



# **Preconditions for Establishing Structural Fiscal Balances in Latin America and the Caribbean: The Case of Brazil**

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## **Abstract**

Fiscal policy has been at the center of Brazil's economic dynamics and performance for more than 30 years. In this line, the approval and implementation of a Fiscal Responsibility Law in 2000 was a key step in supporting fiscal sustainability and the transparency of fiscal accounts. Despite these improvements, removing the uncertainties and addressing the imbalances that still persist in fiscal policy—a long-term trend of rising expenditures and tax burden—will be a crucial step when considering further modifications to the current framework, especially regarding the introduction of a structural fiscal balance rule.

**JEL Codes:** E62, H60

**Keywords:** Fiscal Policy, Fiscal Rules, Fiscal Imbalances, Structural Fiscal Balance Rule

## **1. Introduction**

Fiscal imbalances in Brazil were at the root of the protracted period of high inflation and stagnation in the 1980s and early 1990s. By the same token, improvements in the fiscal framework—along with reduced external vulnerability—were among the main determinants of the consolidation of stability and of the growth resumption that followed in the second half of the 2000s. Thus, it is fair to say that fiscal policy has been at the center of Brazil's economic dynamics and performance over the past 30 years, or even longer if it is taken into account that the above mentioned imbalances developed gradually over the 1970s. It is also fair to say that removing the uncertainties and addressing the imbalances that still persist in fiscal policy will be key to the prospect of a sustainable acceleration of growth that may finally lead Brazil to go along with economies that exhibit living standards at least twice as high as Brazil's today.

It should be noted from the start that significant progress was made over the past fifteen years in the development of a sound fiscal framework, and also that it paid off in terms of fiscal performance. The process in fact started much earlier, but its consolidation really got momentum only more recently, as the principles of sustainable debt and balanced fiscal policy started to draw more widespread support. Nonetheless, there are reasons for concern. Even though the process of unchecked growth in the net public debt to GDP ratio was reversed in the first half of the 2000s thanks, among other factors, to the generation of relatively high primary surpluses, much of the improvement should be attributed to a rising tax burden that reached levels that put Brazil at odds with countries with similar per capita income and that may hamper faster output growth and productivity gains. Second, there was a steady growth of public spending, stemming from social security payments, from social assistance related pressures and from other forms of current expenditures. Finally, it should also be noted that when expenditure control was eventually called upon, it was public investment that suffered the most, so that there is widespread recognition that public investment falls way below the levels required to provide adequate infrastructure to support faster economic growth. Fiscal performance is analyzed in detail in Section 2 of this report.

Brazil has developed a sound and, in some instances, innovative framework for fiscal policy geared towards fiscal sustainability and which includes a well defined sequence for budget elaboration that articulates, at least in principle, with the planning process. It also

comprises restrictions on the federal and subnational governments' expenditures and indebtedness—usually in terms of net current revenues—and supports them with enforcement procedures and a detailed mechanism for reporting and disclosure by the federal and subnational governments that produces broad transparency of fiscal accounts. The Fiscal Responsibility Law (LRF) and the agreements associated with the renegotiation of state governments' debts are the pillars of the current fiscal framework in Brazil, and are discussed in Section 3.

In spite of positive developments, both in terms of performance and institutional building, two facts deserve attention when considering further improvements in the current framework, especially regarding the introduction of a structural fiscal balance (SFB) rule. The first one has already been mentioned above, and has to do with a long term trend of rising expenditures and tax burden, as well as the related problem of an expenditure composition biased towards current expenditures and in detriment of investments. The other fact is an incipient reversal of the strong commitment that prevailed until 2008 to meet primary surplus targets. This change shows up in the form of a more frequent resorting to creative accounting mechanisms that, if maintained in the future, will reduce significantly the credibility of current arrangements. These recent developments are discussed in Section 4.

One important aspect of fiscal policy that has not received appropriate attention is its cyclical behavior. This aspect of fiscal policy seems important both in terms of its implications for budgetary policy—as excessively variable expenditures and/or revenues tend to reduce the quality of fiscal policy—and of its impact on macroeconomic outcomes. In Section 5, calculations for structural or cyclically adjusted fiscal balances (SFB) are presented and some simulations undertaken to identify the debt trajectories that would have been observed had a SFB rule been followed over the relevant period. Also, in this section are discussed the institutional elements that could underpin an eventual switch towards an SFB rule.

## **2. Structure and Evolution of the Public Sector Accounts in Brazil since 1995**

Since the inflation stabilization program known as Real Plan in 1994, Brazil's fiscal policy has been at the center of an intense debate regarding its main features and consequences for macroeconomic outcomes. In fact, both the disequilibria generated in the first four years of

the stabilization program, between 1995 and 1998, and the consistent steps taken afterwards to overcome those imbalances and consolidate a more consistent macroeconomic framework, seem to revolve around the country's ability to address its structural fiscal problems.

In this section, we describe the evolution of Brazil's fiscal accounts since 1995. The period can be subdivided in two subperiods: in the first one, primary surpluses fell right after the monetary stabilization, in June 1994, and remained very small until late 1998. Over this period, small primary surpluses along with high real interest rates and the recognition of previously non-registered debts (known as "skeletons") led to high nominal deficits and a sharp increase in the net public debt to GDP ratio. In the second subperiod, primary surpluses were raised to levels similar to those prevailing in the pre-stabilization period, but now without the help of inflation. After a transition spell in which net debt to GDP kept rising due to the impact of currency depreciation, a virtuous circle set in, allowing for lower real interest rates, which, combined with the higher primary surpluses and higher GDP growth started to push the debt and nominal deficits down.

Between 1990 and 1994, primary surpluses of the consolidated public sector (CPS) were on average 3.4 percent of GDP, but declined to an average deficit of 0,2 percent of GDP in the following four years. However, it is hard to claim that there was a fiscal expansion after stabilization, at least one reflecting a conscious decision. Although fiscal expansions were a common feature of previous heterodox stabilization plans, the decline of primary surpluses after 1994 may have been caused by the mechanism known as "anti-Tanzi effect". The latter describes a situation in which there is an asymmetry regarding indexation rules between tax revenues (highly indexed) and fiscal expenditures (imperfectly indexed) that, under high inflation, would impact favorably primary surpluses. These would result from the ability of policy makers and public managers to control the real value of public spending through delays in the payment dates that may result in significant reductions of the real value of outlays when inflation is of the order of 1 percent per day, as it was in Brazil in that period. High inflation may thus create a deceptive picture of public finances under control – and give support to arguments linking high inflation only to inertial or other distributive mechanisms, rather than to fiscal imbalances. This inability to confront fiscal disequilibria simultaneously with the control of inflation had an influence on policy choices in the aftermath of stabilization and led to an excessive reliance on pegging the exchange rate between 1995 and 1998 as a means of maintaining inflation low.

In the immediate post-stabilization period, as inflation fell quickly, nominal wages in the public sector increased at all government levels, but mainly at the states' level. Contrary to what happened before stabilization, these wage increases – granted with the explicit goal of attracting political support for the upcoming elections in late 1994 –, were not eroded by inflation, thus leading to higher real expenditures. The smaller primary surpluses that followed revealed the weaknesses that were previously masked by inflation. Compounded with the high interest rates required to maintain the exchange rate peg, they led to high nominal deficits and a rising debt to GDP ratio.

In spite of this deterioration in the fiscal picture, several steps were taken over the 1995–98 period towards a structural improvement of public finances. Among them, the renegotiation of state government debts and the solution, mainly through privatization, of government owned state banks' problems were a benchmark. In the relationship between the federal government and state governments, at least two other widespread renegotiation processes had taken place over the previous ten years without solving the problem of state governments finances: state governments would continue to increase expenditures, as they benefited from high inflation through the mechanism described above, plus their use of government owned state banks to float debt and finance higher expenditures. The 1997/98 round of renegotiations of states' debts was different from previous ones as the agreements were tied, in exchange for a discount and favorable repayment terms, to the privatization of state companies and banks, concessions of public services to the private sector and to the earmarking of current revenues to serve the renegotiated debt. More importantly, this time the renegotiation agreements included credible enforcement mechanisms through the use of states' tax revenues as collateral, the inclusion of legal provisions granting interruption of federal transfers to the state and access of the National Treasury to the state's bank accounts in the event of a debt service default.

The second subperiod starts in 1999, which may be set as a turning point for a change of policy regime. Under the pressure of another external crisis and having resorted to the IMF in order to extend the life of the managed exchange rate regime, stringent targets for the consolidated sector primary surplus (as percent of GDP) were set with the explicit goal of reversing the high levels of public debt accumulated in the previous period. Alongside, structural measures were approved in the Congress altering the rules for access to Social Security retirement benefits and establishing a Fiscal Responsibility Law that aimed at introducing an institutional constraint to fiscal policies to be enforced upon all government levels.

Fiscal performance in this second subperiod has been outstanding: primary balances increased from—0.2 percent of GDP on average between 1995 and 1998 to 3.5 percent of GDP in 1999-2008. The debt to GDP ratio, however, maintained its rising trend in the first few years of the adjustment, increasing from 38.9 percent of GDP at the end of 1998 to 60.2 percent of at the end of 2002, before entering on a declining trend that brought it to 38,4 percent of GDP in December 2008. Debt increased in spite of the fiscal adjustment due to the impacts of high interest rates and of depreciation of Brazil's Real that affected a significant part of public debt that was either contracted abroad (external debt) or indexed to the exchange rate in the domestic market—including exchange rate swap operations in derivative markets conducted by the Central Bank as a means of preventing an even more intense depreciation of the Real between 2001 and 2003.

More recently, as result of external adjustments that took place after 2004, which led to a large accumulation of foreign exchange reserves at the Central Bank, exchange rate movements reversed their impact on the debt to GDP ratio as the government became a net creditor in foreign exchange. Now, it is the exchange rate appreciation that leads to higher debt to GDP ratios, or, putting it the other way round, depreciations reduce debt to GDP ratios. Also, as will be shown in Section 4, the trajectory of net and gross public debt-to-GDP ratios were parallel over most of the 2000s, but started to diverge in the most recent period due to financial operations between the Treasury and public financial institutions, mainly BNDES, as well as to the need to sterilize the intense accumulation of foreign exchange reserves by the Central Bank, which led to a sharp increase of repurchasing operations based on Treasury debt. Gross debt over this period went from 68 percent of GDP in 2001 to close to 80 percent of GDP in the last quarter of 2002, declined to 60 percent of GDP in 2008 before increasing again, to 69 percent of GDP in 2009.<sup>1</sup>

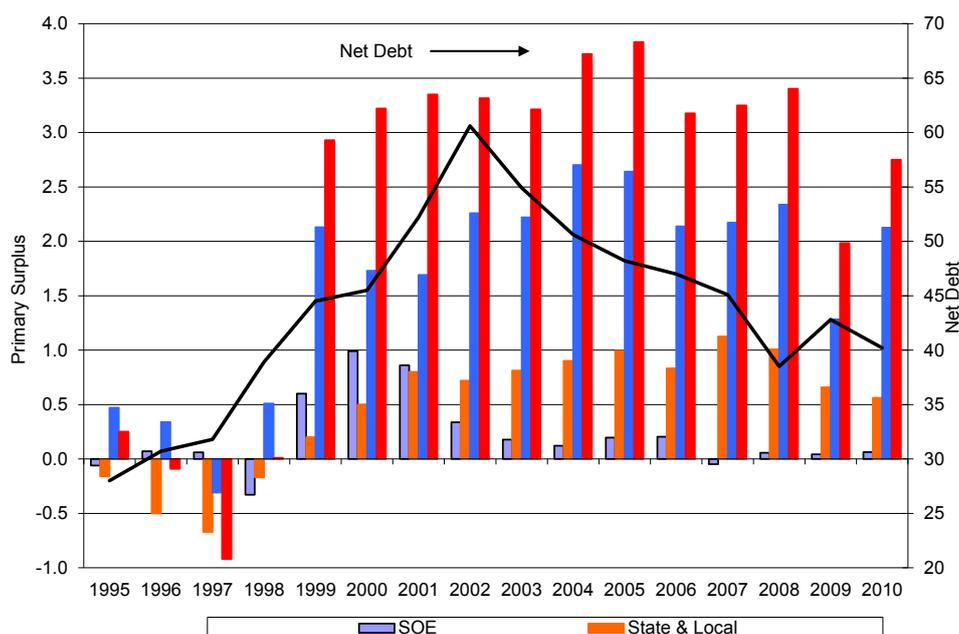
Figure 1, below, shows the trajectory of primary surpluses, according to different government levels, and the net debt to GDP ratio for the consolidated public sector since 1995. It is possible to see the sharp reversal of fiscal outcomes around 1999 towards primary surpluses, and that this change occurred at all government levels, including state and local governments that moved from primary deficits close to 1 percent of GDP to surpluses exceeding 1 percent of GDP by the end of the period. The consolidated public sector reached a primary surplus of 3.4 percent of GDP in 2008—a figure that excludes Petrobras and

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<sup>1</sup> Data from the Central Bank; for an alternative methodology for the calculation of net and gross public debt,

Eletrobras from public accounts, and considers expenditures related to the implementation of a sovereign fund that, in practice, represents a mechanism to allow part of the surplus accumulated in 2008 to be transferred to and spent in future years.<sup>2</sup> If these two components appropriately accounted for in the primary balance, the surplus would have been close to 4.4 percent of GDP.

Figure 1 - Primary Surplus and Net Debt (% of GDP)

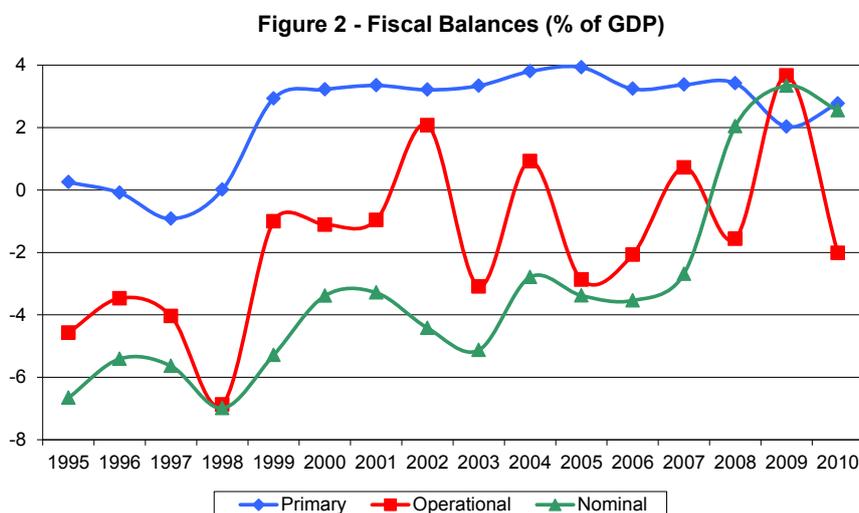


Source: Central Bank.

The evolution of fiscal balances in their three forms—primary, operational (which considers only the “real” financial cost of public sector liabilities) and nominal—is shown in Figure 2. Nominal deficits in the beginning of stabilization were as high as 7 percent of GDP, due to a nominal interest payments’ burden of over 8 percent of GDP at some points. For the dynamics of debt to GDP ratio, it is the real interest rate that matters in comparison with real GDP’s growth rate: the operational deficits were also very high, reaching close to 8 percent of GDP by 1998. After 1999, following adjustments in the primary balance, both operational and nominal deficits started to decline. Notice that until 2002, the nominal deficit declines very gradually as compared to the operational deficit’s trajectory, reflecting among other

<sup>2</sup> The data are not homogeneous over the whole period, as before 2002 they include the PSBR of both state owned companies.

things the impact of surprise inflation that reduced real interest rates ex-post, especially in 2002. After that, the declining trend will be shared by both series. In 2008, the operational balance was in a surplus of close to 2 percent of GDP, while the nominal deficit had fallen to 2 percent of GDP.



Source: Central Bank

As noted above, the net public debt kept rising in the first few years of the 2000s due to exchange rate and nominal interest rate effects. Table 1 and Figure 3 below depict annual average changes of the net debt-to-GDP ratio and the contribution of its main determinants, expressed in percentage points (pp) of GDP, for selected periods. For a reference, the debt-to-GDP ratio was 28 percent of GDP in 1995 and 40.2 percent of GDP in 2010.<sup>3</sup> It can be seen that the average annual increase of the net debt-to-GDP ratio accelerated from 3,7 pp per year in 1996-98 to 4,5 pp in 1999–2002. This is associated with an increase in the impact of the exchange rate and interest rates, to annual averages of 4,9 and 7 pp of GDP, respectively, that more than offset the change in sign of the contribution of the primary surplus (from an annual average of 0,3 to -3 pp of GDP per year). In both periods, the recognition of previously unrecorded liabilities (“skeletons”) is more or less offset by the impact of privatizations, with a net effect in favor of the former that contributed to increase the net debt-to-GDP with approximately 2.8 percentage points of GDP over 1996–2002 (approximately 10 percent of the total increase).

<sup>3</sup> In order to exhibit a longer trajectory it was necessary to chain two different series: the first one includes Petrobras and Eletrobras up to 2001, but not afterwards. In the series used for the graph and table, data for GDP is evaluated at end of the year prices, while in Figure 1 the debt-to-GDP ratio is calculated using average year prices to obtain nominal GDP.

The subsequent period, from 2003 to 2008, features a steady decline in the debt-to-GDP ratio, at an average rate of 3.7 pp of GDP per year. Primary surpluses increased their contribution to this decline with an average of -3.5 percentage points of GDP per year, being now helped by the appreciation of the exchange rate, whose impact on debt-to-GDP changes was on average -1.3 percentage point of GDP per year. Interest rates contributed, on average, with 6.8 pp of GDP per year to the debt-to-GDP growth, but this impact declined over time and it was only 5.8 pp of GDP in 2008. Finally, GDP growth also influenced the net debt-to-GDP trajectory, and its impact in terms of a reduction of the ratio has increased over the three subperiods, reflecting the improved macroeconomic framework that connects the different variables determining the evolution of debt over time.

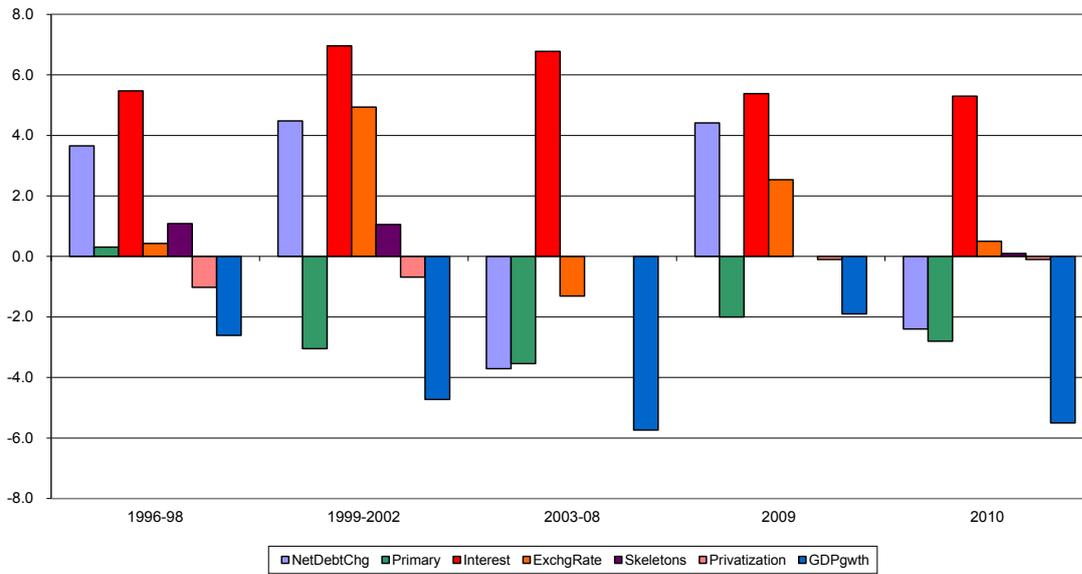
The last columns in the table show the behavior of the debt-to-GDP ratio in 2009 and 2010. In the former, the previous trend of declining debt to GDP ratio is reversed and it increases by 4.4 percentage points of GDP. Counter-cyclical fiscal policy led to a reduction of the primary surplus from 3.5 to 2 percent of GDP, implying a smaller impact of its contribution in reducing the debt. The same can be said of a smaller GDP growth, but a major determinant was the exchange rate, whose 25 percent appreciation this time contributed to an increase of the net debt-to-GDP ratio due to the presence of negative external liabilities in the public sector. In 2010, the debt to GDP ratio returned the declining trend, with a strong contribution of GDP growth and a somewhat larger effect of the primary surplus. The latter, however, was influenced by an accounting artifice that included in the federal government revenues funds obtained through the capitalization of Petrobras by means of selling oil exploration rights of recently discovered oil fields.

	1996-98	1999-2002	2003-08	2009	2010
<b>Net Debt-to-GDP ratio change - average</b>	3.7	4.5	-3.7	4.4	-2.4
Primary Surplus	0.3	-3.0	-3.5	-2.0	-2.8
Interest payments	5.5	7.0	6.8	5.4	5.3
Exchange Rate adjustment	0.4	4.9	-1.3	2.5	0.5
'Skeletons'	1.1	1.1			0.1
Privatizations	-1.0	-0.7		-0.1	-0.1
<b>GDP growth effect</b>	<b>-2.6</b>	<b>-4.7</b>	<b>-5.7</b>	<b>-1.9</b>	<b>-5.5</b>

\* Two differences with respect to debt definitions currently in use: the definition of public sector includes Petrobras up to 2001, and GDP is evaluated at end-of-the-year prices.

Source Central Bank.

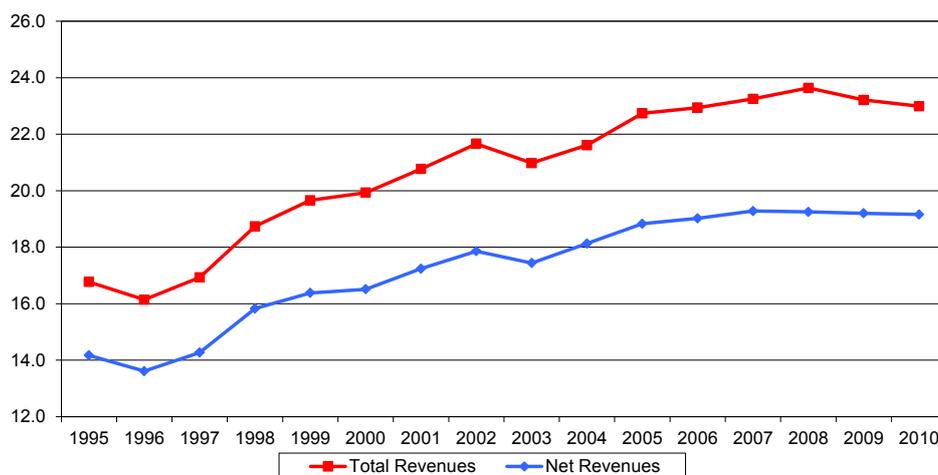
Figure 3- Net Public Debt Changes - Main Determinants  
(pp of GDP, annual averages)



Source Central Bank

In spite of lower deficits and declining debt, not all was good news in fiscal policy over this period. Improvements of the primary surplus reflected a combination of rising taxation and higher expenditures, especially on current outlays, that left public investment still at very low levels. Focusing, from now on, only on the Central Government, comprising the federal government, the Central Bank and the social security system, Figure 4 shows that total revenues increased from 16 percent of GDP in 1996 to close to 24 percent of GDP in 2008. Net revenues followed the same path but increased less than total revenues as a percentage of GDP, indicating higher federal transfers to subnational governments. This happened in spite of the fact that most tax increases fell on social contributions—for instance, the rate hike of Cofins or the creation of a contribution on checking accounts (CPMF)—that are not shared with state and local governments.

**Figure 4 - Federal Government Total and Net Revenues (% of GDP)**

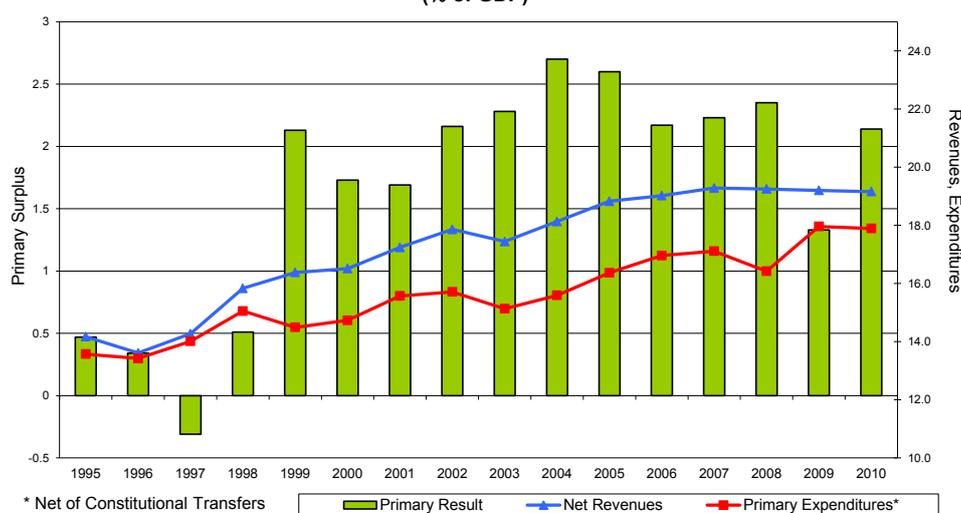


Source Central Bank.

Higher tax collection, even as the economy struggled through a period of relatively low growth between 2001 and 2003, allowed expenditures to maintain their rising trend, as can be seen in the next figure<sup>4</sup>, which shows the primary result of the central government and its determinants: net revenues and primary expenditures, both measured on the right side axis. Even in the face of significant increase in the primary surpluses, equivalent to 2 percentage points of GDP, primary expenditures kept an almost monotonic rising trend, with three small breaks, in 1999, 2003 and 2008. In 2008, primary expenditures were more than 3 percent of GDP higher than they were in 1998, while total revenues increased over 5 percent of GDP. In 2009, primary expenditures accelerated, growing by 1.3 percentage point of GDP, while revenues fell with respect to GDP by 0.3 percentage point, so that the primary surplus declined by more than one percentage point of GDP.

<sup>4</sup> In the figure, the primary surplus follows Central Bank’s “below the line” methodology, and some statistical adjustments are necessary to make it consistent with “above the line” revenue and expenditures data.

**Figure 5 - Central Government - Primary Result, Revenues and Expenditures (% of GDP)**

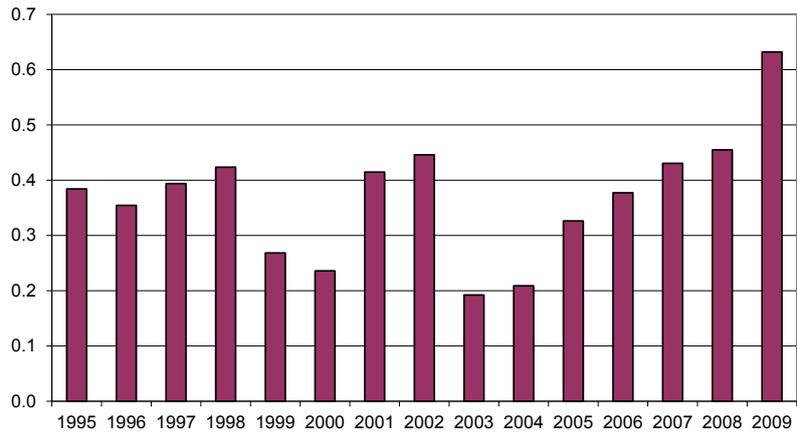


Source: Central Bank

There are several determinants for this rising trend in primary expenditures. By a wide margin, the main driver was the increase in current expenditures, with capital outlays depicting an almost stagnant behavior. Unfortunately, fiscal statistics in Brazil only allow for consistent disaggregated figures for the most recent years. Yet, some calculations (see Gobetti, 2010) show that capital expenditures at the federal government were still very low when compared with the burden of current expenditures, as can be seen in Figure 6.<sup>5</sup> Obviously, given rigidities stemming from legal constraints and political considerations that are associated with most current expenditures, notably personnel outlays and social security transfers, investments are the expenditures category that suffers the most when fiscal adjustments are implemented.

<sup>5</sup> Official data from the Treasury Secretariat disaggregate capital expenditures at the central government only after 2006. Their level is somewhat higher than those estimated by Gobetti (2010), but the trend is similar, growing steadily from 0,7 percent of GDP in 2006 to 1,3 percent of GDP in 2010. Although higher than the figures in the graph, investment still dwarfs when compared to current expenditures.

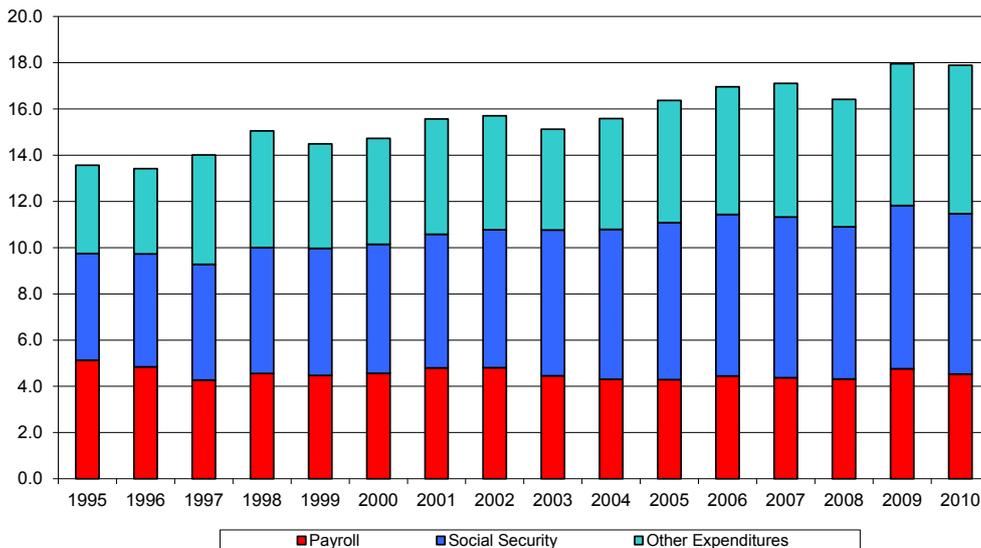
**Figure 6 - Federal Government Investment (% of GDP)**



Source: Gobetti (2010)

Within current expenditures, the main drivers of the growth trend have been social security benefits and other current expenditures: the former went from 4.6 percent of GDP in 1995 to 7,1 percent of GDP in 2009; the latter moved up from 3.8 percent of GDP to 6.2 percent over the same period. The payroll of public sector employees in the federal government declined 0.3 percentage point of GDP over this period, although, after an important effort to contain its increase, it resumed more recently its growth from the lows recorded in 2004–05. In 2009, payroll increased by 0.5 percentage point of GDP, reflecting salary increases negotiated 2008.

**Figure 7 - Federal Government Expenditures (% of GDP)**



Source: Central Bank.

The growing share of current expenditures in the fiscal budget reflects the increasing importance of government transfers to individuals in the form of social security benefits and “other” social transfers. An important aspect of this evolution is that these expenditures are closely tied to the value of the minimum wage—this is true for the “other” social transfers, as well as for the value of the smallest benefit paid by the social security system, where they now account for 65 percent of the number of benefits and about 40 percent of total value. As the minimum wage has had significant increases in real terms, more than doubling between 1995 and 2010 in terms of year averages, the impact on these transfers has been very strong.

In a recent note, Almeida and Pessôa (2010) call attention to the fact that, contrary to widespread perception, the increase of public expenditures would not reflect profligacy on spending—as the remark that current expenditures account for most of that increase may lead to conclude. Between 1999 and 2009, primary expenditures grew at an average real rate of 7.3 percent per year, moving from 14.1 percent of GDP to 18.3 percent of GDP. By rearranging spending categories, these authors show that along with social security benefits, which increased by 1.7 pp of GDP over this period, other meritorious expenditures also went up: other social outlays, which include unemployment insurance, PIS/PASEP-related transfers, social assistance benefits to the elderly and disabled and transfers associated with the family allowance program (“Bolsa Família”), all together amounting to a 1.3 pp of GDP increase; health and education expenditures (0,6 pp of GDP increase) and investments (0.6 pp of GDP increase). Over this period, payroll increased by 0.4 pp of GDP, and what usually comes to mind when one thinks of current expenditures, labeled by the authors as narrow current expenditures—office supplies, traveling and associated allowances, outsourced services etcetera—has in fact declined 0.3 pp of GDP over the period, indicating that what is thought of as a potential source of deficit reduction due to wasteful spending is in fact very small. While there is much to be debated regarding the quality of these expenditures and their impact on poverty reduction, it is clear that higher outlays on these social spending categories involve a public choice and a social contract that will have to be renegotiated in order to produce a sustainable path for the public accounts.

	Total Spending	Social Security	Social Spending*	Investment**	Health & Education	Payroll	"Narrow" Current Expenditures	Other
1999	14.1	5.5	0.6	0.5	0.7	4.5	2.2	0.1
2009	18.3	7.2	1.9	1.1	1.4	4.8	1.8	0.1
Change (pp of GDP)	4.3	1.7	1.3	0.6	0.6	0.4	-0.3	0.0

\* LOAS and RMV (social assistance transfers to the elderly and disabled) and other social transfers (annual bonus - PIS/PASEP - and unemployment benefits)

\*\* does not adjust for non-processed deferred payments

Source: Almeida and Pessôa (2010).

It should be clear from this discussion that even though cyclical factors may have played a role in the fiscal outcomes, especially in the most recent period as will be seen in Section 4, the main influences over public finances in Brazil stemmed from longer term trends that implied rising revenues and expenditures alike. Compounding this picture, cuts in investment spending, at least until 2005, were instrumental in allowing that a fiscal adjustment could take place along with higher current spending. The impact on growth prospects, however, has been large, as infrastructure has deteriorated, posing some critical hurdles on the way towards sustained higher growth rates.

The rigidity in government expenditures, in spite of measures that were introduced to reduce partially the degree of earmarking, has increased over time, and this was reinforced by the government's response to the 2008 world financial crisis. The sharp decline in tax revenues—as result of lower activity and tax incentives and exemptions introduced to stimulate demand—and increases in current expenditures, especially increases in salaries to public sector employees, which were already included in the 2009 budget in a clear miscalculation of the change in the macroeconomic environment that would take place only a month after the budget was sent to Congress, led to a significant reduction in the central government's primary surplus, from close to 3 percent of GDP (including the sovereign fund) to 1,3 percent of GDP. That markets have not reacted negatively to this deterioration is a sound testimony of the improvement in the perception that investors have of Brazil after sustained adjustments. Yet, the fact remains that the government's ability to contribute to domestic savings was considerably reduced, and in order to allow more room for investment to increase its share in total spending current expenditures will have to start to grow less than GDP.

### 3. Institutional Developments and Fiscal Framework in Brazil

Much of fiscal woes in Brazil, and thus of the macroeconomic imbalances that followed, were the result of institutional fragilities that prevailed until the mid-1980s. Maybe due to the fact that this period was characterized mostly by an authoritarian regime, the need of an institutional arrangement to discipline the budgetary process and public finances as a whole does not seem to have a priority matter, as opposed to the other reforms undertaken in the second half of the 1960s, like the tax and financial reforms and the creation of the Central Bank. From this process emerged a very centralized tax structure on the federal government, but one in which the different government levels faced very soft budget constraints due to relatively easy funding access through state owned banks and inflation-indexed public debt. These fragilities started to be faced only in the second half of the 1980s as part of the early attempts at controlling inflation.

The many forms of state intervention in the economy determined the existence of a multiplicity of budgets: a monetary budget, covering the subsidized financial activities of Banco do Brasil and Banco Central; the SOE's budget; the social security budget; and, the fiscal budget narrowly defined, the only one required to be approved by the Congress. Thus, in the beginning of the process macroeconomic reform, between 1985 and 1988, it was necessary to create basic institutions almost from scratch. This included the unification of parallel budgets, the creation of the National Treasury, and the development of an associated system of monitoring and controlling revenues, expenditures and debts (SIAFI)—, and the ending of the “*conta movimento*” of Banco do Brasil at the Central Bank—a mechanism that allowed Banco do Brasil to freely withdraw funds at the Central Bank and to lend them to priority sectors, like agriculture and exports, and to finance government deficits. The existence of multiple budgets clouded transparency and thus prevented a proper assessment of fiscal stance and its relationship to the macroeconomic imbalances, i.e., inflation, as the narrowly defined fiscal budget would seem to be always balanced, with all deficits flowing through the alternative budgets, which did not go through legislative approval.

The 1988 Constitution produced important changes in the fiscal framework. It modernized the budgetary process, whose basic structure has been maintained since then; promoted tax changes aiming at decentralize tax revenues towards the states and local governments and introduced new, mandatory expenditures at the federal level, which entailed significant rigidity in the budget. These new expenditures included, among others, extending social security benefits to rural workers who had not previously contributed to the system,

increasing welfare transfers to vulnerable groups, like the elderly and disabled, and incorporating in the roll of public sector employees a significant number of staff serving at the time in the indirect administration and whose contracts followed the private sector labor legislation. The new Constitution also introduced a significant degree of earmarking of revenues to pre-specified spending categories, which together with the new mandatory expenditures would result in a very high degree of rigidity in the budget.

Under the new Constitution, states and local governments benefited from a sudden increase in their shares of total tax revenues without being required to cover those areas that until then had been the responsibility of federal government. This led to a significant increase of overall expenditure and deficits at subnational government levels. At the same time, the new tax and expenditure structures implied the need to recompose the level of the federal government revenues. This was done through successive increases in social contributions which, unlike taxes, are not shared with subnational governments.

The combination of greater tax autonomy and a larger share in total tax revenues by states and municipalities with an extension social security rights to the population as a whole has created a potential of fiscal imbalances. From the tax and federative perspectives, emerged a dual tax system in which traditional taxes, shared by the different federative levels, live side by side with social contributions financing the social security system and which are not shared with subnational government levels. The result has been a deterioration of the quality of the tax system while the goal of strengthening the federation was progressively abandoned (Rezende *et al.*, 2007).

From the budget and spending allocation perspectives, the new constitutional provisions increased significantly the budget rigidity, with strong implications for the nature of the fiscal adjustment to be undertaken in the post-Real period. As remarked by Rezende *et al.* (2007), “the expansion of social security benefits, the stronger budget rigidity, the size and poor quality of taxation, the federative conflicts and the inefficiencies of the public sector are actually expressions of the multiple faces of the Brazilian fiscal problem whose deterioration stems from the incapacity of undoing the *fiscal knot* tied at the 1988 Constitution” (p. 19).

The need to adjust to these changes shaped institutional developments over the early part of the 1990s. Social contributions, often levied on a cumulative basis, were created or had their rates increased and/or contributive bases widened so as to allow the federal government to face the new expenditures created by the new Constitution. The search for more flexibility also led to the setting up of what was first known as Social Emergency Fund in early 1994, to be made up of 25 percent of all revenues, at the expense of their

predetermined destinations when earmarked, including, at this first moment, constitutional transfers to states and municipalities. This Fund was presented as a pre-condition for setting in motion the previously announced stabilization strategy that would lead to the Real Plan. In fact, it was only after the Congress approved the Fund that the government started the transition to the new currency by means of a virtual unit of account called URV (Real Unit of Value).

The purpose of this Fund was to free previously earmarked revenues –including those from the newly created social contributions, which by law were tied to social security spending – to be either redirected to other current, unprotected by earmarking expenditures or used to form the primary surplus to be generated in order to slowdown debt growth. Given the constitutional status of earmarks, this fund had to be renewed by several times afterwards by means of qualified majorities in the Congress. Currently, the mechanism is known as DRU<sup>6</sup> (un-earmarking of federal revenues), and will have to be renewed in 2011, in what has become a new issue of political bargaining between an incoming administration in its first year of government and the Congress. According to Mendes (2009), in 2006 the DRU was able to increase the volume of freely allocated revenues from 17 percent to 25 percent of the total, of which about 80 percent correspond to freeing social security contributions.

As mentioned in Section 2, the second half of the 1990s, following the adoption of the new currency, was a period marked by high instability. Inflation declined gradually, but relied excessively on an appreciated exchange rate and on high real interest rates. Fiscal balances began to show their real face as the inflation veil dropped, revealing the true dependency of public finance on accelerating prices, particularly through the delaying of payments. Also, on a clear demonstration of the lack of sound institutions to support the stabilization effort, exiting state governors used swollen tax revenues from the economic boom that naturally follows a sudden drop of inflation to significantly expand outlays, especially by granting real gains to public sector employees in an electoral year. Deficits rose and began to put pressure on public debt. That, in turn, forced interest rates up and attracted foreign capital, which supported the exchange rate appreciation and created a sizable current account deficit.

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<sup>6</sup> The DRU is similar to the FSE, and to its successor, the Fiscal Stabilization Fund, except for the fact that, in its more recent version, it does not un-earmark revenues neither in the constitutional funds transferred to states and municipalities nor those earmarked for educational purposes.

Notwithstanding these overall macroeconomic imbalances, structural reforms were undertaken during this period aiming at improving conditions in the financial sector—also dependent on inflation through the protection they could provide to those with access to financial services, and from which they derived significant revenues in the form of floating cash funds—and at solving a long standing overhang of state governments’ debts and their related instrument, state governments’ owned public banks.

In the first case, several interventions in major banks promoted coordinated mergers or acquisitions of stressed institutions, with the Central Bank supplying the required liquidity while keeping the most problematic assets. The two major public banks owned by the federal government had to be capitalized so as to make up for the lower revenues and non-performing loans of the past. The whole program was subject to much criticism but helped to create a sound financial sector by means of eliminating those institutions that could not adapt to the application of risk adjusted capital requirements, among other measures. The PROER, as this program was called, may have been to a large extent responsible for the resiliency shown by the Brazilian banking system on the recent international financial crisis.

The process that involved facing the second structural problem – that of states’ (and later on, states capitals’) debts would also prove to be instrumental in setting up a new framework for fiscal policy. Melo *et al.* (2010) call it a reform of fiscal federalism, as it resulted in the re-concentration of “fiscal power” in the federal government. This process took place between 1997 and 1998, and carried with it the experience of previous rounds of states’ debts renegotiations that had failed in preventing subnational deficits and debt from growing, even as these governments enjoyed a larger share in tax revenues, granted by the new 1988 Constitution. Thus, the renegotiations this time around were much stricter in their terms of repayment and carried very effective enforcement mechanisms. By tying interest and amortization payments to net current revenues, they led the states and the most important municipalities (usually, states’ capitals) to generate primary surpluses while at the same time creating an almost automatic stabilizer that allows fiscal balances to respond, at least partially, on a countercyclical way to the business cycle. Parallel to this, a widespread effort was made to improve states’ capacity in tax collection. The volume of states’ debts absorbed by the federal government topped R\$100 billion.

Towards the end of the 1990s, in the middle of heightening external instability, two others would complement those reforms, which were also part of the need to address longstanding weaknesses in fiscal policy. The first one involved the rules for retirement in the social security system, aiming at reducing the scope for early age retirement in the

general regime for social security (RGPP) in the private sector. As mentioned, the system had to cope with a larger number of beneficiaries whose access to government-sponsored retirement had been granted by the new Constitution. It also faced an increase in the real value of benefits due to the link of the value of the minimum social security benefit to the value of the minimum wage, which was significantly increased over the first few years of the real. As result, social security deficits increased over this period, and the prospects – given, among other things, the projected demographic changes and an already heavy burden of contributions levied on the payroll, which prevented formal labor relations from increasing – did not look good. This change would be supplemented by another reform in 2003 that restricted the retirement benefits for new entrants in the public sector, approximating the rules in this system to those that fall upon workers in the private sector. However, this law still begs for complementary legislation to regulate the pension and retirement funds that will replace the current scheme of predetermined benefits.

***The Fiscal Responsibility Law.*** The second major development regarding fiscal trends was the approval of the Fiscal Responsibility Law (FRL) in 2000. It was called for by the Constitution of 1988 (articles 163, 165 and 169), which established the need for a Complementary Law as a means of introducing standards and control mechanisms for public finances. The FRL represents the convergence of piecemeal changes<sup>7</sup> that had been introduced over the previous years. It consolidates procedural and numerical rules aiming at reducing the degree of discretion in budgetary and fiscal policies, defines a more comprehensive and solid framework for fiscal policy to be followed by all government levels, increases transparency and strengthens the commitment to sustainable debt levels. Even though it may have faced implementation setbacks – due to both lack of appropriate political support and insufficient enforcement in the face of non-compliance and creative accounting – it represents a landmark in the process of institutionalizing sound and sustainable fiscal practices. As important, it contains provisions that integrate the budgeting and planning processes, thus increasing the quality of public policies.

The FRL main goal was to set rules and standards for public finances consistent with a responsible fiscal management. This should involve the planning of fiscal acts and their

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<sup>7</sup> Besides the agreements on the states' debts restructuring, attempts at increasing controls over spending include the "Lei Camata", approved by the Congress in two versions in 1995 and 1998, which set limits to the states' payrolls.

transparent disclosure; aiming at balanced budgets, anticipating risks, correcting for deviations and introducing effective mechanisms of enforcement. In order to achieve these goals, the law set ceilings for the ratio of government payrolls to net current revenues (NCR) and determined that annual budgets should be drawn and implemented so as to achieve targets for the nominal and primary balances to be set in the Budget Guideline Laws that preceded their elaboration. It also set ceilings for the net debt to NCR of the states and determined the Senate, who has the Constitutional mandate to oversee public debt issues, to do the same for the federal government, something which has not been done yet, more than 10 years after the approval of the FRL. Also, it restricted new credit operations to be limited to the amount of planned capital expenditures (“golden rule”).

In order to introduce sustainability in public finances, the FRL determined that the creation of new, continued expenditures<sup>8</sup> would only be allowed if accompanied by the identification of permanent revenue sources. As an additional discipline tool, in order to reduce the scope of the influence of electoral years in public finances, deferred payments (*restos a pagar*) from one year’s budget to the following one should be limited in the last year of government to the value of cash funds. On the institutional framework, the FRL calls for the creation of a Fiscal Management Council (*Conselho de Gestão Fiscal*) that has not happened so far.

According to Nascimento and Debus (2002), the FRL followed on the steps of the above mentioned renegotiation of states’ debts, which already included targets for several aspects of the subnational fiscal performance, like limits to financial debts, targets for the primary surpluses, limits to the payrolls, targets for own revenues, commitments to privatizations and concessions of public services and targets for public investments. The FRL, however, goes beyond the Law 9496, of September 1997, that regulated the debt renegotiation agreements, and blocks in its article 35 any attempts at debt refinancing, or simply postponing their payment.<sup>9</sup>

**Budget Structure** The budget structure follows from the 1988 Constitution, which had a clear goal of integrating the planning and budgeting processes. Planning of fiscal actions is supposed to stem from a hierarchical structure of budgets: the Multi-year Budget Plan (PPA); the Budget Guidelines Law (LDO) and Annual Budget Law (LOA). The FRL strengthens the role of planning activities by linking the execution of public spending to the existing plan, as

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<sup>8</sup> Defined as expenditures expected to last for at least two years.

<sup>9</sup> A summary of FRL’s provisions can be found in Melo *et alli* (2010), Annex 6.

embodied in the PPA, which sets the priorities in terms of capital expenditures and investment programs on four-years horizon and in its version approved by the Senate, required that the PPA included an Annex of Fiscal Policy to show the consistency of the multi-year goals and targets with the main guidelines of economic and social development policies. This provision was later on vetoed by the Presidency.

The FRL added importance to the LDO by requiring it to set fiscal targets for the following three years, and also to discuss the risks that may jeopardize meeting those targets. Anticipating risks and spelling out the correcting mechanisms in the case of deviations from targets is also an important aspect of each year's LDO, as it is required the identification of those expenditures whose "commitments" (*empenhos*) can be made only upon a reasonable degree of certainty regarding the realization of expected revenues, according to a financial programming that is done every two months over the budget year.<sup>10</sup> If the government has evidence that the budget has overestimated revenues, then it is required to withhold (*contingenciar*) expenditure commitments up to an amount that ensures that the fiscal targets will be met.

The LDO sets up the value of macroeconomic parameters that will guide the elaboration of the annual budget. In its Fiscal Targets Annex, it specifies the targets for nominal and primary balances as well as for the stock of public debt over the following three years. This annex must also include an assessment of fiscal performance regarding the attainment of past targets, the prospective impact on the fiscal balance of tax expenditures and fiscal incentives, the scope for increasing mandatory permanent expenditures due to a permanent increase in tax revenues, the evolution of the governments net worth and an assessment of the balance sheet of retirement and pension funds. Besides the targets annex, the LDO also comprises an annex to assess fiscal risks that may impact fiscal performance over the budget year.

Taking the LDO as a reference, the Annual Budget Law will detail revenue sources and spending programs and activities subject to the fiscal targets. It will also include contingency reserves as a percentage of Net Current Revenues (NCR) to meet deferred expenditures (*restos a pagar*) payments and contingent liabilities, besides other unforeseen fiscal events. In the execution of the budget approved by the Congress (by local legislative

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<sup>10</sup> The identification may be done the other way around, by singling out those non-mandatory expenditures that are deemed to be government priorities and thus non-subject to withholding. In the execution of the budget, withholding will usually fall upon the congressmen's amendments to the budget proposal sent to the Congress by the Executive, and negotiations of their release an important part of the process of bargaining for political support between the Executive and the Congress.

powers in the case of subnational governments), the government is required to present every two months a financial programming for the rest of the year and a monthly schedule for outlays. Expenditures commitments may be restricted if it is perceived that the pace of tax collection will not allow the targets to be met. This process is called “contingencing”, and only mandatory expenditures (either by force of the Constitution or of other legal provision), the debt service and specific expenditures indicated in the LDO will not be subject to being restricted. Every four months the government will report to the Congress to present the budget performance and its position regarding the accomplishment of the targets.

To sum it up, Brazil’s fiscal framework is made up of three main components: the agreements underlying the states’ debt renegotiations, the Fiscal Responsibility Law and the budgetary process, including rules for its execution. Among the main features of this framework, stand out the centralization of revenues in the federal government and the rigidity of expenditures, in the sense of either being mandatory or funded by earmarked revenues.

#### **4. Recent Developments in Fiscal Policy and Framework**

In 2008, before the onset of the international financial crisis, as the economy boomed and revenues increased at a fast pace the primary surplus reached record levels in spite of an acceleration of public expenditures. By October, the 12 months accumulated primary surplus had reached 4 percent of GDP, for a target set in the LDO of 3.3 percent of GDP.<sup>11</sup> At the same time, the Ministry of Finance perceived the appreciating trend of the Real as a potential threat to dynamic macroeconomic stability. A debate started then on the appropriateness of setting up a sovereign fund through which the National Treasury would buy foreign currency, beyond its needs to service its external debt, with the alleged purpose of supporting Brazilian companies willing to invest abroad, that is, to support the internationalization of Brazilian companies. Obviously, the short-term goal was to prevent the appreciation of the Real, and the Brazilian Sovereign Fund (BSF) was set up in December by deducting the equivalent of 0.5 percent of GDP from the primary surplus, which closed the year at 3.4 percent of GDP.

With the international crisis deepening after September 2008, capital flows went through another sudden stop and the *Real* depreciated sharply. The idea of using the proceeds to intervene in foreign exchange markets became unreasonable and the funds were frozen. More recently, the goal of strengthening public financial institutions, like BNDES, has

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<sup>11</sup> Both figures are already adjusted for the subsequent withdrawal of Petrobras from PSBR calculations.

spurred the idea of using the proceeds that formed the sovereign fund as a source of capital. What this reveals, however, is that the sovereign fund may have been the first step towards a real fiscal stabilization fund, for it is clear that its side intention was, from the beginning, to use the excess primary surplus in one year to cover expenditures in the future, instead of maintaining the funds indefinitely frozen at the Treasury's account at the Central Bank or using them to service the public debt.

Indeed, had this been possible and the BSF could have been used to cover for expenditures in 2009, when growth and tax collection declined sharply. Instead, tax breaks and rising expenditures were accommodated by means of a smaller primary surplus target. First, as already mentioned, it was decided that Petrobras, which had contributed to the consolidated primary surplus with 0,5 percent of GDP in the past and whose investments were rising sharply as result of newly found offshore oil reserves, would no longer be part of PSBR calculations; second, the target itself was lowered to 2,5 percent of GDP. Besides a lower target, an ad hoc amendment to the LDO allowed the attainment of the target, from a legal point of view and if necessary, to take place by deducting investment outlays of up to 0,5 percent of GDP.

Other recent initiatives that distort fiscal performance and policy framework, besides the non-transparent reduction of the primary surplus target by the federal government in 2009, were the use of special operations with BNDES that implied raising cash positions at the end of the year at the expense of future revenues (dividend anticipations) and, in 2010, the use of revenues associated with the transfer to Petrobras of the exploration rights over the newly found oil fields at the *pre-salt* basin. On a broader perspective, over 2009 public commercial banks were stimulated to increase their credit operations to offset the retrenchment of private institutions, leading to an increase of close to eight percentage points, from 34 percent to 42 percent, of their share in outstanding credit between the end of 2008 and 2010, and in the specific case of BNDES, were funded through fiscal resources not duly accounted for in PSBR figures.

There is no dispute that lower primary surpluses were partially warranted on the basis of a structural deficit calculation, as will be seen below, in order to face the 2008/09 crisis through countercyclical fiscal policy. In fact, high primary surpluses sustained over almost a decade, and the consequent reduction of net debt-to-GDP ratios, had created the room for countercyclical policies that would not jeopardize the longer term goal of bringing the debt-to-GDP ratio to levels more in accordance with those exhibited by countries with per capita income similar to Brazil's.

What is disturbing is that the non-compliance with the target in 2009 (when it reached only 2 percent of GDP), even after its reduction, was justified by resorting to a escape clause, included in the LDO, that allows netting out from overall outlays the investments included in the Pilot Program of Investments (PPI in the Portuguese acronym), a provision that had been in place for some time but had not been used before, and in the “Growth Acceleration Program” (PAC), as an amendment to the LDO over 2009 also allowed for. However, most of the frustration of the target came from an acceleration of current expenditures, a trend that, as previously noted, has been in place for several years and which seems to have gained additional strength more recently.

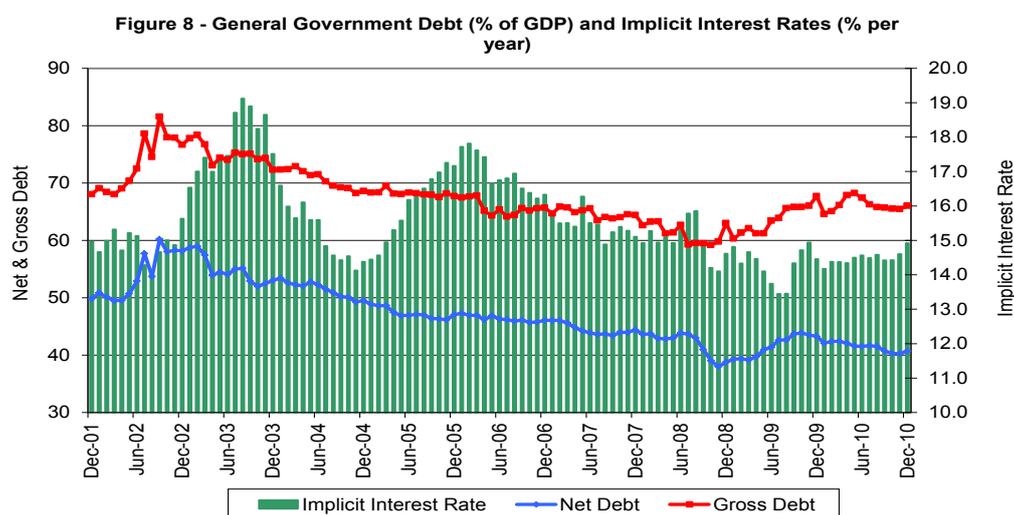
Creative accounting also operated on the revenues side and prevented fiscal performance from looking even worse as the Treasury resorted to extraordinary, one-off revenues. These included down payments associated with tax arrears amnesty, the already mentioned dividends anticipation and the transfer of tax related judicial deposits from Caixa Economica (a state bank) to the Treasury, among others. All these accounting devices may have amounted to close to 2 percent of GDP (Ter-Minassian, 2011).

The idea of preserving public investments in the context of fiscal adjustment programs was already present in the discussions between Brazil and the IMF in the early 2000s. It seems to have followed from the concept of “fiscal space”, which aimed at combining adjustment efforts with the building up of conditions for sustained growth, especially regarding the need for improved infrastructure. That is why the selection of investment projects was very careful, picking up only those that had high impact on growth, either at regional or national levels. While that may have been valid when the fiscal space was much narrower, and capital expenditures’ cuts would take place along with a reduction in the pace of current expenditures growth in order to meet the primary surplus targets, it seems questionable when it is used to preserve the space for accelerating current expenditures growth, as it happened in 2009 and 2010.

The Budget Guidelines Law (LDO) for 2010 took this stance a step further by allowing any investment outlay, without a ceiling for their overall value as in previous years, to be deducted from the primary surplus target. In practice, that leaves the target undefined as any expenditure that is classified as investment could be deducted from the target, almost as if there had been a change from a primary surplus target to a “primary current public savings” target. According to Afonso (2010), this is the culmination of a long process of undermining the credibility of traditional fiscal indicators, and includes also the overutilization of “deferred payments” from one year to the next and the conversion of tax payments under

dispute in the courts (“judiciary deposits”) into net revenues, among other examples that end up distorting the real stance of fiscal policy. In 2011 the process of reducing the scope of a rules-based fiscal policy would be further reduced as targets were set in nominal terms instead of as a percent of GDP, which will contribute to reinforce the procyclical stance of fiscal policy.

As mentioned above, on the wake of the so-called countercyclical policies there has been a revival of the importance of public banks as instruments of economic policy. In the downturn that followed the international crisis, public banks were key in maintaining credit supply, whereas private banks, due to the drying up of their international funding in some cases, or out of concerns with the quality of credit in others, retreated sharply. Treasury credits against public financial institutions increased from 0.5 percent of GDP at the end of 2007 to 6.5 percent of GDP in December 2010, about 90 percent of the increase corresponding to credits to BNDES. Given the imbalances presented by public banks in the past, this move gave rise to a more careful assessment of the government debt, and reinforced the perception that the evolution of gross debt may be more relevant to determine government solvency prospects than the net debt, until now the focus of analysis by financial markets (Figure 8).



Source: Central Bank

There are large subsidies involved in these transfers, as the opportunity cost of public debt is much higher than the rates at which BNDES lends, basically TJLP plus a margin, where the former is a long term interest rate that used to combine domestic and international financial costs, but more recently lost this relation to the government’s funding cost. The TJLP is set

every quarter by the National Monetary Council (CMN), currently standing at 6 percent per year. The same reasoning applies to sterilized interventions by the Central Bank in foreign exchange markets, due to the enormous difference between the domestic and the international interest rates that foreign exchange reserves can earn. This facts help to explain why the implicit cost of net public sector debt, also shown in Figure 8, has fallen so much less than the cost of domestic bonded debt, given to a first approximation by the Selic rate.

These recent developments certainly cannot produce by themselves a major rupture in the robust fiscal framework that evolved over the past decade. However, they seem to reveal a weaker determination in the pursuit of a consistent fiscal policy, including in that term not only issues regarding fiscal sustainability, but also its connection to monetary policy so as to produce a less volatile and more growth supportive macroeconomic policy. Before the crisis onset in the last quarter of 2008, domestic absorption was rising very fast and even though the primary surplus was rising, there was a feeling that fiscal policy was being once again procyclical. The calculations for the structural budget balance, presented below, show that the policy turned expansionary already in 2006 (an election year), and that the trend intensified in 2007, even if data for 2008 reveal an increase in the non-adjusted primary surplus, which eventually exceeded the year's target. This excess surplus has been saved in the form of the already mentioned sovereign fund, which may act as a stabilization fund, except that these decisions of fiscal policy are being taken on ad hoc terms.

In 2009, on the other hand, a decision was taken early in the year to reduce the primary surplus target from 3.3 percent of GDP to 2.5 percent of GDP as a means of facing the economic slowdown that followed the onset of the international crisis. Tax incentives in the form of lower tax rates for individuals' income tax and tax breaks in IPI of the auto, home appliances and construction inputs sectors were put in place and combined with a strong increase of public spending already envisioned in the budget law sent to the Congress in the middle of 2008, before the beginning of the crisis.<sup>12</sup> In the end, the primary surplus actually observed was 2.1 percent of GDP, with the difference to the target being explained by the realization of investments whose deduction from total expenditures was allowed by the LDO (the overall deduction could reach 0.95 percent of GDP, from a total effectively invested of 1.1 percent of GDP).

In 2010 the economy fully recovered from the crisis, with domestic absorption accelerating as result of expansionary monetary and fiscal policies that led to a fast pace of

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<sup>12</sup> For the set of measures fiscal implemented in the aftermath of the international financial crisis, see Pires (2009).

growth in consumption and investment. As inflation fears rekindled, the need to reverse policy stimulus was clear since the first half of the year, but the burden of the adjustment fell entirely on monetary policy. Fiscal policy remained very loose, and in spite of a GDP growth of 7.5 percent, against -0.6 percent in 2009, the primary surplus for the consolidated public sector actually declined, from 2.1 to 1.9 percent of GDP when the trick with revenues from Petrobras is excluded from the accounting (in the official statistics, the primary surplus was 2,8 percent of GDP). In spite of promises to hold spending, primary outlays at the central government increased by 9.4 percent in real terms, although it should be pointed out that contrary to previous years, investment expenditures increased significantly, over 30 percent in real terms.

The performance of regional governments, especially of the states, followed that of the federal government. Between 2001 and 2008, these governments produced an average primary surplus of 0,9 percent of GDP per year. In 2009 and 2010, the surplus fell to 0,7 and 0,6 percent of GDP, respectively. While in the first year it can be argued, as below, that the reduction was a consequence of a decline in their revenues—with impact in the required surplus to meet the service of their renegotiated debt—in the latter the reduction seems to have followed a looser stance by the federal government and the Congress regarding their ability to incur into new debt. In fact, in the process of revamping public investment through PAC (Program for Acceleration of Growth) the federal government has stimulated state and local governments to increase their indebtedness at the federal public banks in order to undertake projects in urban infrastructure and housing. More recently, in view of the realization of large sporting events in Brazil, the Soccer World Cup in 2014, and the Olympic games in 2016 in Rio de Janeiro these investment expenditures gained an additional impulse, although without breaching the constraints imposed by the FRL.

In spite of the deterioration of the fiscal policy framework as of late, there are also positive institutional developments to be reported coming from the Congress, in the form of a modernization of the budgetary process, which still follows Law 4320 of 1964. This new regulatory framework, dubbed Budget Responsibility Law (BRL), was also called for by the 1998 Constitution as a complementary law to regulate the new budget structure, which comprises the PPA, the LDO and the LOA. The LDO has been used so far as a mechanism to rule over the elaboration and execution of budgets—repeating every year, for example, the definitions that should have been given by this law—but that still leaves a void regarding uniform rules for subnational governments. The proposal currently under discussion merges two senators' projects and aims at restructuring the process of budget elaboration, making

congressmen's participation in the process more effective and defining accounting and control standards that increase transparency and reinforce the FRL's austerity (Tollini, 2010).

Among the changes to be included in this new legislation it is worth highlighting the simplification of the multi-year budget (PPA), which would become a more political document, defining strategies and guidelines and the goals of long term fiscal policy in the context of a prospective scenario. Its submission to the Congress would be anticipated to the month of April (currently it is August). The multi-year character, which currently involves the need for the Congress in each year's budget to appropriate the funds required for the execution of a certain investment or program, would be strengthened by requiring that each project be approved by its whole value and that budget allocations be made in the subsequent years' annual budgets in levels that allow the projects implementation, in an attempt to preclude the proliferation of "unfinished investments". In order to achieve that, the proposed legislation determines that at least 20 percent of the programs included in the PPA be indicated as priorities in each year's LDO.

In the legislative process of approving the budget proposal, the law imposes a streamlining of the number of expenditure amendments made by congressmen, currently summing up to ten thousand, and changes the procedures regarding revenues' estimates. In the case of the amendments, they would be limited, in the case of projects of interest of a specific state, to be presented by the three senators representing that state and in their whole (for the 27 states) can not exceed 0,2 percent of NCR. Lower house representatives will continue to present individual amendments, but limited to ten per term and it becomes prohibited to indicate private entities as beneficiaries of the amendment. In their whole, these representative's amendments are limited to 0,3 percent of NCR.

In the case of estimating revenues, the FRL determines that it should be done by a committee made up of half of its members from the executive and the other half from the legislative and civil society. This is a crucial aspect in the context of setting up fiscal rules and targets based on structural balances.

## **5. Countercyclical Fiscal Policy and SFB rule**

The major developments of fiscal policy and its related performance were reviewed in sections 3 through 4 of this report. One aspect that stands out in the analysis of this period is the tension existing between monetary and fiscal policy. It was shown on Section 2 that interest rates were the main factor explaining the increase in the debt-to-GDP ratio over the

1995–2009 period, and that the primary surplus acted in the opposite direction from 1998 onwards.

When debt sustainability was the main issue, especially due to the burden of foreign and exchange rate-indexed public debt, there was agreement that primary surpluses had to be adjusted to prevent debt to GDP ratios from growing out of control, even at the cost of deepening demand and output contraction. So, it is no surprise that fiscal policies in the recent past acted procyclically during output downturns by either increasing taxes or, less frequently, by cutting on spending, as it was crucial to ensure the government's commitment to sustainable debt trends.

The procyclicality of fiscal policy has been identified in several studies, and Brazil fits into that picture nicely. However, those studies have drawn their conclusions mostly from developments in the late 1990s and first half of the 2000s, when procyclicality meant tightening fiscal policy in the context of an externally-led economic downturn. This has been identified by Mello and Moccero (2006) as evidence in favor of policies aiming at debt sustainability. Indeed, economic downturns over that period stemmed mainly from external shocks that produced sudden interruptions of capital flows at a time when financing needs, due to large external debt and current account deficits, were sizable. Exchange rate pressures usually led to large depreciations, which impacted not only external debt but also exchange rate-indexed domestic debt. To prevent inflation from getting out of control, interest rates had to go up, which added to the debt problem as duration was very low, in fact, zero in the case of floating rate, Selic-linked bonds. In that context, the main goal was to sustain the credibility of economic policy, and fiscal policy would be tightened to ensure that the debt to GDP ratio would not enter on an explosive path. Even though Brazil's 2002/03 downturn was caused by internal factors, associated with the uncertainties stemming from the prospects of the then opposition Workers Party winning the election, the main impact was felt on the exchange rate.

It seems, then, that procyclicality was not so much a matter of choice, but of circumstances determined by credit constraints. After 2003, under a new administration that maintained the previous policy framework and benefited from a more favorable international environment, such a pattern started to change. In the first moment, when the quest for credibility led to higher interest rates and a decision to raise the primary surplus target, there were calls within the government itself for countercyclical policies, but they waned as the economy resumed growth already in the second half of that year. The trends of higher taxes and spending resumed shortly after, and talks about countercyclical fiscal policies would

resurface only at the recent international crisis. Not a word about countercyclical policy was heard when the economy boomed in 2004, reflecting the lagged effects of exchange rate depreciation and an incipient acceleration of the world economy, or in 2007/08 and 2010, when domestic absorption was growing at clearly unsustainable rates. In sum, it seems that countercyclical policy means simply a “license to spend”—which is consistent with the asymmetry of cyclical responses that leads to the deficit bias, also identified in the literature.<sup>13</sup>

In what follows, we present the estimates of cyclically-adjusted budget balances for the consolidated public sector, the central government and for the states and municipalities. Some simulations are also presented regarding the alternative trajectories of public debt had a structural fiscal balance rule been followed, and a target for such a structural primary surplus is suggested to achieve a net debt-to-GDP ratio of 30 percent by 2020. Next, we discuss whether Brazil meets the institutional requirements for introducing such a SFB rule.

## **5.1 The SFB estimation and simulations**

### **(i) Accounting and methodological adjustments.**

The methodology employed for computing the cyclically-adjusted fiscal balance for Brazil follows that of OECD and focuses on five revenue items at the federal level: personal income taxes (IRPF and IRRF), corporate income tax and contribution over net profits (IRPJ and CSLL, respectively), tax on industrialized products (IPI), social contributions (COFINS and PIS-PASEP), mostly levied on firms’ turnover, and Social Security contributions of the private sector that are levied on payroll (RGPS). For those 5 items we have used the elasticities with respect to GDP estimated by Mello and Moccero (2006) and by Peres and Ellery Junior (2009). These elasticities are presented in Table 3. At the states level, the elasticity of ICMS (states’ value added tax) was calculated with a VEC model, while that of constitutional transfers received from the federal government was calculated based on their composition.

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<sup>13</sup> It has been argued that the public debate on the possible adoption of countercyclical fiscal policy in Brazil has followed itself a countercyclical pattern: intense during downturns, but losing momentum as the economy recovers and eventually booms (World Bank, 2008, p.13).

For the ICMS, the result was somewhat higher than that found in alternative studies, but not by much.<sup>14</sup> For other relevant tax revenue items, an elasticity of one was employed. It can be shown that the results in terms of cyclically-adjusted primary fiscal balances are consistent with other studies that follow the IMF methodology, which involves direct estimation of the elasticities of different revenues and expenditures aggregates with respect to GDP fluctuations. On the expenditure side we also follow the OECD methodology and consider that only unemployment related transfers (*Abono e Seguro Desemprego*) are affected by the business cycle.

Table 3 - Elasticities	
PRIMARY REVENUE	Elasticity
<b>DIRECT TAXES</b>	
Personal Income Tax (IRPF + IRRF)	2.70
Corporate Income Tax (IRPJ + CSLL)	1.20
<b>INDIRECT TAXES</b>	
Tax on Industrialized Products (IPI)	2.90
Tax on Imported Goods (II)	1.00
Other indirect Taxes	1.00
CPMF	1.00
CONFINS + PIS/Pasep	0.26
<b>SOCIAL SECURITY CONTRIBUTIONS</b>	
Social Security Contributions - Public Servants (CPSS)	1.00
Social Security Contributions - Private Sector (RGPS)	0.70
<b>STATES REVENUE</b>	
ICMS	2.00
Transfers	2.00
PRIMARY EXPENDITURE	Elasticity
Unemployment Related Transfers - ( <i>Abono e Seguro Desemprego</i> )	-2.00
Subsidies and Transfers (Subsídios + subvenções sociais)	0.00
Other Current and Capital outlays (OCC)	0.00
Primary Federal spending on personnel	0.00
Other Expenditures	0.00

Source: Mello and Moccerro (2006) and Peres and Ellery Junior (2009)

## (ii) Potential GDP Estimation

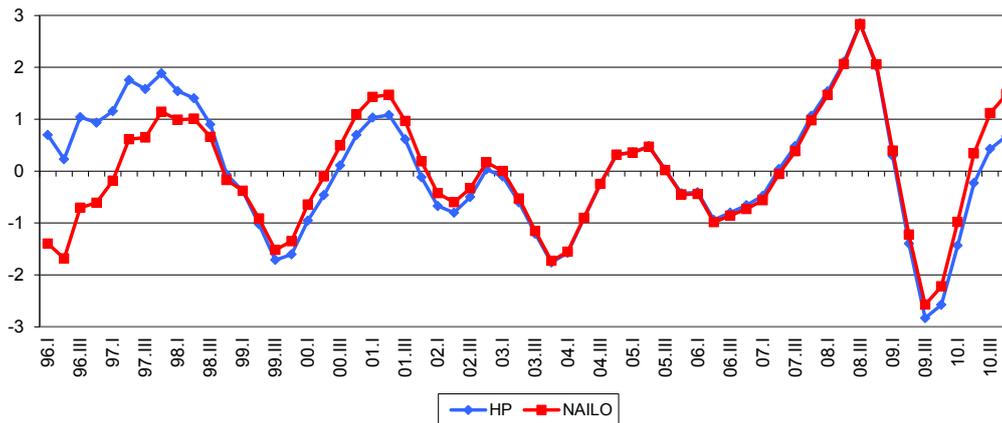
Potential GDP was calculated from the estimation of a Phillips curve for Brazil aiming to obtain the **Non-Accelerating Inflation Level of Output (NAILO)**.<sup>15</sup> We also estimate the Brazilian potential output using the HP filter with parameter equal to 1600 (recommended for quarterly data). In the case of NAILO, estimation involved quarterly data for Brazilian real GDP and for the rate of inflation measured by the extended consumer price index (IPCA), both collected by IBGE (Brazilian Institute of Geography and Statistics) from 1980 to 2010.

<sup>14</sup> For example, Gobetti, Gouvêa, and Schettini (2010) found 1,456 as the median value of their estimates using several econometric methods and model specifications, which compares with a value of 2 used in the estimations below.

<sup>15</sup> See Brito and Lima (2009).

We estimated a model where NAILO is changing over time according to a hidden Markov chain specification, which allows for persistent heteroskedasticity and a richer pattern of time variation. A detailed description of the estimation of NAILO can be found in the Appendix. Figure 9 presents the output gap estimated using NAILO and HP filter methodologies.

Figure 9 - Output Gap (%)



Source: Author's calculations.

### (iii) Estimating primary structural fiscal balances (SFB)

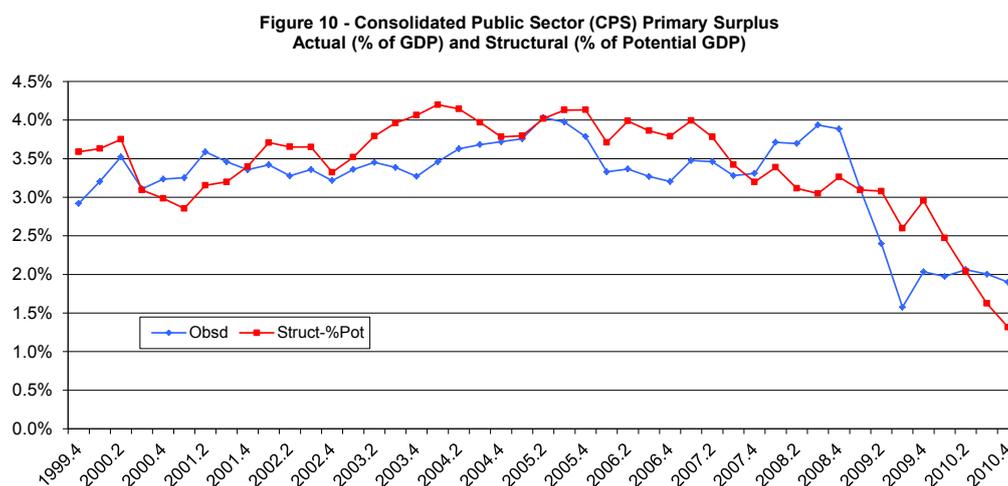
Following the OECD methodology, structural primary balances have been calculated using the elasticities presented in Table 3 and potential output estimated according to the two different methods above described:

$$b^* = \frac{\left[ \sum_i T_i (Y^*/Y)^{\varepsilon_{T_i,Y}} - G (Y^*/Y)^{\varepsilon_{G,Y}} + X \right]}{Y^*},$$

where  $T_i$  and  $G$  are the revenue and expenditure (in our case, unemployment insurance) components sensitive to the business cycle,  $\varepsilon_{T_i,Y}$  and  $\varepsilon_{G,Y}$  their corresponding elasticities with respect to GDP, and  $X$  stands for revenue and expenditure components not sensitive to the business cycle. Because the differences between potential output estimated according to the NAILO and HP filter methodologies are not significant, the results presented below will be based only on the former.

Two major adjustments to the official data have been performed, as discussed in Section 4. First, we have maintained in the primary surplus of the fourth quarter of 2008 the expenditures associated with the Brazilian sovereign fund (FSB), as this was a purely accounting device with no economic impact. This adjustment increases the primary surplus in 2008 by about 0,5 percent of GDP. Second, we have adjusted net revenues associated with the capitalization of Petrobras in September 2010, which implied reducing revenues by about R\$32 billion, equivalent to 0,9 percent of GDP.

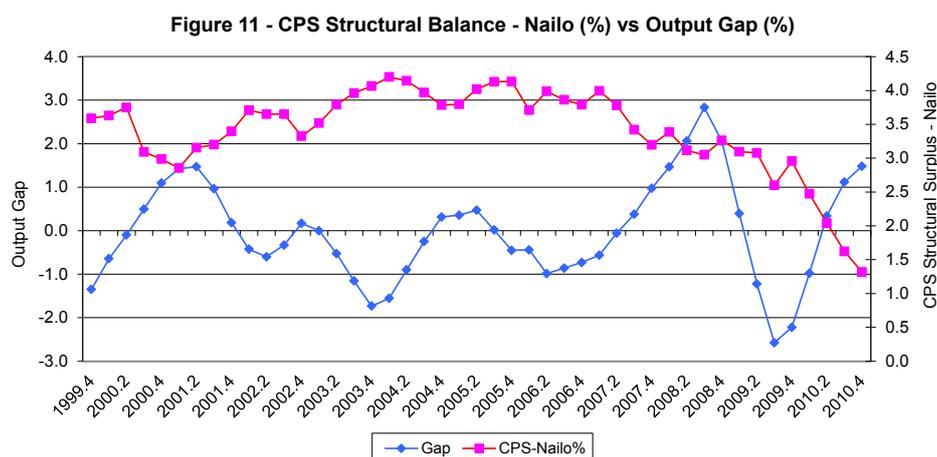
The estimated structural balance trajectory is presented in Figure 10, measured as a percentage of potential output, while actual balances are measured as a percentage of actual GDP. The differences between actual and cyclically-adjusted primary balances are not very large until the end of 2007: for both, the trend is increasing up to 2005, but slightly more intensely for the structural surplus as of 2001, indicating the dominance of debt sustainability factors over cyclical behavior. After 2005, actual surpluses decline almost 1 ppt of GDP, but then increase again to levels close to 4 percent of GDP at the end of 2008. On a cyclically-adjusted basis, however, primary surpluses decline over this period by over 1 ppt of GDP. After that, in response to the crisis, both measures decline to about one half what they were before. In 2010, though, while actual surpluses partially recover, structural surpluses continue to decline until the end of 2010.



Source: Mello and Moccerro (2006) and Peres and Ellery Junior (2009), and author's calculations

According to Figure 10, the usual view that fiscal policy was procyclical might be accurate when considering the period up to 2004, as well as in the most recent period. As mentioned above, structural primary surpluses first declined as the output gap widened in 2000 (when

the economy grew 4.3 percent) but then increased from 2001 through the middle of 2004, a period in which the average growth was relatively low, of 1.7 percent on average, and actual surpluses remained roughly constant, at 3.5 percent of GDP. That can be seen more clearly when we plot the structural primary surplus and the output gap, both calculated according to the NAILO methodology, as in Figure 11 below.

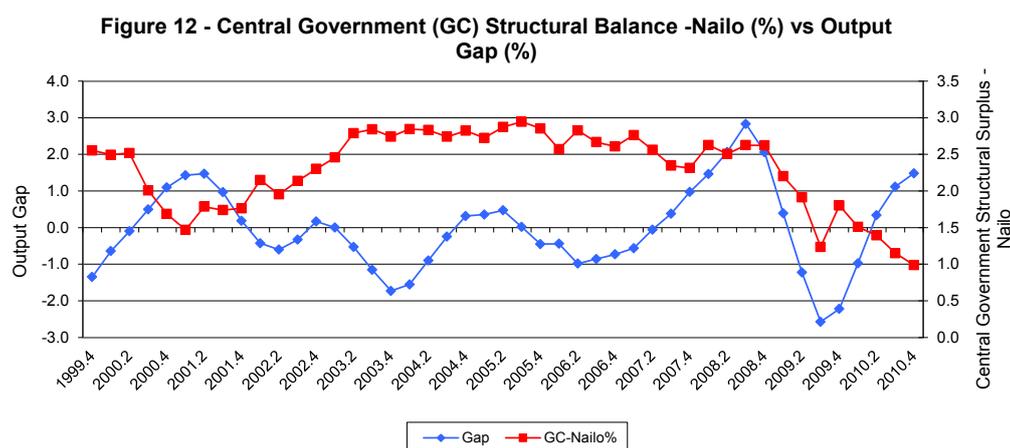


Source: Mello and Moccero (2006) and Peres and Ellery Junior (2009), and author's calculations

In the figure, structural primary surplus for the consolidated public sector (CPS) increased from 2.7 percent to over 4 percent of GDP, while the economy's output gap went from 1.4 percent to -1.6 percent between the first quarter of 2001 and that of 2004. Fiscal policy remained then roughly neutral, with the structural surplus oscillating around 4 percent of GDP up to 2006. Procyclicality would show up again as the economy rebounded after 2006 to peak in 2008, period over which primary surpluses declined from close to 4 percent of GDP to 3 percent of GDP. The trend towards lower structural surpluses would continue as a response to the recession in the beginning of 2009, this time on a clearly counter-cyclical pattern. That feature, however, was to be short lived as the economy rapidly recovered, but primary surpluses failed to do the same and continued to decline.

The behavior of the consolidated public sector is replicated at both central government and states and municipalities, perhaps with a stronger contribution of the latter. In Figure 12, the central government's cyclically-adjusted primary surplus trajectory is compared with that of the output gap. Similarly to the consolidated public sector, a procyclical behavior is discernible between 2000 and 2004, neutrality would best characterize the period up to 2006, which was to be followed again by a slight procyclical behavior, this

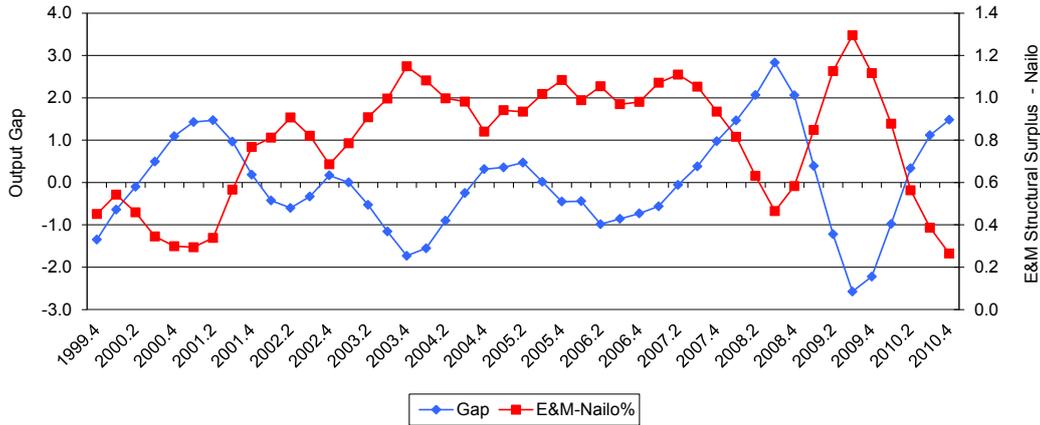
time in the form of lower primary surpluses along with a strong upward trend of output. A strong countercyclical fiscal policy was the response to the crisis over 2009, but, after a blip reflecting extraordinary, one-off revenues, the structural primary surplus continued to decline even after the economy recovered to resume an output gap similar to the one recorded right before the crisis.



Source: Mello and Moccero (2006) and Peres and Ellery Junior (2009), and author's calculations

The pattern followed by states and municipalities was also strongly procyclical as shown in Figure 13. That is somewhat surprising given the analysis of fiscal policy in Brazil in sections II and III, where it was highlighted that the debt renegotiations involving the states and the federal government produced significant results in terms of the formers' performance. The Fiscal Responsibility Law complemented that movement by establishing enforceable limits to debt levels as well as to key expenditures in relation to their net revenues. The fact that interest payments on the renegotiated debt were linked to net current revenues would lead one to expect a countercyclical behavior, with the primary surplus expanding with the economy and revenues and contracting (due to lower interest payments) in the opposite situation. A simple regression, with 12 observations, implies that a 1 ppt of GDP increase in states and municipalities revenues should lead to a 0.44 ppt of GDP increase in the primary surplus. In the picture, however, the pattern is clearly procyclical, even more than at the central government. This pattern has also been found in other studies, as Arena and Revilla (2009) and World Bank (2010).

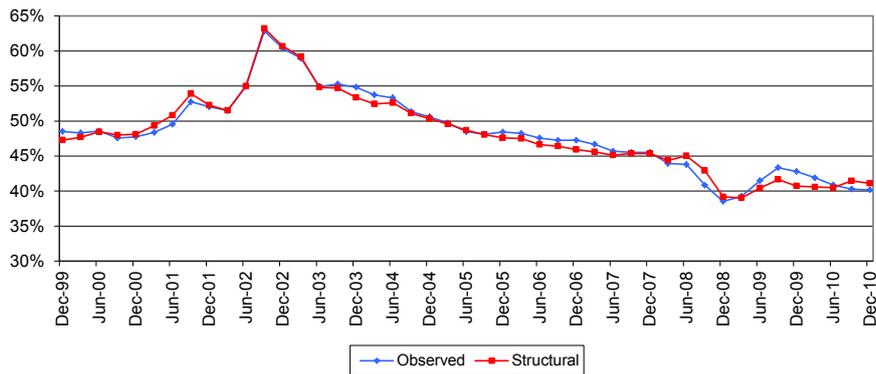
**Figure 13 - States & Municipalities (E&M) Structural Balance - Nailo (%) vs Output Gap (%)**



Source: Mello and Moccerro (2006) and Peres and Ellery Junior (2009), and author's calculations

A simulation of the trajectory of public debt that would have been followed by the Consolidated Public Sector, had the primary surplus been adjusted for cyclical effects is presented in Figure 14. There is no significant effect of cyclical fluctuations on the level of the public debt, as the differences between observed and cyclically-adjusted primary surplus were relatively minor over most of the period. At the end of the period the debt calculated on the basis of structural balances is larger than the actual one, reflecting the very low levels of structural primary surpluses associated with the expansionary fiscal policy.

**Figure 14 - Structural and Actual Debt - CPS (% of GDP)**



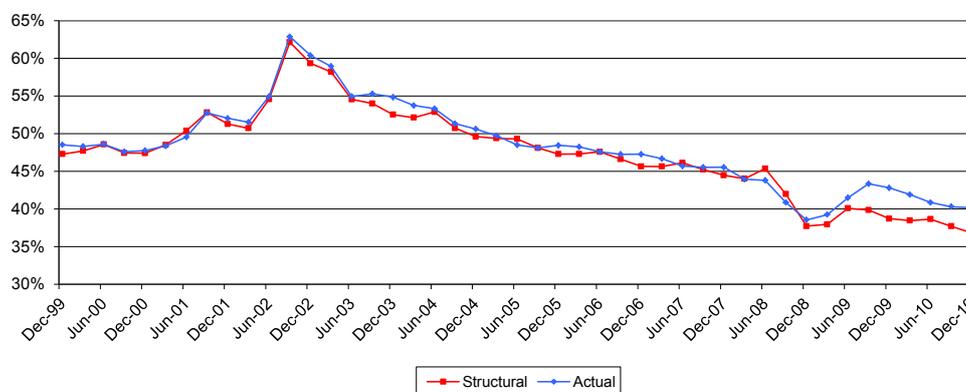
Source: Mello and Moccerro (2006) and Peres and Ellery Junior (2009), and author's calculations

The same pattern is followed at the central government and subnational levels. This might be the result of the fact, as noted above, that the differences between structural and actual primary balances were not very large. Also, the short time span for which the simulations were carried out might have contributed to this apparently negligible effect that a potential

SFB-based fiscal rule could have had on the debt trajectory. However, fiscal policy turned very expansionary after 2009, even as the economy recovered from the relatively brief contraction spell. The maintenance of this pattern could then produce a larger difference between actual and simulated debt paths, which is not captured in the graph. Another source of bias in the debt simulation stems from the fact that implicit interest rates are taken as given in the simulated debt path, even though they could have responded to the perceived fiscal policy stance if it had followed a different path.

These caveats notwithstanding, a simulation of the effect of a 3.5 percent structural primary surplus rule on the net public debt of the consolidated public sector was carried out and its results are shown in Figure 14. As expected this has not affected the trajectory of public debt on a substantial way, for 3.5 percent of GDP is approximately the primary surplus annual average between 1998 and 2008. The only major difference appears towards the end of the period, due to the sharp reduction in primary surpluses, both structural and observed, due to the crisis. At the end of 2010, the net debt to GDP ratio could have been 3.4 ppt to GDP lower than what was actually observed.

Figure 15 - CPS Net Debt Simulation with a 3,5% SFB Rule (% of GDP)



Source: Author's calculations

The dynamic government budget constraint might be approached through an accounting identity linking monetary and fiscal policies at each point in time and across time. The government budget constraint for period  $j$  can be written in nominal terms as<sup>16</sup>

$$B_j = (T_j - G_j) + (M_{j+1} - M_j) + B_{j+1}/(1 + i_j) \quad (1)$$

<sup>16</sup> We are assuming the government issues nominal liabilities ( $M$  and  $B$ ); while the nominal values of these liabilities are fixed at the beginning of the period, their real values depend on the price level.

where  $M_j$  and  $B_j$  are the stocks of base money and government debt at the beginning of period  $j$ ,  $T_j - G_j$  is the primary surplus during period  $j$ , and  $i_j$  is the interest rate for period  $j$ .

Expressing the budget constraint in terms of total government liabilities,  $M + B$ , and scaling the fiscal variables on GDP, we have that

$$\frac{M_j + B_j}{P_j y_j} = \left[ \frac{T_j - G_j}{P_j y_j} + \left( \frac{M_{j+1}}{P_j y_j} \right) \left( \frac{i_j}{1 + i_j} \right) \right] + \left( \frac{y_{j+1}/y_j}{(1 + i_j)(P_j/P_{j+1})} \right) \left( \frac{M_{j+1} + B_{j+1}}{P_{j+1} y_{j+1}} \right) \quad (2)$$

Equation (2) can be written synthetically as

$$w_j = s_j + \alpha_j w_{j+1} \quad (3)$$

Where  $w_j$  are the liabilities to GDP ratio,  $s_j$  is the surplus (including seigniorage) to GDP ratio, and  $\alpha_j$  is the discount factor represented by the ratio of the real growth in GDP to the real interest rate.

Taking further on the simulations, it is possible to determine the required primary surplus to achieve a pre-determined trajectory for the net debt to GDP ratio. For instance, considering alternative hypotheses about the real rate of interest on public debt and the rate of growth of GDP, what would be the primary surplus needed to achieve a reduction of the consolidated public sector net debt to GDP ratio from its size of 40 percent of GDP at the end of 2010 to 30 percent of GDP within 10 years. Solving forwardly equation (3) we obtain the results that are presented in Table 4.

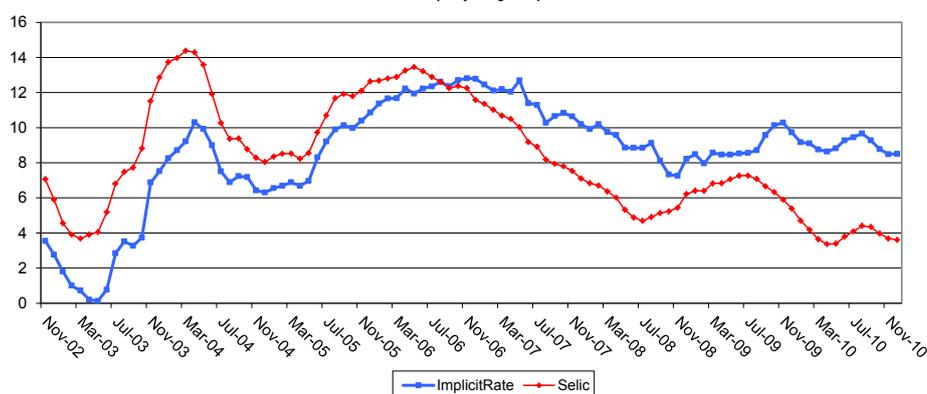
Table 4 - Primary Surplus to reduce Net Debt to GDP ratio from 40% to 30% in 10 yrs

Interest Rate ▶						
GDP growth ▼	4.0	5.0	6.0	7.0	8.0	9.0
3.0	1.6	2.0	2.3	2.6	3.0	3.3
4.0	-	1.6	2.0	2.3	2.6	2.9
4.5	1.1	1.5	1.8	2.1	2.5	2.8
5.0	0.9	-	1.6	2.0	2.3	2.6
5.5	0.8	1.1	1.5	1.8	2.1	2.4
6.0	0.6	0.9	-	1.6	2.0	2.3

Source: Author's calculations

Current estimates have potential, non-accelerating inflation GDP growing 4 percent per year. As shown in Section 4, the implicit interest rate on net public debt is much higher than the interest rate falling on bonded public debt mainly due to sterilized reserves accumulation and, more recently, to increased funding of BNDES by the Treasury. Both involve a mismatch between the interest rate falling on federal government liabilities and that accruing to its assets. This situation is depicted in Figure 16.

Figure 16 - Ex-post Real (IPCA) Selic and Implicit Interest Rate on Net CPS Debt (% per year)



Source: Author's calculations

The implicit ex-post real interest rate has hovered around 9 percent per year lately, while the real Selic rate is around 4 percent per year. Taking the 9 percent per year real rate as a reference for the implicit rate and potential growth at 4 percent per year, the primary surplus required to bring the net debt to GDP ratio to 30 percent in 10 years would be around 3 percent of GDP. This means that policy would have to be significantly tightened in the following decade, as the structural primary surplus at the end of 2010, according to our estimates, was only 1.3 percent of GDP.

Table 5 presents calculations of the required primary surplus to maintain constant the net debt-to-GDP ratio, once this 30 percent target is achieved, again considering different hypotheses for the real interest rate and output growth. Obviously, as the target is achieved the surplus can be lowered: all else constant, the surplus, for the same parameters simulated above, could be lowered by half, to 1.4 percent of GDP.

Table 5 - Primary Surplus to maintain Net Debt to GDP ratio at 30%						
Interest Rate ▶	4.0	5.0	6.0	7.0	8.0	9.0
GDP growth ▼						
3.0	0.3	0.6	0.9	1.1	1.4	1.7
4.0	0.0	0.3	0.6	0.8	1.1	1.4
4.5	-0.1	0.1	0.4	0.7	1.0	1.2
5.0	-0.3	0.0	0.3	0.6	0.8	1.1
5.5	-0.4	-0.1	0.1	0.4	0.7	1.0
6.0	-0.6	-0.3	0.0	0.3	0.6	0.8

Source: Author's calculations

These exercises allow us to suggest a structural primary surplus target to be pursued. The implicit cost of the consolidated public sector net debt has increased recently due to factors that might be considered temporary. A decline of the domestic-international interest rate differential, as well as of the subsidies involved in the funding of BNDES, might not be unreasonable, bringing the real cost of net public debt to around 8 percent per year. That would give us, for a gradually accelerating potential growth rate of GDP to 4.5 percent, a primary structural surplus of 2.5 percent of GDP to achieve the desired net debt-to-GDP ratio.

## 5.2 Brazil's Fiscal Framework and SFB Rule

Brazil's fiscal framework, as described previously, may be characterized by three main components: the states' debt renegotiation agreements; the Fiscal Responsibility Law and the budget process. Two other features are worth stressing: the high degree of rigidity of expenditures and the centralization of tax revenues at the federal level, although Brazil is probably a federation where the states enjoy one of the most significant degrees of tax autonomy. Is this framework consistent with the implementation of SFB rule?

Gutiérrez and Revilla (2010) summarize the pre-conditions for the implementation of countercyclical fiscal policy, and they seem to be met by Brazil. Considering the aspects under the heading of "transparency and institutions" in their paper, Section III tried to argue in favor of the strength of fiscal institutions that developed in Brazil over the past ten to fifteen years and went on in the end of Section IV to point that this is a process still running its course, as new legislation aiming at correcting imbalances and distortions existing in the current framework are now being debated in Congress. Both the FRL and the provisions in

the states' debts renegotiation agreements were subject to proposals of change by the executive or the Congress, but only two changes in the past ten years did in fact go through, both of minor consequences. Part of that resilience comes from the fact that the FRL is a complementary law, where changes require absolute majorities in two rounds of voting in the two chambers. On the other hand, it has also been emphasized that there has been a weakening of the resolve in pursuing more austere fiscal policies in the last two years, as shown by a clearly procyclical fiscal policy in 2010 at the federal level, followed by a reduction of fiscal transparency due to the use of creative accounting mechanisms that blurred the actual deterioration in primary surpluses

Other aspect raised as precondition for counter-cyclical fiscal policy under this heading is the timeliness, accuracy, relevance and reliability of fiscal statistics: even though there could be improvements at the states and municipalities' levels, the reporting of fiscal accounts in Brazil, as determined by the FRL, is very thorough. Also, the accuracy of the reports is subject to close scrutiny by National Treasury secretariat—in the context of the FRL and of the agreements that resulted from the states' debts renegotiations—as well as by the *Tribunais de Contas* – Fiscal Courts, which are bodies related to the Legislative branch at each government level with the mandate to monitor and audit fiscal behavior by the three government branches and that are charged with the responsibility of making sure that public administration rules, like procurement processes, are being followed and, after the FRL, that performance targets or spending limits are met.

Aggregate fiscal accounts are released about three weeks after the end of the month by the Central Bank using the “below the line” (financing approach) concept; in the case of the central government, the monthly results are also presented according to the Treasury's “above the line” discrimination of revenues and expenditures. Because of close scrutiny by the public in general, but especially by financial market analysts, there is not much room for fiddling with concepts or figures without being detected. However, as mentioned before, the federal government has used the definition of public sector, which excludes public financial institutions from fiscal accounting, to generate revenues through the issuance of debt that is then transformed into loans to these institutions. Due to this artifice, many have claimed that the relevant concept to assess fiscal policy sustainability should move from net to gross public debt. Also, due to some conceptual loopholes, the states and the Congress have been able to manipulate the concepts of net current revenues and payroll in order to reduce states'

compliance with FRL-imposed payroll and debt ceilings. However, this is about to be dealt with through the new legislation being proposed under the Budget Responsibility Law.

One aspect regarding the soundness of fiscal institutions refers to the ability of public bodies outside the budgetary process “to impose hard budget constraints on the public sector as a whole, particularly if coupled with sanctions for non-compliance” (p. 36).

The approval of the FRL was accompanied shortly after by that of the Fiscal Crimes Law which set the administrative and criminal penalties for non-compliance, including imprisonment at the individual level. As argued by Melo *et al.* (2010), the enforcement of the Brazilian FRL requires an external enforcer, the *Tribunais de Contas*, as a central element of fiscal governance. These fiscal courts have shown a general trend towards greater professionalism and independence from the State executive in most states after the 1988 Constitution, but there remains some room for political influence in their composition, particularly on the least politically competitive states (Melo *et al.*, 2010, p. 50) These authors show that the degree of FRL’s breaching may be related to the strength and independence of these fiscal courts: accounting tricks are proxied by the volume of *restos a pagar* (deferred payments of committed expenditures) and the impact of the fiscal courts by the ratio between the number of auditing processes and the number of administrative units under their jurisdictions. The relationship is controlled by the political environment in each state, the degree of independence of the fiscal court, as captured by the presence of a senior auditor and / or a public prosecutor in the court’s board, and the results point to a positive influence of the fiscal courts on compliance with responsible fiscal behavior. The conclusion is that “the Achile’s heel of the [FR] law is the quality of subnational institutions and the degree of political competition” (p. 57)

The issue of deferred payments (*restos a pagar*) from one year to the following has also been widely used by the federal government as a means of artificially inflating its primary balance so as to meet targets set in the LDO. This is a form of *floating debt* not captured by Central Bank fiscal statistics, and have reached over R\$ 100 billion at the end of 2010 only in *non-processed* outlays, i.e., those that have been *committed* but whose conclusion has not been recognized. Obviously, the problem is not with the level, but with the growth as it allows for higher expenditures without affecting the primary surplus of a certain year, although this eventually will have to be paid.

Other precondition for the implementation of counter-cyclical fiscal policies, according to Gutiérrez and Revilla (2010) relates to the “credibility and feasibility” of fiscal policy and institutions. Specifically, “having a track record of satisfactory compliance” and

“improve budget formulation, execution, and reporting, and strengthen accounting and statistical standards” are conditions that have been shown above (sections 3 and 4) to be present and evolving in the right direction in Brazil. However, the need for fiscal policy to “be supported by well-specified future policy measures, including, if necessary, deep structural reforms” is clearly a weak spot as it involves dealing with two sensitive issues: the tax reform and the social security reform. The first is a necessity when it is observed the distortions that characterize the Brazilian tax system and that result in a considerable degree of inefficiency and regressiveness. The second relates to the long term sustainability of fiscal policy, and although it has been object of previous reforms, current demographic trends point to the need of a more effective approach to deal with the ageing of the population and increases in life expectancy. Important as they may be for long term debt sustainability, however, these two factors do not seem to be insurmountable hurdles in the way of implementing an SFB rule.<sup>17</sup>

In a recent article, Mendes (2009) argues that the Brazilian system of planning and budget execution is conditioned by two important features of Brazilian political system: the electoral and political incentives to increase current public expenditures and the difficulty faced by the Executive branch to form majority coalitions in Congress. As result, the Brazilian fiscal regime holds a precarious balance in which the government tries to simultaneously meet fiscal targets while spending as much as possible of those outlays that interest its supporting coalition in Congress.

The result, as noted in Section 2, has been a trend towards an ever increasing tax burden, coupled with mechanisms of withholding spending, especially investments, whose execution becomes contingent on the realization of revenues (contingency mechanism). In the process of debating the government’s budget proposal for the following year, the incentives structure leads the Congress to overestimate fiscal revenues in order to accommodate its spending amendments. Congressmen know that these expenditures’ realization will be contingent on actual revenues, but also believe that they will succeed to free them in the bargaining-for-support game between the government and its supporting coalition. By the same token, it provides the government with a tool to bargain political support without necessarily threatening the fiscal targets.

In the context of a potential SFB rule, the fact that the execution of the budget approved by the Congress is not mandatory is a useful mechanism, as it could allow budget

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<sup>17</sup> See Ter-Minassian (2011).

execution to follow the desired counter-cyclical trajectory by responding to the economy's performance and its impact on revenues collection. However, as it breaks with the link that takes from the PPA to the LDO to the annual budget, it tends to reduce the quality of fiscal spending and hence of public policies.

In fact, among the main features of the Brazilian fiscal and budgetary framework, probably the rigidity of the budgets stands out as a major hurdle to be overcome, especially regarding the large volume of revenues' earmarking. Although they are not an impediment to an SFB rule, it tends to reduce the scope for countercyclical fiscal policies. From an allocation perspective it tends to increase the volatility of non-protected expenditures, usually investments, which are the preferred targets for cuts in the case of the expansionary phase of the cycle. The rigidity in the budget has been dealt with at the beginning of each year by means of non-earmarked, non-mandatory expenditures withholding. That in turn creates several inefficiencies, as these expenditures mainly tend to be investments, while at the same creating a source of political bargaining that may be detrimental to efficiency and transparency. So, although the excess of current, mandatory expenditures may not preclude the implementation of a SFB rule, it seems to reduce its potential benefits for fiscal policy and the economy.

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