
achieve equilibrium in all markets.\(^7\)

However, even minimally, Smith recognized the share of government ownership. For him, the
state should act as a provider of specific goods - goods that the market would not produce in
the socially desired amount - the so-called public goods.

To Abel, Bernanke and Croushore (2014):

\begin{quote}
The use of classical approach carries with it some strong policy implications.
Because the classical assumptions imply that the invisible hand works well,
classical economists often argue (as a normative proposition) that the
government should have, at most, a limited role in the economy. As a positive
proposition, classical economists also often argue that government policies will
be ineffective or counterproductive at achieving their stated goals. Thus, most
classicals believe that the government should not try actively to eliminate
business cycles.\(^8\)
\end{quote}

At the beginning of the twentieth century, a new doctrinal line, the Keynesian approach,
emerged. At its core, this economic philosophy understood that the role of governments
needed to be broader and more intense. It would be up to the state to provide much more
than simple services. In the view of these economists, the state is also responsible for social
welfare, in other words, the range of desirable goals for the state society.

Compared with the classical approach, the Keynesian approach assumes that wages and prices
adjust slowly. In Keynes's theory, unemployment can persist because wages and prices do not
adjust to equalize the number of people that firms want to employ with the number of people
who want to work.

Basically, Keynes's proposed solution to high unemployment was to have the government
increase its purchase of goods and services, thus raising demand for output. More generally, in
contrast to classicals, keynesians tend to be skeptical about the invisible hand and thus are
more willing to advocate a role for the government in improving macroeconomic performance.

According to Abel, Bernanke and Croushore (2014):

\begin{quote}
Because the Great Depression so strongly shook many economists' faith in the
classical approach, the Keynesian approach dominated macroeconomic theory
and policy from World War II until about 1970. At the height of Keynesian
influence, economists widely believed that, through the skillful use of
macroeconomic policies, the government could promote economic growth
while avoiding inflation or recession.\(^9\)
\end{quote}

\(^7\) ABEL, Andrew; BERNANKE, Ben; CROUSHORE, Dean. Macroeconomics. Eighth Edition. 2014.
\(^8\) Ibidem.
\(^9\) Ibidem.
However, in the 1970s the United States suffered from both high unemployment and high inflation, also called the stagflation. This experience weakened economists’ and policymakers’ confidence in the traditional Keynesian approach. And so, in the past three decades, advocates of both approaches have reworked these approaches extensively to repair their weaknesses.

Despite the numerous debates about the ideal size of the state and its role in the economic cycle, the most appropriate way to analyze the role played by the state in the market is related to the so-called market failures; disorders that prevent the perfect ratio of their agents, which for many thinkers those failures ensures the government action in the economy.

Musgrave, studying the role played by the state, brought together its goals in three major aspects: ensuring adjustments in the allocation of resources (allocative function); achieving adjustments in the distribution of income and wealth (distribution function); and ensuring economic stabilization (stabilizing function).

The classic work by the author also shows that government actions are essential to guide, to correct and to supplement the market mechanisms. In his view, the flaws do not exhaust the motivation for the existence of government in the economic system. He claims that the presence of the government to provide a legal framework to ensure the property and regulate the transactions of economic agents is necessary because sometimes the market equilibrium can generate a situation in which the distribution of income among individuals is greater than the socially desired. In this case, the government has the function of redistributing income through public policies.

However, despite those failures justify the large government presence in the economy, which in some extent ensures the existence of the public economy, one must keep in mind that the state also commits errors, which are generated by incorrect actions that cause instabilities in the economic system and natural barriers to development.

So, the big question discussed today is how to keep the right balance between the natural market and the state intervention. In other words, how public finances must be conducted in ways that ensure a less aggressive state action to the market without compromising the private activity.

Certainly, public interventions might be more appropriate and consistent with the economic model adopted. It is essential that public managers seek to analyze and quantify the possible impacts that may occur in the relationship between the players.

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2.3 Economic activity developed by the state

The main purpose of the state is to provide common goods and attend to public needs. Meanwhile, the state also seeks to pursue so-called secondary interests, which are utilities that interest only the state. To Harada (2002), the state develops numerous activities, each aiming to protect certain public needs. Some of these needs are of essential nature, for example, those pertaining to public safety. Meeting these demands undeniably results in the spending of public resources. Therefore, it is critical that the state has at its disposal the resources necessary for the implementation of numerous demands it receives by the society. This function characterizes the financial activity performed by the government. According to Pascoal (2009):

*The financial activity consists in the acquisition, creation, management and expenditure of resources indispensable to the needs, which satisfaction the state assumed or committed other persons under public law.*

(Loosely translated)

For Torres (2004), this financial activity consists of several actions taken to achieve the revenue and the performance of essential public needs. This state practice is performed through government actions - dynamics usually translated into projects, specific programs or activities - whose purpose is to generate specific results, whether in the economic or the social aspect. For its materialization, the bureaucratic state makes use of the public budget, an instrument which, over the past few years, came to hold high importance, becoming the key factor for the development of a nation. Albuquerque, Medeiros and Feijó (2008) emphasize this necessity by stating:

*The objectives of budgetary policy are achieved due to the ability of the state to influence the economy through recombination of the funds raised at the time of conducting the public expense. By applying the resources collected in programs and activities which respect the objectives of budgetary policy, the state is exercising its regulatory power in the market for the benefit of society.*

(Loosely translated)

As a strategy variable for sustaining economic and social progress of the country, the budget deserves due attention. This is one of the most important wheels in the government machinery. Through it the execution of several work plans of the government, namely, the development of public policies, is traced. Brazilian literature presents a large amount of concepts for the public budget. All reflect different views about the role of the state, via the public budget, to society. In the current Brazilian model, the budget framework seeks to reflect the elaborate planning by the government for the next few years of management. This is the topic of the next chapter. The public budget plays a very important role in the economy as a whole. Its correct handling may represent years of prosperity for a country. Its improper use can cause periods of instability.

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3. BRAZILIAN BUDGET SYSTEM

3.1 Origin and characteristics

If previously the Brazilian budget system primarily represented a mere document of an accounting nature focused on the fulfillment of legal enforcement of public spending formalities, today this view has changed. The budget has a new direction and importance to the public administration.

The origin of public budgets is intrinsically related to the development of democracy, opposing the old form of government in which the monarch considered himself sovereign and holder of the community assets. In old despotic regimes, the chief of the Executive Branch usually held the power to institute the collection of taxes and determine where resources would be applied, without being required any accountability to society.¹⁴

As an instrument formally finished, the public budget originated in England in the early nineteenth century. In this initial stage, the budget was prepared with the concept of an instrument of political control of the agencies of representation part of the Executive Branch. With the changes in the functions of the state and the development of a more dynamic and complex economic environment, public managers needed the budget to also subsidize administrative activities. With its evolution, the budget has been designed as a management tool, which is realized mainly through programs and performance targets.¹⁵

The modernization initiatives of the budget in the United States, strongly based on military programs and corporate strategies, contributed significantly to the modern conception of the budget.

Characterized as formal law in Brazil, the public budget only foresees public revenue (projects the revenue for a given year) and, based on this expected tax collection, authorizes expenditures (actions and proposals prepared by various agencies belonging to the administrative apparatus) without modifying the legal system or creating subjective rights.¹⁶

In Brazil, much of the doctrine understands that the budget is merely a legal authorization for the realization of the planned expenditure, with no mandatory nature. It is, therefore, merely an intention, a projection, of the Executive Branch for a specific fiscal year.¹⁷

Currently there is a big legal debate occurring at the Brazilian federal level on such understanding about this projection by the Executive Branch, because for some the Budget Law (LOA) has an imposing character. A change in interpretation would lead the Brazilian budget to status of impositive laws, forcing the government to faithfully fulfill what was established by the Legislature.

¹⁵ CRUZ, Claudia Ferreira. MARTINS, Elói. ENAP. 2013.
The possibility of this new legal framework can be extremely harmful to the little discretionary that still exists today. It does not take into account the dynamics that currently exist in the economy, which imposes the need for managers to have a greater flexibility during the fiscal year so that adjustments can be made throughout it. With such an understanding, the Executive Branch would be obliged to implement the law as approved by the Legislature, and would ensure that the budget would be the original approved. This line of thinking would only enlarge the rigidity of the machine, going totally against the idea of a managerial state. With one of the most bureaucratic and rigid budgets in the world, considering the several existing constitutional obligations, the degree of freedom that the ruler has to make public policy in Brazil is extremely small. Such inflexibility is witnessed both by the revenue and the spending side which imposes to public managers the obligation to allocate some budget resources in certain areas. Thus, for various reasons, the Brazilian budgetary process was accumulating problems that create limitations to the effective use by the state of an instrument of vital importance for the effectiveness of public policies, the necessity of a comprehensive reform in this sector of the public administration becoming more evident each year.

3.2 The instruments: PPA, LDO and LOA

Reaffirming the Brazilian tradition of linking planning to the budget, a budget model based on three interdependent and legal instruments was built in the country.

The first instrument and guidance for government action is the Plano Plurianual (PPA, Multiyear Plan), a four-year plan which is meant to reflect strategic government priorities and to constrain the annual budget.

As the most complete and comprehensive management instrument of the three, the PPA constitutes the starting point of the government's plan. It tries to explain how the government will seek the development of the state in that period. The instrument seeks to equalize the commitment assumed with strategies and future vision. It is vital to properly plan all desired accomplishments over the course of the four years, otherwise the budget will not allocate resources to actions that were not foreseen in the original plan.

According to the Brazilian Constitution, the PPA provides the guidelines, the objectives and the targets to be achieved by the public administration. Its elaboration occurs in the first year in office of the Chief Executive, taking effect in the second year and remaining so until the end of the first year of the subsequent management period when a new administration will be responsible for its preparation. Therefore, the time gap of the plan does not coincide with time lapse of the mandate of the ruler who developed it, constituting the idea of continuity with different governments.

The Lei de Diretrizes Orçamentárias (LDO, Budget Guidelines Law), the second instrument, acts as a true link between the PPA and the third instrument, the budget. Through the LDO, the government seeks to establish the goals and priorities of the management for a particular fiscal year. With its intermediate position, the LDO plays the role of balancing between the strategy outlined in the planning and actual implementation possibilities in the budget.
With the creation of this instrument, the legislator sought to broaden the discussion period of budgeting. The concern of establishing mechanisms for a more clear and rigid connections between the multi-year planning and budget, has always been one of the main weaknesses of the Brazilian budgetary mechanism.

The last instrument in this ingenious process is the Lei Orçamentária Anual (LOA, Annual Budget Law). The legislator is left to provide to the Annual Budget Law the allocation of the resources foreseen by the Executive Branch for the fiscal year through the composition of programs and the elaboration of projects and activities. The budgeting process occurs according to the guidelines established in LDO.

Charts 1 and 2 show the relationship between these instruments (PPA, LDO and LOA) and how they connect to each other over the years.

**Chart 1: PPA, LDO and LOA.**

<table>
<thead>
<tr>
<th>PPA (Multiyear Plan)</th>
<th>LDO (Budget Guidelines Law)</th>
<th>LOA (Budget)</th>
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<td>LDO 2009</td>
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<td>LDO 2015</td>
<td>LOA 2015</td>
<td>2014</td>
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</tbody>
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*Source: Brazilian Federal Constitution, ADCT, art. 35.*

**Chart 2: PPA, LDO and LOA in time.**

<table>
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<th>X</th>
<th>Y</th>
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<tbody>
<tr>
<td>t4</td>
<td>t1</td>
<td>t2</td>
<td>t3</td>
</tr>
<tr>
<td>PPA_Gov X</td>
<td>PPA_Gov Y</td>
<td>PPA_Gov Z</td>
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<td>LDO</td>
<td>LDO</td>
<td>LDO</td>
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<td>LOA</td>
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</table>

*NOTE: The innovations introduced by the Constitution resulted in a new budget model. At least technically, this model is much more connected to the route planning.*

Thus, the PPA establishes the long-term planning and the budget executes it. In other words, the budget annually materializes the existing actions (programs) in the elaborate planning. According to Cruz and Martins (2013), these instruments represent a process to creating a good public management.
(...) planning, programming and budget are processes by which the objectives and resources are considered, and their interrelationships in order to obtain a consistent and comprehensive program of action for the government.¹⁸
(Loosely translated)

3.3 The missing link between the Planning and the Budget

Until the first decades of the twentieth century, the classical budget was intended primarily to confer legality to the estimated revenue and expenditure, not exactly taking into account the instrument function-part of planning in the public sector.

With the development of knowledge and techniques for planning and management of public actions, new functions were incorporated into the budget. This new budgeting phase transformed the ordinary process. The budget has acquired an instrument whose nature is inherent in government planning; it was no longer a mere system of control.

Over the years, different methodologies of budget configuration was experienced over time. All, however, highlight a specific moment in the evolution of public management: leaving behind the control of the public expenditure applied in the 80s to achieve the managerial state of the 90s.

The doctrine presents the following as the best known models over the years: the Traditional technique; the Performance; the Incremental; the Zero Base Budget; and the Program Budget.

Some of these techniques use the modern concept applied on the public budget: It is an instrument of high and complex dynamics that attempts to take into account aspects of the recent past (data) and the present reality (economic sensibility) to design the state's ability to perform all actions required or planned to the future. Conversely, some techniques still have the budget as merely a device authorization, which informs the public expenditure intended for a specific fiscal year not showing any economic analysis that justifies or reviews the programs and the projects designed.

The Brazilian experience in the area can be divided into three phases: Budgeting Plans, Planning-Budget, and finally and currently applied, the Program Budget. The first phase (Budgeting Plans) includes the Brazilian experiences that tried to define the central plan as part of the budget. In the second stage, the budget was concerned with the detailing of public resources needed for the execution of intended plans. Basically, in this phase, the public budget already reflected the correlation between the planning and the budgeting, a link that would eventually serve the function of giving content to the budgeting process.

By the early 1960s, the Brazilian government designed the National Planning System (NPS) which established the guidelines for the preparation of a budget as a basic element of the central plan. To some researchers as Biderman and Arvate (2004), the NPS laid the foundations of the Program Budget, also known as the third phase. For them the Program Budget is a

¹⁸ CRUZ, Claudia Ferreira. MARTINS, Elói. ENAP. 2013.
formal document in which financial resources are discriminated and the intended public actions for the fiscal year are exposed. Differently from the other proposals, the Program Budget is far from being confused with a mere accounting piece where revenues and expenses are related. In it, the actions seek to be correlated with a long-term planning. In other words, the budget is seen as the materialization of the goals planned for various lines of public action which are developed by the state. According to Biderman and Arvate (2004):

The planning, budgeting and finance management and public policies comprise a whole set of actions ranging from the construction of the future vision until the definition and implementation of physical and financial targets.

The Program Budget is an instrument closely associated with the planning, largely reflecting the work plan of the government, indicating the programs and actions to be undertaken, including the discrimination of projects and activities, and the amounts and sources of resources to be used to implement.\(^{19}\) (Loosely translated).

Despite the existing characteristics in this model (Program Budget), it gives the impression of a perfectly operating system network between the budget and the central planning, with a kind of interconnected mechanism, but in fact it is perceived in practice something very far from the original idea. The expected synchronization between both instruments was never actually achieved. For some Brazilian researchers, the role envisaged for the PPA - guiding budget pieces - was not yet recognized, preventing its use as an effective tool for strategic management.

For Mendes (2009), the Brazilian model of planning is extremely bureaucratic and contradicts the logic of the political system. For him, the fact the model determines fiscal targets made by previous governments for future administrations is something unacceptable. Also in the author's view, there is a definite problem in the linking between the instruments. For him, this problem is largely caused by the different deadlines in the preparation stage, which end up disrupting further the subordination’s logic that should exist between them.

In addition, despite the strength of the democracy in the country, the author sees the active presence of the Legislative Branch in the budget preparation process as contributing to the loss of the desired connectivity between the planning and the budget prepared by the Executive Branch.

Certainly, the Theory of Separation of Powers developed by Locke and Montesquieu influenced the existing institutional arrangements in the countries and contributed decisively in the design of the current Brazilian budgetary process. However, it becomes increasingly clear the negative effect generated by the merger of the political side in the technical apparatus of public administration.

\(^{19}\) ALBUQUERQUE, Claudiano; MEDEIROS, Márcio; FEIJÓ, Paulo Henrique. Gestão de Finanças Públicas. Fundamentos e Práticas de Planejamento, Orçamento e Administração Financeira com Responsabilidade Fiscal. 2ª Edição. 2008.
The mixed budget model is in place in Brazil provides for the joint performance of the two powers of Executive and Legislative Branches. According to this structure, the participation of the two branches in the budget process occurs since its preparation, in a kind of alternation of competencies.

Theoretically, this structure would provide a cooperative relationship between the branches. In Brazil, such a union, or partnership, is not very friendly. This institutional disorder directly affects the technical work done by agencies from the Executive and deforms the initial goals intended by the government planning.

According to Mendes (2009), Brazil’s central and subnational government structures shows a strong incentive into the political-electoral expansion of current public expenditures. Such expenditures disrupt any planning technique used by the Executive Branch.

With the incorporation of political vision in the process, the budget has become a reflection of the concern of the Executive with the fiscal balance in the short term. The achievement of the objectives intended by the government for next years of management was left out. Inevitably, the LOA no longer represents a natural unfolding of PPA.

Reflecting on the analysis observed by Mendes (2009), the chart 3 presents some data of different budgets from the State of Rio de Janeiro (SRJ) between the years 2011 and 2014. The values presented below indicate the budget at four different times (stages): the Executive Project; Initial Budget; Final Budget; and the Executed Budget.

**Chart 3: The difference between the Executive project, the Legislative approval and the Annual Budget.**

<table>
<thead>
<tr>
<th>BUDGET</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014 *</th>
</tr>
</thead>
<tbody>
<tr>
<td>Executive Project</td>
<td>54,406,198,618</td>
<td>61,964,268,158</td>
<td>71,832,304,974</td>
<td>75,903,914,312</td>
</tr>
<tr>
<td>Initial Budget</td>
<td>56,213,625,432</td>
<td>64,032,218,033</td>
<td>72,739,524,652</td>
<td>77,088,941,150</td>
</tr>
<tr>
<td>Final Budget</td>
<td>62,541,765,693</td>
<td>71,996,525,368</td>
<td>85,418,499,242</td>
<td>78,844,698,875</td>
</tr>
<tr>
<td>Executed Budget</td>
<td>56,553,049,861</td>
<td>63,819,246,972</td>
<td>71,663,151,029</td>
<td>47,215,114,317</td>
</tr>
</tbody>
</table>

OBS: * Values executed in 2014 until August.

Source: Secretariat of Finance and Secretariat of Planning.

The first stage (Executive Project) presents the proposed budget prepared by the Executive Branch and forwarded to the Legislature. The second stage (Initial Budget) indicates the amount actually approved by the Legislature after analyzing the project elaborated by the Executive. It is the authorized budget for the given fiscal year. The third step, Final Budget, demonstrates the authorized budget at end of year with all the financial changes that have occurred over the year. Finally, the last one (Executed Budget) presents the amount actually spent by the government throughout the fiscal year.

In the last two years the final amount spent by the government in the year has been less than the initial budget. In 2013 this amount was also below the Executive Project.
In other words, even with the Legislative Branch inflating the LOA, a technique used to create new spaces in the budget that allows the Legislative Branch to include their actions or needs, the expenditures were not even close to the original budget (Initial Budget). The graphic 1 shows the difference between the four stages.

*Graphic 1: Rio de Janeiro Annual Budget – the four steps.*

Comparing the project prepared by the Executive Branch (Executive Project) and the law approved by Legislative Branch (Initial Budget), an almost constant growth between the two stages can be noted: In 2011 and 2012, the approved project by the Parliamentary House indicated an addition of 3.3% in the revenues projected by the Executive for each fiscal year. In 2013 and 2014, this factor was lower: 1.3% and 1.6%, respectively. In 2011, only 90.4% of the authorized expenditures in the final version of the budget law were performed by the Executive Branch. By contrast, such amount differs only 3.9% of the proposal prepared by the Executive agency.

This diagnosis repeats in 2012 at rates of 88.8% (Executed Budget/Final Budget) and 3.0% (Executed Budget/Executive Project), becoming quite different in 2013: The data shows a higher gap between the Executed Budget and the Final Budget (83.9%) but also a lower difference between the Executed Budget and the Final Budget (-0.2%) which represent a budget executed almost equal to the project made by the Executive Branch.

When the expenditure executed (Executed Budget) is evaluated with the authorized expenditure (Final Budget), the rate increases considerably, showing the missing link described by Mendes (2009). The difference observed in 2012 (12.8%) and in 2013 (19.2%) reinforces the deterioration of the budget technique.

It is important to note that some evidences in the literature, based on empirical research, considers that realistic budgets are more associated with greater balance in the public
accounts. In this line, according to Cruz and Martins (2013), overestimated budgets open up space for more discretionary actions of public managers, which is a problem for strategic decisions that involve the allocation of resources in priority areas, having a greater tendency to imbalance in the short and medium run. According to the authors, recent literature has studied how political-institutional factors can explain the experiences of fiscal performance between countries: The main factors that have been emphasized as political determinants of budget deficit are political polarization, government structure and electoral systems.

Cruz and Martins (2013) investigated the differences between the fiscal performance of Latin American countries from budget procedures adopted by them in terms of preparation, approval and implementation of the budget. Their conclusions reinforce the issue presented by Mendes (2009), that the nature of budgetary procedures strongly influences fiscal performance.

Therefore, the simple and routine technique used by the Legislative Branch of inflating the estimate of revenues that will be collected by the Executive in the next fiscal year as a way to open budget space to serve the political interests, undermines the entire management planned by the Executive Branch to the public administration (agencies) and commits the projected fiscal results.

In reaction to this effect (political interference), the Executive is becoming increasingly concerned only with the fiscal balance, leaving behind the core objective of the budget which is the materialization of the elaborate planning.

This process or this new goal forces the public managers to perform conservative economic forecasts in a futile attempt to contain the political and the discretionary advances over a technical instrument.

The question addressed by Mendes (2009) - the difficulty of maintaining any kind of link between the budget with the instrument produced by the central planning - certainly portrays the reality of the three levels of public management in Brazil. Despite being democratically interesting, the participation of the Legislative house in this process leads to a strong impairment of the technical part of the budget.

The difference between the initially planned (Executive Project), the approved at the beginning of the fiscal year (Initial Budget) and the authorized in the end of the year (Final Budget) with the amount that is actually accomplished by the government (Executed Budget) confirm this understanding.

For some, the redemocratization experienced in Brazil in the 1980s reflects on the public budget. The formulation of the PPA became merely a lawful act, without real impact on the reality of public action. There is no consistent planning in the medium and long-run for government action. For different reasons, of institutional and economic nature, the Program Budget model still failed to meet its real function, as understood by Paulo (2010):

> Despite the clarity of the constitutional provisions, the recognition of the strategic nature of the PPA still meets resistance, either at the administrative
level, either among researchers, parliamentarians and specialists. (Loosely translated)

The passage below was taken from the book *Economics of the Public Sector in Brazil*. The author, Vignoli (2002), tried to correlate the current legislation with the budget execution.

Therefore, with few exceptions, the budget turns out to be an instrument intended to the mere fulfillment of a legal-formal agenda, which is reproduced mechanically, year after year, without its being taken advantage of its greatest feature, which is to be genuine instrument able to define intervention actions to transform reality, and, of course, to ensure as many for the maintenance of equipment and services already provided to the community.

The best way to ensure that the budget is executed in a planned way is to program in advance the execution. It means that, considering the time left until the approval of the LOA by the Legislative Branch, the budget must be detailed in order to have clarity on what material and human resources will be needed to give effect to desired setting. (Loosely translated)

It is important to emphasize that realistic budgets, where it is possible to verify a greater accuracy in forecasting revenues and expenditures are consistent with the logic of a managerial administration, where budgetary instruments assists in the decision making of public managers and actively participate in the maintainer of balancing of the state. According to the World Bank (2013):

> The LDO and the PPA were meant to introduce medium-term fiscal constraints and strategic government priorities into the budget process, to increase transparency and accountability, and to enhance fiscal controls. The system has achieved greater success on the third and, to some extent, the secound objectives. However, strategic government objectives and resource allocation targets in the PPA have not necessarily been reflected in the annual budget because the PPA have is not subject to annual changes and has, in practice, a relatively limited impact on the budget preparation process.

Despite the instruments are linked – annual budget Law are required to be consistent with the PPA and the LDO – in practice, the PPA is subject to change during the preparation of the Budget Guidelines Law (LDO), when revenue estimates can also be updated.

Therefore, while the PPA emphasizes performance, in practice the quality of performance indicators is low. This is perhaps the weakest aspect of budget reform. The Annual Budgets (LOA) still lack credibility because of significant

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carryover between years, and their link to strategic government priorities is weak.\textsuperscript{22}

In addition, according to the Public Expenditure Management Handbook, a manual produced by the World Bank (WB) in 1998, the failure to link policy, planning and budgeting may be the single most important factor contributing to poor budgeting outcomes at the macro, strategic and operational levels in developing countries, resulting in a fragmented system.

To the WB (1998), policy making, planning and budgeting take place independently of each other. Planning is often confined to investment activities, which in many developing countries refers to a series of donor-funded projects. Capital expenditures are already largely accounted the planning process, and large portion of recurrent expenditures are pre-committed to the wage bill. For this reason, annual budgeting is reduced to allocating resources thinly across donor and domestically funded “investment” projects, as well as to the non-wage portion of the recurrent budget. Unpredictability of funding, from one year to the next and within the budget year is one of many factors that contribute to the poor operational performance of public sectors.

In the absence of effective decision making processes, policy making and planning are disconnected from each other and from budgeting, and they are not constrained by resource availability or by strategic priorities. Overall, this leads to a massive mismatch between what is promised through government policies and what is affordable. In this line, the annual budgeting process becomes more about scrambling to keep things afloat rather than allocating resources on basis of clear policy choices to achieve strategic objectives.

The passage below was taken from the manual Public Expenditure Management Handbook. The text tries to reinforce the idea exposed here: weak links result in poor budgeting performance by the state and unreached targets which were plotted in the central planning.

Poor performance is often to be found in the weak links between policy making, planning and budgeting, resulting in little relationship between the budget as formulated and the budget as executed. At one level, policy making and planning are unconstrained by what a country will be able to afford over the medium-term. At another level, policy making and planning are insufficiently informed by their budgetary implications and by their likely impacts in the wider community. The inadequacy of hard budget restraints on decision makers at the planning and budget formulation stage of the cycle leads to inadequate funding of operations, poor expenditure control and unpredictability in the flow of budgeted resources.\textsuperscript{23}

The WB’s report provides a framework for thinking about public expenditure management and how it affects the budgetary outcomes. By doing this, the handbook highlights the fact that good analysis and sound policy are not enough to ensure a sustainable development outcomes, a new concept that will be developed in the next chapter.

\textsuperscript{22} WORLD BANK. Beyond the Annual Budget. 2013.

\textsuperscript{23} WORLD BANK. Public Expenditure Management Handbook. 1998.
4. FISCAL MANAGEMENT IN BRAZIL

4.1 Concept

One of the most important aspects of economic analysis is the fiscal sustainability of countries. According to Luporini (2006), the term Fiscal Sustainability has often been used by government agencies, private institutions involved in discussions of fiscal default of governments, and by multilateral organizations, whose loans and suggestions of economic policy are often seen as key to ensuring that same sustainability.  

Usually measured by fiscal solvency, the degree of sustainability generated by the fiscal policies taken by the government ensure, in the short and medium run, the desired economic effects that will have repercussions in the medium and long term, strengthening the productive capacity of the country, i.e. its Gross Domestic Product (GDP).

Several researchers have contributed to this field. In the current economic dynamic, it is essential to have the basic knowledge of the financial health of a private or public entity. The possible effects caused by unexpected risks may lead to economic crises with spotlights in different regions. Baghdassarian (2006) highlights this idea:

(...) several researchers and institutions have been developing investigations on the causes and consequences of the public noncompliance, having in mind that the topic (fiscal sustainability) is of great interest to public managers, financial institutions, rating agencies, and society itself, which is increasingly concerned with maintaining its well-being. (Loosely translated)

The International Monetary Fund (IMF) defines sustainability as the ability of countries to meet the intertemporal budget constraint, without the need for major changes in their revenues and expenditures, considering the usual cost of debt financing.

From the definition given by the IMF to the theme, Baghdassarian (2006) tried to refine the concept by adding the aspect of liquidity, linking the central idea presented by the international agency for the intertemporal government’s ability with the state’s obligations:

Sustainability is defined as the condition in which both aspects of long-term solvency and liquidity restrictions in the short-term are met, so that the government does not need to make any drastic intervention in public policy, as well as to continue honoring its obligations. (Loosely translated)

In fact, responsible fiscal management is an expression that is related to the financial management of public entities. This idea is based on the sense of responsibility of the entity and it is supported in medium and long term planning that had been developed.

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26 Ibidem.
However, the relevant issue in this evaluation process does not end in the risk analysis for potential defaulters by the public sector, which would represent real threats to the stability of the capital market, nor is it limited to the simple control of liquidity in the coming years. The arena should be understood in a broader way. It is extremely important to evaluate the consequences of government actions over the market and the society. Baghdassarian (2006) shows the importance of looking at this matter in a more extensive form:

*Governments will always change their policies if it becomes clear that the debt trajectory is unsustainable. In this case, the focus of fiscal sustainability analysis is often not simply the default, but in the effectiveness of possible changes in policy which is necessary to avoid it.*

(Loosely translated)

Several concepts and sustainability tests can be used as possible indicators of a balanced fiscal policy. The debt / GDP ratio is certainly one of the most used indicators.

The traditional approach that is most commonly used to assess the fiscal sustainability of countries was proposed by Blanchard and uses macroeconomic variables to determine the intertemporal evolution of public debt. Other models seek to analyze future market responses to the public debt.

However, everyone tries to verify the intertemporal sustainability starting from the same premise: What are the consequences in the case of a possible budget constraint due to changes in macroeconomic variables? In other words, how can we sustain the commitments made by governments, maintain the state on fiscal balance, and ensure the transfer of resources to the discharge current expenditure with a tax collection below the projected amount for the period? Certainly, this concern is one of the most important for public managers in current day.

### 4.2 Brazilian Fiscal Law

For years, the fiscal disequilibrium, or simply the negative result of the basilar equation of public finances (government revenue less government expenditure), was predominant in the Brazilian Public Administration (BPA). Some of the most disastrous effects on the Brazilian economy were a runaway inflation, high interest rates, and the loss of fiscal and monetary powers of the state.

This reality has led governments - central and subnational - to a fiscal situation that ended up limiting their ability to meet social demands, realize the common good and serve public needs with disastrous consequences for the poorer segments.

Considering this scenario of total insolvency, mainly in subnational governments and following the international trend of the time (many countries that went through similar situations developed courageous initiatives to reverse the inefficiency and poor performance of the sector through strict fiscal control laws), the Brazilian government, searching for a greater

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seriousness and good use of public resources, elaborated the Fiscal Responsibility Law (LRF, Lei de Responsabilidade Fiscal) in the late 1990s.

Of an anglo-saxon origin, the LRF (Complementary Law N° 101/2000) sought to regulate, in many respects, the standards of public finances in the country. It is actually the main guiding instrument of public accounts in Brazil.

With a more liberal view, in a way that puts the public expenditure as a dependent variable of expected revenue collection (principle of balanced budgets), the elaboration of the Fiscal Law highlighted the concern of maintaining the state in the fiscal balance. The state can only spend the amount it earns. According to the text of the Law, the spending should be done through planned and transparent actions that prevent risks and correct deviations that may affect the balance of public accounts.

Much of this change in attitude was influenced by the economic history experienced by the country in the 80s that raged until the mid-90s: the shocks in the global economy of the 70s caused strong impacts on the Brazilian economy, which for years used an economic model strongly dependent on international reserves. As a result, the country experienced a period of uncontrolled inflation and failures of economic policies, which led the public finances, mainly of the subnational governments, to a situation very close to public "insolvency."

The process of drafting the new legislation took the experiences from other countries as reference. The country adopted from New Zealand (Responsibility Act of 1994) the model of the Fiscal Management Report. Brazil also looked to the Maastricht Treaty (European Economic Community, 1992), which was designed to assess the financial sustainability of each European government, as a source of inspiration. The restriction of public expenditure in order to ensure limits to governments and to fulfill previously established fiscal targets came from the United States experience in the field of fiscal responsibility (Budget Enforcement Act, 1990).

Each of these international acts sought to implement a greater control over government spending and, at the same time, reinforce the need for fiscal planning. They are important milestones in the evolution of public finances. According to the Brazilian Ministry of Finance:

The LRF is an instrument to help governments to manage the public resources within a framework of clear and precise rules applied to all managers of public resources in all spheres of government, relating to the management of public revenue and public expenditure; to the public debt; and to the management of public assets.28 (Loosely translated)

The analysis of the objectives listed in the Law leads to make note of the clear intention of improving the integration between planning and budget, always focusing on medium-term fiscal control.

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To the World Bank (2013), the main goal behind the introduction of these instruments was to coordinate planning of the budget through a hierarchical structure that develops this process over a four-year period. The bank also affirms that two additional motivations existed for this reform: On the one hand, the Brazilian government wanted to introduce greater transparency and accountability to the process, given that the country was coming out of a military dictatorship, and, on the other hand, the fiscal act was important to introduce fiscal controls, given the previous history of macroeconomic instability, while allowing some fiscal policy flexibility.

The Fiscal Law tried to contribute to the improvement of public finance management by requiring greater responsibility by the public managers in the maintenance of the sustainability of the entity for the following years. According to Queiroz (2014):

> The reason for this Law lies in the repeated abuse committed in financial and asset management of public entities that have significant deficits result. At the level of states, the abuses have been astonishing, with the accumulation of extravagant deficits, covered, in general, through financial transactions with banks controlled by themselves, which, after all, were taken irresponsibly to the state of total bankruptcy.  

(Loosely translated)

According to the best practices of fiscal management disseminated by the Brazilian Ministry of Finance, obedience to these new rules allows a permanent fiscal adjustment in the country. To the financial agency, the fiscal discipline introduced by the act gives the strengthening of the financial situation of the entities, enabling the increased availability of resources for investment in social and economic development programs.

The budgetary limitations imposed by the new Law were designed to preserve the fiscal situation of governments in order to ensure the financial health of federal entities; to ensure the application of resources in the appropriate spheres; and to guarantee a good administrative heritage for future managers.

In short, the LRF was created in order to cure the deficiency of control of public finances, which was essentially nonexistent in the country prior to the act. Because it is strongly based on the manager’s responsibility with public resources, the Law has resulted in new challenges for public managers, especially by having as one of its pillars the principle of planning, a concept hardly inefficient in the country.

As well clarified by Afonso (2002), the LRF is perceived to be more than merely a new legal framework. Although influenced by acts in other countries, it is largely unique to Brazil and changed the mentality of those in public management.

All things considered, however, significant changes do not occur as a consequence of a single movement, in this case the LRF. The culture of responsible management of public resources in Brazil is still far from a complete and finished achievement.

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4.3 Searching for the fiscal sustainability

The Brazilian Fiscal Responsibility Law defines, in its first paragraph, fiscal management as a planned and transparent action where the risks are foreseen and the possible deviations (liabilities) that might affect the balance of public accounts are adjusted.

The Law establishes that such management must be performed by fulfilling certain targets. Some of these include positive results between revenues and expenditures; control and obeying limits to domestic debt; and control of credit operations (loans).

In Brazil, the purpose behind the requirement imposed on governments to maintain proper fiscal management is to control the public deficit. It is important to stabilize the debt at a sustainable level, without compromising the country's economy. For Martins and Marques (2013):

*The LRF has established more stringent mechanisms for managers of public finances in the three spheres of government in Brazil. These managers must observe these mechanisms in order to avoid committing criminal activities. The major changes occurred on the practice applied by many managers of transfer tax difficulties encountered in their years of government to future administrations. Governmental authorities and officials have become criminally liable for mismanagement of public resources and the acts that cause damage to the treasury.*

Some technical analyses were imposed by the new legislation in an attempt to control or at least have an idea of possible future scenarios. The Fiscal Risks Annex (Anexo de Risco Fiscal) and the Fiscal Targets Annex (Anexo de Metas Fiscais) tried to establish forecasts of potential risks that may compromise the fiscal balance of the entity, and current and constant values related to revenues - expenses and results (nominal and primary) planned for next fiscal years.

However, according to Cruz and Martins (2013), after many years since the enactment of the new structure, the current question borders on the following point: Are the four pillars of fiscal responsibility (planning, transparency, control and accountability) are being effectively implemented? According to the major empirical studies on the topic, only the pillar of responsibility on the limitations imposed by the law is being applied by the public administration. To Cruz and Martins (2013), although the legislation does not establish any hierarchy between the pillars, there is a clear difference between the model applied today, based on the control of fiscal indicators, and the idealized, based on strategic action by the state with clear and planned actions.

Afonso (2004) endorsed this thinking. For him, there is a danger of reducing the ability of the Law to a mere instrument of fiscal adjustment of the short-term. In his understanding, the Fiscal Law is turning into a mere pretext for simple generation of surplus at any cost, configuring a clear lack of strategic vision of public management and going against its major objective: the establishment of a new fiscal culture.

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In fact, good management requires not only the achievement of economic stability, which provides certain specific controls, but also commitment to a long-term fiscal responsibility. Any economic program that seeks a long-term sustainability and tries to build a strategic vision for government action should be the pillars for the decision making process and support for the policies.

Even if only on a small scale, there is no denying that a continuous evolution of the administrative apparatus exists in the country. But undoubtedly there is much to build. The administrative reform started in the 1990s has not been completed yet, at least with regard to the change in the culture and in the process of implementing a new management structure. Thus, the issues highlighted by several authors, about how the concept and the management of fiscal sustainability in the country is being applied, confirms this need.

An ideal fiscal administration should not just seek to execute the established formal compliance with standards, predict the course of public policies adopted, or achieve specific targets. The management must develop and innovate itself. According to Afonso (2004), the modernization of management and the strengthening of a management culture represent key factors for building a structured technique to fiscal management in the country.

Certainly, since the imposition of this new fiscal regime, with control mechanisms of public accounts clearly defined, a new milestone was set in the federation. The commitment of managers in achieving the established targets and the obligation to protect the Treasury against possible unwanted legacies for future administrations became part of the everyday government.

Afonso (2004) points out that, in the view of international agencies, Brazil took a leap in public management. According to him, for the IMF, this new regime of public accountability represented a watershed. The Organization for Economic Co-operation and Development (OECD) also released a extremely favorable analysis to the country’s fiscal position, highlighting the advances generated by the new legislation. The World Bank, meanwhile, emphasized the revitalization of government planning process.

However, bearing in mind that Brazilian legislation, as well as other countries’ position about fiscal responsibility, indicates that the scope of responsible fiscal management is not restricted merely to the attendance of fiscal targets, but it is directly associated with factors which strengthen its applicability. Let us now return to the focus of this paper, the study of a new methodology, responsible for assisting public managers in the process of improving the fiscal management by using a intertemporal model.
5. LOOKING FORWARD

5.1 The importance of a multi-year fiscal model

Basically, as discussed in previous chapters, the state acts as a determining player of performance in economy by forming the mainframe of the market.

All governments have to execute their fiscal activity by collecting resources from the economy and allocating responsively by using the budget. Every country, developed or not, needs serious financial resources for its existence. However, the growing fiscal burdens can be a barrier to the development of the local economy. Thus, state’s budget keeps participation of the government relevant in the local economy.

As a result of this concern, the increasing significance of budgets in the economy, particularly in developing countries, indirectly forces the Executive Branch to study and discover new techniques in managing it. Following this necessity, the World Bank (WB) created a manual – the Public Expenditure Management Handbook (PEM) – to guide public financial managers, especially for those working in developing countries, in this process of seeking the perfect level tax collection to ensure all planned actions without resulting in unmanageable debt.

According to the WB, the key aspect behind this type of guideline is that it must be seen as an important instrument of government policy. In other words, the guide is just a concept, a methodology, of how the policymakers and the government must make correct choices in policy distributing and utilize productively, effectively and sensitively the scarce resources they have while presenting new approaches.

Djordjevic and Djurovic-Todorovic (2009) share the same view:

Since the application of initial state budgets, the achieving of sources, effective and productive usage, source allocation, deficits and gradually increasing public loans have continued to become a problem. Owing to these reasons, scientific studies made heavily depend of state budgets’ expenditure direction in the last twenty years in particular. The public expenditure management presents new approaches for these former problems mentioned (Schick, 1999).31

A clear distinction occurs between expenditure management and expenditure policy: while expenditure policy is trying to find an answer for the public question (what must be done to change the public problem?), expenditure management tries hardly and incessantly to find the answer for the question on how to do it.

For the World Bank (1998), public expenditure management system varies from one country to another although it necessitates accomplishing some complicated and determined duties. The basic principles of the concept are accomplishing macro financial discipline, strategical priorities and functional application (technical productivity). All these three goals are in a very strong interaction, both theoretically and practically, and its very important to keep in mind that

these three objectives are complementary and interdependent. Without fiscal discipline, it is not possible to achieve effective prioritisation and implementation of policy priorities and programmes. On the other hand, mere fiscal discipline in the presence of arbitrary resource allocation and inefficient operations is inherently unsustainable. Djordjevic and Djurovic-Todorovic (2009) reinforce this thought:

*Efficiency in allocation is the skill of distributing source in budget priorities. Replacing inefficient activities with more productive activities, leaving former priorities to newer ones and accomplishing these values in line with the state’s goals are of great significance.*

Public expenditures must be based on governments priorities and the efficiency of public programs. In this way, budget system should act according to each important step of reallocation of resources in order to secure the fiscal equilibrium between revenues and expenditures. This new concept of control and management by the expenditure has been taken into consideration not only by the WB and International Monetary Fund (IMF) but also the Organization for Economic Co-operation and Development (OECD) and the European Union. All these organizations have supported this approach and considered it extremely important.

Today, many countries have been able to create and develop their own institutional capacities for conducting budget allocations and budget plans better through this methodology. According to Djordjevic and Djurovic-Todorovic (2009), throughout the next several years, public expenditure management is going to maintain its feature of being an important means and basic guide in public finance.

Aggregating fiscal discipline requires overall expenditure control, with expenditure estimates based on realistic revenue forecast, and the capacity to set up fiscal targets and enforce them. The preparation of a macroeconomic and fiscal framework must be the starting point of budget formulation. Also, the allocative efficiency, which operates in different levels within the government, must be done correctly among the strategic agencies of the state, enabling public managers to formulate good policies.

However, Djordjevic and Djurovic-Todorovic (2009) claims that aggregate fiscal discipline and the efficient allocation of resources are often impeded by the so-called “tragedy of commons”. The authors use this idea of “pressure groups” as an example of how the public sources must be spent in order to show how the allocation of resources in the budget process is the most challenging of the three key objectives in modern public management. According to them, the allocation process is dominated by political factors, a characteristic that can become increasingly stronger in the Brazilian federation:

*There are many claimants to the budget and each has preferences over the manner in which the budget should be allocated. The sum of these individual preferences put pressure on increased expenditures. Budgetary outcomes are*

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pronfoundly influenced by institutions, which comprise both formal and informal rules.³³

Thus, to achieve aggregate fiscal discipline and be able to create and forecast real and consistent scenarios, it is crucial for a good relationship between the Executive Branch and the Legislative Branch, which is the house that approves the budget in its final version. Also, the circulation of information inside the Executive Branch is essential. The Treasure must know in advance the actions intended by the other agencies to be able to predict future consequences and to assist in any step of the decision making.

Baghdassarian (2006) shows another face of this necessity:

> In stable economies usually do not question the ability of the government to honor its short-term liabilities, falling a focus on maintaining the intertemporal solvency of the debt, due to the current macroeconomic policies. On the other hand, economies with greater vulnerability are questioned not only in relation to the intertemporal solvency, but also about the ability of the government to honor its short-term commitments.³⁴ (Loosely translated)

The public budget system in the United State has a quite interesting standard of how the Executive and the Legislative Branches can mix their responsibilities in favor of a better management of public affairs.

Although the Executive Branch prepare a budget proposal, estimating the tax collection capacity for next year, the legislature also makes their analysis and seeks to interact with managers of the executive power by analyzing point to point, on a completely technical analysis. As a final product, the Congressional Budget Office (CBO) assists the parliamentarians, through technical and nonsubjective analysis on how to best allocate the resources in projects, including an approximation on possible future impacts and fiscal results.

To fulfill this responsibility of correctly advising the House about budget aspects, the CBO also makes projections for the next 10 years. The intention is to evaluate the ability of economic growth, confronting this expectation with the expected growth in government expenditures and monitoring the evolution of public deficit, an intertemporal model, a very innovative model compared to the Brazilian system.

Certainly, in a superficial analysis of the process, the benefits with such independence and technical analysis point to a more efficient use of public resources and to a more balanced and realistic budget. The chart 4 shows the CBO’s projections for the next years.

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The conclusion is basic: we must keep in our mind that if budget managers do not follow certain actions, or if public funds are used for private purposes, it is doubtful whether either public managers can achieve fiscal discipline or efficiently allocate resources.

In a highly competitive global economy, the state has to be more concerned with the possible negative impacts on the economy. Now, projecting possible future scenarios by using a multi-year model, assessing risks and controlling results are the Keys to maintaining the economic development.

5.2 Medium-Term Expenditure Framework (MTEF)

5.2.1 A little of history first

In this ongoing search by securing fiscal sustainability, both to the new as to the existing programs, so that the financial capacity of the state is not reduced, which would mean a real threat to the development of many nations, most developed countries have adopted new practices on the fiscal management, expanding the existing tools and greatly improving this study field. The MTEF can be seen as a positive result of this transformation process.

The world saw, in the middle to late 1990s, the proleferation of the MTEF throughout the developing countries. This process has occurred over a relatively short time period. Of the twenty-five existing MTEFs, nearly 90% were adopted over the five-year period (1997-2001). The graphic 2 shows this proleferation along the years.
It is not premature to say that MTEFs are a trend in developing country public expenditure management. Moreover, this trend is particularly pronounced in Africa, which accounts for over half of the existing models in the developing world. In some sense, then, the African experience with the developing of this methodology has served as a catalyst for adoption of the reform in other regions. More and more, MTEFs are considered the sine qua non of good public management.

Basically, at the beginning, when the notion of an MTEF was added to the tool kit of development planning, by the WB and the IMF, the model referred to a change in the process of financial resource allocation from the traditional one-year budget to a multi-annual budget. The focus was on fiscal policy considerations. But this has considerably changed.

Low and middle-income countries adopted the methodology primarily because donors viewed them as a way to ensure a multi-year commitment of resource to the policies included in Poverty Reduction Strategy Papers (PRSPs) and incorporated them into their standard advice on budget reforms. High-income countries adopted the model as a way to support budgetary targets, improve expenditure prioritization, and Foster improved government performance.35

The chart 5 shows how the methodology is disseminated and applied by different countries.

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35 WORLD BANK. *Beyond the Annual Budget*. 2013.
Today, a growing number of governments, international organizations and donors have come to realize that what is needed is a concept that links policy, planning and budgeting within a coherent process. Given that this disconnection problem is a common condition found in developing countries, a medium-term approach to budgeting is seen as a way to more effectively link resource allocation, which occurs through the annual budget process, to policy and planning, which are long-term processes.

To Djordjevic and Djurovic-Todorovic (2009), an intertemporal model provides an important help in the technical aspect of public management:

\[
\text{In many cases, the public and political needs exceed reachable sources by quite a lot and the medium-term provides a technical help on the issue of allocating these limited sources to decision makers.}^{36}
\]

Therefore, many see the MTEF as the center piece of a modern and strong public administration, a central element of the public expenditure management reform programs.

### 5.2.2 MTEF in theory

The MTEF can be defined, in a simplistic characterization, as a methodology that assists governments to develop a plan for medium/long-term that acts as a guiding instrument of managerial decisions that cause impacts on the financial health of the entity, providing greater

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rationality to state action and maximizing the good use of resources for the development of the country. It is a whole-of-government strategic policy and expenditure framework.

The WB compares the importance of the implementation of MTEF in some developing countries with the development of a necessary tool that allows a dynamic panel framework which help in the process of estimation of some possible impacts, in the future, caused by public policies.

To the Bank, most public programs require funding and yield benefits over a period of years, but annual budgeting largely ignores future costs and benefits. Multi-year budget planning is the defining characteristic of MTEFs:

*Annual budgets typically start with the previous year’s budget and modify it in an incremental manner, making it difficult to reprioritize policies and spending. As a result, spending patterns become entrenched, even in the face of changing needs. MTEFs take a strategic forward-looking approach to establishing priorities and allocating resources, which allows the level and composition of public expenditure to be determined in light of emerging needs. MTEFs also require policy makers to look across sectors, programs and projects to see how spending can be restructured to best serve established policy objectives.*

The WB’s study concluded that this idea helps to improve the fiscal discipline and the allocative efficiency in those countries, representing, in the end of the conclusion step, positive effects on the technical area of public management:

*In the last two decades more than 120 countries have adopted a version of a Medium-Term Expenditure Framework (MTEF). These are budget institutions whose rationale it is to enable the central government to make credible multi-year fiscal commitments. The analysis finds that MTEFs strongly improve fiscal discipline, with more advanced MTEF phases having a larger impact. Higher-phase MTEFs also improve allocative efficiency. Only top-phase MTEFs have a significantly positive effect on technical efficiency.*

Djordjevic and Djurovic-Todorovic (2009) describes the methodology as a process estimation for sources affecting political changes and new programs and arranging budget necessities in future with a multi-year expenditure planning applications.

The depth study about the medium-term system takes to see it as a powerful tool used to estimate resources and strategically allocate expenditures among a several public choices and necessities. The methodology can be also looked as a basis for measuring the effects of political changes on budget, because the model provides an opportunity for viewing the comparison with financial magnitudes during the application of budget expenditure. If the problem is that there is no link between creating policy, planning and budgeting, the MTEF has

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37 WORLD BANK. *Beyond the Annual Budget*. 2013.
been viewed as a potential solution because it provides the linking framework that allows expenditures to be driven by policy priorities and disciplined by budget realities. To the WB:

*It is an expenditure planning orientating expenditures with political priorities and making it possible to connect to a definite method with budget realities and presenting connective frame. (World Bank, Public Expenditure Management Handbook).*

According to the WB, the MTEF consists of a top-down resource envelope, a bottom-up estimation of the current and medium-term costs of existing policy and, ultimately, the matching of these costs with available resources, in the context of the annual budget process.

The “top-down resource envelope” is fundamentally a macroeconomic model that indicates fiscal targets and estimates revenues and expenditures, including government financial obligations and high cost government-wide programs such as civil service reform. To complement this macroeconomic model, the sectors must engage in a bottom-up reviews that begin by scrutinizing sector policies and activities with an eye toward optimizing intra-sectoral allocations. So, the value added of the MTEF approach comes from integrating the top-down resource envelope with a bottom-up sector programs.

The integration occurs by means of a formal decision making process. Once the strategic expenditure framework is developed, the government defines the sectoral resource allocations, which are then used by the sectors to finalize their programs and budgets. With its development and implementation, it is rolling in the sense that the first outward year’s estimates become the basis for the subsequent year’s budget, once changes in economic conditions and policies are taken into account.

The chart 6 shows the interaction between the baselines and MTEF taken from the *Good Practice Guidance Note* by the Overseas Development Institute London (ODI).

*Chart 6: Rolling baselines and MTEF.*

*Source: ODI, Good Practice Guidance Note.*
The methodology is intended to facilitate a number of important outcomes. Improve macroeconomic balance, including fiscal discipline, by developing a consistent and realistic resource framework (good estimates of the available resource); improve the allocation of resources to strategic priorities between and within sectors; increase commitment to predictability of both policy and funding so that ministries can plan ahead and programs can be sustained (greater budgetary predictability which is expected as a result of commitment to more credible sectoral budget ceilings); provide line agencies with a hard budget constraint and increased autonomy, thereby increasing incentives for efficient and effective use of funds (better use of public monies). MTEF also aim to improve inter and intra sectoral resource allocation by effectively prioritizing all expenditures and dedicating resources only to the most important ones.

The chart 7 shows, schematically, the assessment about traditional budget and MTEF by the World Bank and the Korea Development Institute for the budget process.

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

Defining and implementing a sectoral MTEF involves preparing estimates of overall resource availability, reviewing financing mechanisms, and preparing prioritized government spending plans. According to the *Public Expenditure Management Handbook*:

> Years of short-term planning for annual budgets and hand-to-mouth adjustments during the budget year have led to accumulated over commitments and inefficiencies at the operational level. The separation of policy making, planning and budgeting so often in evidence at the center of government is replicated at the sector level. The requirement, therefore, is to create enough certainty so that line ministries and agencies can plan ahead, have the incentives to do so, and have better information on which to base strategic and operational decisions. In other words, it requires, at its core, the development and effective implementation of a comprehensive MTEF.  

When a MTEF is implemented well, public expenditure is limited by the availability of resources; budget allocations reflect spending priorities; and public goods and service are delivered cost-effectively.

MTEFs therefore offer the prospect of achieving the three high-level objectives of public expenditure management: aggregate fiscal discipline, allocative efficiency and technical efficiency. Efficient public spending makes it easier to maintain fiscal discipline, since both allocative and technical efficiency reduce waste and thus alleviate the overall resource constraints.

By increasing predictability of public resource flows and helping in the criteria process by which the funding decisions are made, the MTEF represents a new package of public expenditure management reforms conceptualized and grounded in a new way of how governments must manage the public goods. The methodology can signal a government’s commitment to high-quality adjustment based on prioritization of expenditures and reduction of waste, which are often key to successful adjustment.

### 5.2.3 MTEF in practice

The key to a successful MTEF is that institutional mechanisms assist and require relevant decision makers to balance what is affordable in aggregate against the policy priorities of the country. But how the MTEF works in practice?

The development and implementation of a medium-term framework can be accomplished progressively at a pace that fits a country’s capacities. Some countries began by developing an overall medium-term framework (a top-down approach) for allocating resources between

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41 WORLD BANK. *Beyond the Annual Budget*. 2013.
sectors. Others prefer starts with a more bottom-up, focusing first on developing the MTEF at the sector level to govern resource allocation within individual sectors. The approach to building a medium-term model will depend on the conditions in the particular country.

Basically, the more unstable fiscal policy is the more out of balance are available resources and policy, program and project demands. The less integrated policy making, planning and budgeting are, the more budget making is focused on funding. The more unsustainable particular categories of expenditure are the longer it will take to put in place a credible MTEF.

The WB’s analysis tells that countries often choose to begin at the sector level because this represents a manageable change from the status quo. However, in the Bank’s opinion this approach should only be viewed as a building block to achieving a comprehensive medium-term approach. The ideal is to develop a medium-term approach to decision making and resource allocation across the whole of government that combines top-down and bottom-up decision making for expenditure allocation. In doing so, it will help to achieve greater conjunction between what is promised by government policies and what is affordable in the short-run and over the medium-term.

The preparation and implementation of an MTEF takes place through an integrated planning process which consists of seven main steps. The chart 8 provides a schematic representation of the stages describes by the World Bank.

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**Chart 8: The stages of the MTEF.**

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The stage 1 involves developing the macroeconomic framework, which will be used to make projections of revenues and expenditures for three years. The key activity here is macroanalysis and modeling, a necessary step in achieving aggregate fiscal discipline. This
stage shows the importance of linking economic projections to fiscal targets and the requirements for constructing and using models must be kept in mind. The second stage involves a sector review process through which sector objectives and activities are agreed and then costed. The stage 3 involves a series of hearings between the Ministry of Finance and sector ministries to go over the outputs of the sector review. At stage 4, with the macroeconomic framework and the sector review output, the Ministry of Finance now develops a strategic expenditure framework. This framework must cover a medium-term time frame and should be used to guide the deliberations of the decision making body that makes strategic resource allocation decisions.

The stage 5 is a crucial step of the MTEF process and requires the main decision making body in government to make medium-term sectoral resources allocations on the basis of affordability and intersectoral priorities. This is done by defining sector resource envelopes for the next three years. At the stage 6, ministries make revisions to the budget estimates to make them fit within the approved ceilings. Stage 7 shows the review made by the Ministry of Finance before sending to final approval (Legislative).

Taliercio and Houerou (2002), studying the subject and analyzing the lessons learned from the models implemented in Africa, synthesized the MTEF stages, presented in the World Bank’s report, in the chart 9.

Before concluding this topic we would like to present some international results, or international experience, to describe how the model can differ across countries and how it can be found in industrialized and developing/transitional countries. To do it we will use some parts from the analysis made by Schiller in the report Medium-Term Framework in Public Finances – An Introduction. Some of the main centers of public management (developed countries) and other from developing countries were chosen to show their strategy in doing the MTEF.
• The Australia approach to MTEFs reflects one end of the spectrum of choices. The main purpose of the model is to show the medium-term fiscal consequences of government policies which have already been enacted. As such, these multi-year budget estimates reflect future fiscal flows under current tax and spending policies and are basically strictly informative in nature. Unlike in many other countries, the Australian model is not produced concurrently with the annual budget, but later in the year. The idea is not to submitted to the Parliament, but just published by the government.

• The New Zealand model is quite different. The budget process has undergone a series of important reforms in the past decade. It is highly devolved and places a large share of the responsibility for financial management at the ministerial level. Consistent with this philosophy, the multi-year estimates are produced by the line departments. The multi-year fiscal and economic projections, one of the three key documents that are produced throughout the year as part of the budget cycle, is published twice each year. The others documents are the Fiscal Strategy Report, a document which contains update fiscal estimates, and the Budget Policy Statement, the short-term fiscal plan as well as medium-term strategic fiscal policy objectives.

• The federal budget process in the United States contains several multi-year elements. Most importantly, actual multi-year appropriations are included in the budget for certain capital projects. In addition, the annual budget includes expenditure and revenue estimates for the coming year and for four additional years. The multi-year expenditure estimates provides an informal starting point for the formulation of the annual budget for the following year.

• In Ghana, the model built on reforms started in budget preparation, in the civil service and in development planning. The medium-term analysis in Ghana is a multi-year (this is a departure from previous annual budgeting to a three year budgeting), integrated (the process integrates both development and recurrent expenditures), broad based (it involves domestic as well as foreign resources) and performance based (the process is based on achieving agreed levels of performance or deliverables).

Thus, as demonstrated above, implementing na MTEF is a complex task which requires a radical shift in perspective and way in which business is done. Success hinges on a variety of factors, which are not only technical. It depends on political commitment; strong management; willingness to subject policy decisions with financial implications, made outside the budget process, to the discipline of the MTEF; understanding of, and commitment to, the difficult decisions; commitment at all levels to abide by the budget decision so that new expenditure decisions are not introduced during budget implementation that would require reallocation of resources; improvements in expenditure control; and improved macroeconomic management and revenue collection.
5.3 What to expect? Outcomes

For the World Bank, the medium–term expenditure system can be seen as the most important step of public expenditure management and budget rules, representing a huge improvement in the government controls and into a more realistic budget. It can also represents the missing link between it and the main strategic plan as we might realize.

But how can we expect so much for a methodology? It may indeed be the “salvation” awaited by so many government, especially for the most inefficient? The answer is obviously no! But, certainly, the MTEF may represent a more advanced stage, an achievement, in the process for seeking the excellence in public management. This study assumes this because the medium-term approach, which encompasses all government expenditures, provides a strong linking framework in the governance and facilitates the management of policies and budget realities.

The chart 10 presents the idea behind these concept and shows how it interacts with the budget cycle.

*Chart 10: Strengthening the links.*

The medium-term framework acts directly in step 2 and 3, but also indirectly in later stages, helping to improve the quality in the process of public choice (budget cycle) by using, if we can say so, management techniques from the private sector. It’s the concept of a managerial state brought by the new public management model. The step 2 is a strategic point in the process. Decision are made by the core of the government in this point to adjust the public priorities with the fiscal reality and the natural obligations that the state has (mandatory expenses). In step 3, with strategic decisions defined in the previous stage, occurs the preparation of the public budget.

Thus, the methodology directly helps in designing a much more concise and appropriate budget with the reality, resulting in the strengthening of interrelations that exist between the management instruments of the state.
Basically, the technique provides a different way to treat the recurring problem between the public necessity and the lack of resources in the public administration, facilitating the management of the tension between policy and budget, by putting all variables together in a general framework. As result, of course, the government has a better control of expenditure and a greater efficiency and effectiveness in implementing policies, programs and projects.

As discussed previously, the weakness that exist in the link between policy, planning and budgeting may be the single most important factor which contributes immensely to poor budgeting outcomes at the macro, strategic and operational levels in developing countries.

In some of this countries, the resource allocation process is plagued by uncertainty of resource flows. The complete mismatch between policy decisions and available resources in another source of uncertainty, again self-inflicted because it could be avoided by implementing a rigorous process that links policy making, planning and budgeting. And knowing this, the model provides a new concept on how to manage the budget cycle by integrating these three components (policy, planning and budgeting) in a unique aspect or step, which is obviously not a easy task. The challenge, of course, is to manage the tensions between the needs (public actions and intentions) with the availabilities (public money and public realities) more effectively.

The medium-term approach provides such link and facilitates the work of the public manager in this arena of policy and budget, and for acting like that, the MTEF helps a lot in the process of reducing the natural pressure which exists today in the whole budget cycle.

According to WB (1998):

\[
\text{Integrated policy, planning and budgeting is fundamentally about having expenditure programs that are driven by policy priorities and disciplined by budget realities.}^{42}
\]

And to do so the key to increasing predictability and strengthening the links inside the government is an effective forum (group) at the center of the government and associated institutional mechanisms that facilitate the making and enforcement of strategic resource allocation decisions.

An effective decision making group is not only more likely to produce fiscally resource allocation decisions but also ensures that those decisions have legitimacy. Therefore, those decisions are more likely to be properly implemented. To the WB:

\[
\text{An effective decision making forum demands information to facilitate the decision making process, which improves the quality of the decision and increase accountability for results and transparency.}^{43}
\]

Thus, we must keep in our mind that predictability, in other words, means knowing the possible future. This process allows departments to plan and manage resources more efficiently within the time frame of the annual budget cycle and over the longer-term. So, the

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43 Ibidem.
reasons for adopting and creating a MTEF model are numerous and the outcomes from it are consistent.

Usually, the immediate benefits that come with the political decisions making and with the development of a cooperative governance are the main and the most importante ones. But, from the design of a medium-term model, countries also improve the efficiency on the public sector and creates a more predictable environment within which public sector organizations can raise the quality of their services to citizens. Therefore, future resource allocations based on a specific policy mix will be more predictable where a medium-term expenditure framework enforces such discipline.

Strategic resource allocation with a macro view of the public revenue and expenditure in the next few years allows to moves the policy, the planning and the budgeting into a crucial nexus between politics and administration. Those are the main goals behind the methodology and the principal results obtained with its implementation.
6. CASE STUDY: THE STATE OF RIO DE JANEIRO

6.1 Reasons for building a model

An alternative way to assess the problem of fiscal sustainability of states is the evaluation of the possible macroeconomic impacts generated by government policies that, in a first moment, may seem consistent with the intertemporal government budget constraint. Therefore, there exists today in Brazil, mainly in subnational governments, a real need to improve the fiscal management of the entities.

According to Queiroz (citing José Roberto Afonso, Martus Tavares and Álvaro Manoel):

\[
\text{The management of the state should be made as the management of companies and families: making expenditures and incurring in debt in a prudent manner, generating reserves in times of prosperity, which can be burned in times of crisis and thus avoiding tax failure.}^{44} \text{ (Loosely translated)}
\]

But, the innovations that came from the development of the LRF no longer produce the same effects as once promoted. The impacts from the implemented management tools are no longer so new as once were. They require some improvements immediately. Nascimento (2014) emphasizes this question in his opinion:

\[
\text{The prolonged situation of chronic deficit and debt have made impossible to the brazilian state to provide the basic needs that can not be delegated, among them education, public health, welfare and safety of citizens. And the reasons that led, not only Brazil, but most of the so-called developing countries, to a situation of fiscal imbalances, reside, largely, in the fiscal indiscipline and the lack of guidelines and mindset for the planning (…).}^{45} \text{ (Loosely translated)}
\]

Today the largest battle fought in the brazilian agencies is regarding the projection of future trends. The creation of stochastic scenarios of medium and long run to assist in the fiscal analysis of the entity, and to enable the preparation of a fiscal planning, not only bureaucratic but highly managerial, became fundamental.

It is very important to have a balance between the costs incurred and the tax collection capacity of the state. Brazilian Public Administration lacks new management techniques in this field.

It is unwise to allow the mandatory expenses growing at a rate equal to or higher than the expected growth of its main sources of funds or equivalent to the country's GDP itself, the main landmark for the growth of public revenues. It is noteworthy that several measures adopted by managers in t (time), on many occasions, only have effect in t+1, t+2 or even t+3, which may cause imbalances in the coming years.

\[^{44}\] QUEIROZ, Cid Heraclito. A Gestão Fiscal Responsável.

So, as discussed in previous chapters, the fiscal impacts change the allocations of resources, weakening the link between planning and budget, and reflects on the future fiscal space, which is the amount available to the government hold their primaries expenses.

Thus, it is necessary to provide the public administration of appropriate tools and techniques, allowing the managers to draw up a strong fiscal planning. Nascimento (2014) realized this situation and defends this necessity:

In these times of economic and social crisis in which the country is going through, it becomes urgent to search for new management practices for government area. Of another sort, commits itself the very future of Brazil, who wants to become an economic power even at the threshold of century. (Loosely translated).

Before such scenario, and given the good economic times experienced by the SRJ, the state began the process of preparing its own MTEF model. The local government was aware of the need to constantly invest in the administrative apparatus.

It is worth mentioning that the SRJ, since 2007, has been implementing several reforms in its Fiscal Management, in order to align their practices with the most advanced utilized by other public administrations.

At the same time, the state started a movement to strengthen the transparency in the management of the public accounts. In recent years, numerous actions have been implemented to provide technical information to society which is in line with one of the pillars of the methodology (MTEF).

The current objective of the local government is expand their economic and fiscal analysis to a larger horizons, enabling a greater control through the creation and manipulation of future scenarios. It is the first entity on the Brazilian federation to start the production of an intertemporal model to control their public expenditure.

Of course, as many others countries in the world, the necessity of having a macro view of the expect future for the state tax collection (a medium-term framework) and the current concerns with the future resource allocations in the budget (policies) were the main reasons for introducing the methodology in the state.

Therefore, the model is aimed at maintaining the fiscal sustainability of the state. The idea behind is to combine the budgetary technique used normally by the brazilian governments with the structure provided by a MTEF model.

With the fiscal stability achieved in the past few years in the country, and with the big portfolio of investments that the state has promoted in the last years (mainly because of the international events like World Cup and Olympics Games), the local government saw, in 2012, the importance of developing an intertemporal model.

In recent years, the state’s ability to raise direct funds from the society was able to secure with relative safety margin the payment of their current expenses, primarily administrative
expenses (such as the payment of payroll) and costs of programs and projects implemented in the state. The residue was applied strategically in investment actions.

Technically, this type of public intervention (public investments) is of great importance to the strengthening of the local economy because it has, mostly, the characteristic to generate positive effects in the future on the economic system. The expansionist movement maximizes the tax collection capacity for the public coffers.

However, from 2012, this scenario began to indicate a change of profile. Revenues collected directly by the state (current revenues, in large part, tax collection) now only cover current expenses. Thus, the expenditures originated from the investments made, began to be secured with external resources, which is, essentially, revenues obtained from the financial market, like loans assumed by SRJ.

Graphic 3 shows data obtained from the Transparency Portal of the Secretariat of Finance of State of Rio de Janeiro (SRJ). It emphasizes the importance of implementing such control: in 2013 the current expenditure equaled the current revenue, which resulted in the increase of the capital revenue as a source for the capital expenditure planned by the government.

Opening further the data, graphic 5 shows that in 2011 these expenditures (Fixed Cost) maintained its growth almost constant while the main resource of the state (Tax) demonstrated a more modest growth. This diagnosis was repeated in the following years.
The increase in public expenditure which has continued nature (the cost of the machine as is commonly said in Brazilian literature), if done in an unplanned way, represents a threat to the balance of accounts in the future.

These are expenses that once extended or granted become extremely difficult to be repealed, causing some perverse effects on the fiscal management of the state. The chart 11 shows the government's concern with the future scenario of the SRJ.

The development of fiscal results in recent years highlights the need for greater control over the actions taken today so that their effects do not represent a total lack of public accounts of the entity.

The calculation of negative primary outcome (indicator which excludes of total revenues the gains from investments, and from the expenditures, the nominal interests payed) in two

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**Graphic 4: Source of financing against the costs.**

**Fiscal Analysis - State of Rio de Janeiro**

**Source: Secretariat of Finance, Portal of Transparency. State of Rio de Janeiro.**

**Chart 11: The evolution of Fiscal Results in the SRJ.**

**Amounts in R$**

<table>
<thead>
<tr>
<th>INDICATOR PER YEAR</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Resultado Primário</td>
<td>1.446.492.226</td>
<td>1.414.746.524</td>
<td>2.599.970.035</td>
<td>-908.716.936</td>
<td>-4.704.246.422</td>
</tr>
<tr>
<td>Receita Corrente Líquida - RCL</td>
<td>28.976.687.000</td>
<td>34.534.904.291</td>
<td>39.268.345.357</td>
<td>40.613.414.957</td>
<td>47.064.197.575</td>
</tr>
<tr>
<td>Divídia Consolidada Líquida - DCL</td>
<td>47.204.512.000</td>
<td>53.952.732.370</td>
<td>57.378.213.514</td>
<td>67.094.118.254</td>
<td>72.380.973.777</td>
</tr>
<tr>
<td>% da DCL sobre a RCL</td>
<td>162,9%</td>
<td>156,2%</td>
<td>146,1%</td>
<td>165,2%</td>
<td>153,8%</td>
</tr>
</tbody>
</table>

**Source: Secretariat of Finance, Portal of Transparency. State of Rio de Janeiro.**
consecutive years, indicates that the government failed to save resources during the fiscal year, resulting in the increase of the debt. The main purpose of this calculation is to evaluate the sustainability of fiscal policy in a given year, considering the current level of the consolidated debt and the state’s ability to pay it in the long-term. It measures how the current actions of the public sector affect the path of net debt. Thus, the primary outcome is important to evaluate the consistency between the targets of macroeconomic policy and debt sustainability, in other words, the government's ability to honor its commitments.

Such metrics are of great relevance in the process of evaluating the fiscal health of the public entity. They try to indicate the paths to be traced by the central body in the way of managing the common good.

Therefore, the key concerns to the SRJ to build a MTEF model were to bringing about improvements in the budget formulation and strengthening the links between sector policies and allocations. The government saw that the appeal of the MTEFs lies in their potential to link the often competing short term imperatives of macroeconomic stabilization with the medium and longer term demands on the budget. The government also realized how the methodology can contribute to improve their policy making process and the planning strategy, leading both issues to an efficiency and effectiveness in service delivery.

Thus, the SRJ is trying to improve the way of doing the public management by creating a new concept, which is more focused on the control of the public expenditure in the real time. But at the same time, the state is putting more attention on the direct and indirect effects generated by the taken policies in the medium and long run.

It is the necessity of always being concerned with the effects that some acts that we make today can cause in the future. The decision making process needs to be done consistently and constructively with the government’s fiscal reality.

6.2 General characteristics

Based on macroeconomic assumptions that strategically assist the development of government actions (the decision making process), the technique of construction and analysis of scenario applied in SRJ enables the managers to evaluate previously the impact and risks of each action taken today in the future scenarios of the state.

The fiscal model developed is an important tool for tax planning. It will allow preliminary assessment of the paths to be taken by the public administration by knowing the possible outcomes of each.

The methodology was based on the use of general parameters for the creation of the future scenarios. Uniform rules of consistency were established for both revenue projections as for the expenditure projections, and take into consideration others basic information which are engaged in the business rules of the finance of the entity.

Important to note that this stage of mapping the existing budget structure as well as the legal rules imposed on the state is crucial for appropriate use of the tool.
In the model all interrelationships between the key variables for the construction of scenarios were identified. Projection rules, the degree of detail of each module and the closure rule of the same were also defined. Each module represents a large cluster of strategic information for the fiscal planning.

We can say that essentially, the model was designed based on the three pillars of a good public finance management: the scenario of revenue; the expenditure management; and the debt control.

As demonstrated in the previous chapter, the methodology and the good practice of intertemporal models such as the MTEF emphasize the importance of these models being aligned with the budget framework applied in the country or state.

Thus, to ensure their efficiency and also maximizing the good results which studies highlight the state is seeking to operationalize the model as a system integrate with the budget process. Managers must have the feeling that it should not be used as an island, in other words, as an independent system which does not integrate the existing process.

Having this in mind, the SRJ began designing the model through its financial agency, the Secretariat of Finance. Today, the process already involves other strategic partners, such as the Secretariat of Planning, a centralizer agency of important informations for the projection stage. This concern does not occur only in view of the need to institutionalize the new instrument in the administrative body of the state. It also occurs as a way to strengthen the channels of communication between agencies. Such channels remain fragile state. The intention with this strengthening of the management is to make the strategic informations, which are extremely important to the fiscal health of the state, to be spread with greater speed and quality. This is important because the agencies of control and management must know with some advance the intentions of public managers. The logic behind is the creation of a network structure with a coordinated and cooperative action among the players.

**6.3 The logical structure: the relationship between the past and the future**

The structure of the Fiscal Model was developed with three central points: the module of revenue, expenditure, and public debt.

Giving a basis for the proper functioning of this ingenious structure, a specific core containing projection rules was created. This nucleus contains the main macroeconomic variables and others relevant economic factors for the projections of revenue and expenditure. Together, these factors act directly in the process of building the baseline for subsequent years.

Of course, these modules are not entirely independent. There is a relationship between them. This intersection results in the elaboration of different scenarios (Baseline, A, B, C, ...) to the horizon (timeline) established for the model. The chart 12 shows schematically the logic used in creating the fiscal model.
The dynamics of construction and manipulation of the model starts with the assessment of detailed data of revenues and expenditures from previous years. Such information is used as the basis for projections of future years.

Despite being an instrument for prediction and simulation of alternative fiscal policies, the model has, at its base, data (revenues and expenses) made in recent years. The purpose of bringing these elements (historical data) is to enable the preparation of projections based on past accomplishments. However, these data are not treated in their raw form. The state is concerned with this basis before using the information: it is important to exclude extraordinary events that occurred in the past and will not repeat in the future. The idea is simple: clear the base of information, for such sporadic events do not have an impact on unrealistic projections. This cleanup step describes the work performed and results in better projections.

The projection of the debt respects each contract assumed by the state government with its creditors. Thus, the module of the debt is kept almost externally to the core of the structure projection.

The study and control of the debt/RCL ratio of public entities in Brazil is very important because, at the request of the LRF, the Senate (Federal Legislature) has imposed specific limits for subnational governments (200% to States and 120% to Municipalities). So, it is vital that this ratio lies within the limits established. However, it is noteworthy that the model is not meant to estimate, from certain statistical methods, the fiscal results or predict the revenue of the state for the next few years. The methodology developed in the state makes use of statistical parameters previously estimated by the strategic areas of public administration to design the budgetary balance in conjunction with other logical rules. Therefore, it is not an econometric model, but a model of consistency.

Its main objective is to provide the SRJ of the technical capacity which is required for the construction of future fiscal scenarios from its budget balance (revenue confronted with
expenses) and from the stocks and debt services (interest and charges added to the payment of principal). The charts 13 and 14 show, through logical schemes, the interrelationship that exists in the model developed for the state budget with support from the World Bank.

*Chart 13: The internal relationship.*

Projection rules only apply to the base scenario (Baseline). The alternative scenarios (A, B, C, ...), which should contain distinct variables and assumptions of expected macroeconomic variables and others relevant economic factors for the projections, that work at the baseline, are built making the use of other rules of projection.

*Chart 14: The constructions of different scenarios.*
The idea is to create speculative scenarios with input from extrapolated macroeconomic variables (which can be either under or overestimated), to assess and quantify potential future impacts on the budget.

Given the legislation in force, the model was constructed to project the fiscal situation of the state (evolution of revenues, expenses and debt) in two distinct criteria. In the first, the projections are designed to answer the guidelines of the Fiscal Responsibility Law (LRF); legislation already exposed in this paper. In the second, the projections are focused on the management of the Program of Restructure and Fiscal Adjustment (PAF). The program is a contract made between subnational entities with the central government, in which the central government assumed the debts of states and municipalities in an attempt to balance the public accounts and handle the fiscal imbalance that was there at the time.

Therefore, as output, the model provides a state framework with key fiscal results in the medium-term, allowing public managers to simulate scenarios with impacts caused by possible changes in macroeconomic, fiscal and governmental parameters. Thus, new loans, the implementation or expansion of public policy, judicial decisions, human resource policies, the formulation of new investment projects, and many other public actions that need previous studies to assist the decision making process, may be prepared with the necessary technical support.

In short, the fiscal state model seeks to contribute directly to the maintenance of fiscal sustainability in the medium and long-term. It appreciates the correct use of budgeting and public finances. The methodology can revolutionize the management of public finances, which inhibit irresponsible attitudes and avoid excessive public debt. The model represents a true progress in the way to manage the res publica.
7. CONCLUSIONS

This study sought to contribute to the ongoing development of the field of public finance in Brazil. The study showed that the economic activity developed by the state is indeed achieved through the public budget, in which the state makes use of the resources obtained from society to realize the actions outlined in the planning process.

The paper discussed public finance in the Brazilian system, a federation with three different levels of government and with a well-advanced budget structure.

Since the end of the 1980’s (with the 1988 Federal Constitution) and the early 2000’s (when Brazilian politicians introduced new techniques of public finance management), the Brazilian system has improved substantially in the field of public administration.

A new legal framework was created by the Executive and the Legislature Branches in an attempt to improve the public management of the central government and of the subnational levels. Today, the country uses powerful tools that aim to link the public action which are required annually (LOA) with the medium-term strategic plan prepared by each new government (PPA). This link is guaranteed and strengthened through another legal instrument, the LDO.

The importance of the LDO has grown as a consequence of the strong fiscal adjustment implemented since 1999 and enactment of the Fiscal Responsibility Law (LRF) in 2000. As a result, a MTFF (Medium-Term Fiscal Framework) became fully functional in 2001.

The main goal behind the introduction of these instruments, especially with the PPA, LDO and LRF, was to coordinate planning of budget through a hierarchical structure that develops this process over a four-year period.

Even with all designed logical structure, the annual budget still lacks credibility because of significant carryover between years. Their link to the strategic government priorities still are the weakness in this process. According to the WB (2013):

*The credibility of the PPA and LOA (annual budget) is compromised because they can be easily amended, as in the case of the Budget Guidelines Law (LDO). Moreover, the larger amount of carryover allows for greater within-year budget flexibility for the Executive, which can choose whether to execute the current year’s planned expenditure or the expenditure planned for the previous years but carried forward.*

As the World Bank concluded, although Brazil does not have a formal MTEF, the building blocks are in place for its development. The 1998 Constitution created a new set of rules and processes for managing budget decision making at all levels of government. In its view, the equivalent of an MTFF has been in place since 2001. To the Bank, the LDO is in effect an MTFF.

However, by the other side, the PPA can’t be classified as an Medium-Term Budgetary Framework (MTBF) because the plan is not binding in practice, as it is subject to annual

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46 WORLD BANK. Beyond the Annual Budget. 2013.
changes. Thus, it became evident that, despite all the legal tools available to public managers, their concepts have been twisted and lost its essence over the last few years.

Today exists a huge gap between what is planning to build (government planning) with what is done punctually every year. Added to this the fact that more and more constant between the members of the federation, the existence of financial imbalances in the present and the future fiscal risks which represents a barrier to development of a good budget management.

The technical and qualitative work of public managers, who should act strongly in the decision making process assisting with current information and possible future scenarios (risks or liabilities that management may face) does not occur as thought. As a result, such threats become more common everyday in the Brazilian Public Administration.

Numerous policies are taken without the proper technical support from strategic areas of management. These effects threaten not only the management capacity of future administrations as well as the social welfare and economic development of the country.

Facing the necessity to changes, a new technique for fiscal management was brought to debate, a very widespread one in the world, the MTEF. This work attempted to present the methodology from their methodological concepts as well as their implementation in practice.

Conceptually, MTEF is the ideal tool for bringing a new dynamic in the public administration by improving their management capacity. But the methodology is not capable of solving all the structural problems that may exist in the system. It's just a tool to maximize your fiscal control with extremely positive results.

The methodology provides the linking framework that allows expenditures to be driven by policy priorities and disciplined by budget realities. Basically, the appeal of the MTEFs lies in their potential to link the often competing short term imperatives of macroeconomic stabilization with the medium and longer term demands on the budget to contribute to improved policy making and planning and to efficiency and effectiveness of service delivery.

In the end, the MTEF promotes a greater macroeconomic balance with a greater budgetary predictability (fiscal discipline), and also, more efficiency in the use of public resources. And this was the interest/reasons for the development of methodology in the government of the State of Rio de Janeiro, which has been made with the support of the World Bank.

The intention was to create a new public management with new budget techniques and train their managers on the best practices currently applied in the field of public finance. With all these theoretical inputs, and after more in depth study of the subject in question, we can certainly say that an effective budget pursues three objectives: maintaining fiscal discipline; allocating resources in accordance with policy priorities; and efficiently delivering services.

In this hard task, it is easy to say that developing countries are different from the others, but, in fact, all governments need to acquire effective fiscal discipline, by improving their capacity to allocate correctly the public resources in strategic priorities. In order to promote this objective, a budget must contain some importants elements: a macroeconomic framework
and revenue forecast; fiscal stability; a discussion of budget priorities; planned expenditure and past outturns; and a medium-term framework.

Although budgets are usually approved on an annual basis, they should include a multi-year outlook. Many projects and programs take more than one year to implement or may have future financing implications, and such costs must be indicated in the budget. It is crucial that the public administration account for the possible effects generated by the commitments made today, such as investments initiated, contracted loans, expansion and creation of social policies, subsidies and benefits granted, wage improvements in public careers. Therefore, the decision making process needs to be aligned with the expectation of future scenarios. A process of developing public policies adherent to the vision of the future strengthens the management of the res publica. This also prevents the existence of accented and continued financial imbalances and that budgets be developed without alignment with proper government planning.

So, in this evolution process, the medium-term approach seems to be the right answer because it is intended to strengthen the link between expenditure projections and budget policy by integrating all expenditures into a unified budget.

The power of the MTEF to generate good fiscal performance derives from its impact on the quality of budgeting and budget credibility. The methodology helps to reduce shortcomings of annual budgeting by achieving more realism in the budget; spending driven by medium-term sector strategies; budgets containing multi-year spending allocations; budget funding linked more closely to results; and a greater fiscal transparency and accountability.

Thus, although we recognize that government planning is essentially a political exercise, the central idea defended here is that the better the technical and methodological basis used to support the process of public choice, the lower the risks of future fiscal disequilibrium. To reach this achievement, especially in Brazil, budgets should be more comprehensive, transparent, technical and realistic.

Although some studies suggest, as preliminary conclusions, that the MTEF must rest upon a good macro-fiscal model and solid budgetary management foundation, this aspects seems not to be a huge problem to the SRJ. Nevertheless, some adjustments need to be made. But, most importantly, the idea needs to be disseminated in a top-down flow. The agencies must be committed to the new budget model. Bureaucratic incentives to support the model must be taken into account and addressed by specific measures to increase the overall credibility of the reform.

As recommended by several analysis made on the development of MTEFs around the world, the methodology should be seen as a complement to basic budgetary management reform. In other words, the MTEF must not be seen as a substitute for the necessary reforms. And also, the MTEF must be integrated with the existing budget process, i.e., built into the budget process from the start.

This is important because the key elements of the MTEF must be integrated with the existing budget process from the start. The MTEF should not operate as a parallel system. For being
together with the normal process, the model will be able to maximize its effects, producing gains.

After all, we must keep in mind that strategic resource allocation moves policy, planning and budgeting into the nexus of politics and administration. This is the only way to reach the main goal of public administration nowadays: The use of resources, which are becoming more and more scarce, in an efficient and effective manner.

Another point must be clear to the public managers: MTEFs alone cannot deliver improved public expenditure management in countries which other key aspects of budget management remain weak. An MTEF requires policy makers to look across sectors, programs, and projects to examine how public spending can best serve national development objectives over the medium-term. In doing so, they must weigh the importance attached to short-term goals against that attached to medium-term objectives and set aside the narrow self-interests of spending agencies and politicians. Prioritization subject to resource constraints becomes the guiding principle of budgeting.\footnote{WORLD BANK. Beyond the Annual Budget. 2013}

To conclude, if more progress is needed in the work of reforming the Brazilian state, I believe it should be characterized less by new legislative changes and more by processes of modernization and seek effectiveness in public action and in their management practices. Advance further in the reform of the Brazilian state, as observed in this work, means giving emphasis on modernization and more effective public action and in management practices.

Certainly, a new milestone in the management of the subnational public finance in Brazil is being built, leaving to the SRJ the duty of being the pioneer in this line of action. A new reality for the Brazilian federation.
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