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WHO DECIDES ON PUBLIC EXPENDITURES? A POLITICAL ECONOMY ANALYSIS OF THE BUDGET PROCESS: THE CASE OF BRAZIL

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I - Introduction

In this project we analyze the budgetary process to determine who decides on public expenditures in Brazil. The focus is not so much on the actual fiscal outcomes that emerge from the budgetary process, but rather on the policy making process that generates those outcomes. This involves looking not only at the budgetary rules and institutions but also at the political institutions that determine the players involved, their motivations, their incentives, and their power. In essence: who can initiate proposals that affect the budget and spending, who can vote, who can veto, and what is the sequence in which these actions take place? The political institutions set the formal and informal rules under which these players interact, that is, the policy making game. The policy space, i.e., also influences the game and the outcomes. The acts of crafting, approving, executing and controlling a budget give rise to specific types of inter-temporal political transactions among the various players that set the stage in which the budgetary policy making game takes place. The final outcomes from this game will vary over time as they are affected as well by economic and political shocks. However, the outcomes will tend to have certain characteristics that we repeatedly observe. For the outcomes of the budgetary process the most important characteristics relate to the efficiency, representativeness and sustainability of those outcomes. Efficient outcomes occur when the marginal budgetary allocations provide equal benefits to society across all potential spending possibilities. Representative outcomes are those that mirror the preferences of society rather than those of specific groups. Outcomes are sustainable when they can be replicated over time without resulting in economic crises. In this project we describe the characteristics of budgetary outcomes in Brazil in terms of these criteria by showing how those outcomes map into the country's political institutions.

This project follows another paper by the authors that applied the same framework to the general policy making process in Brazil.[1] In that paper the focus was broad, covering all policy areas and all major political players. In this paper our interest is on the budgetary process, which is a key component of the general policy making

[1] Alston, Melo, Mueller and Pereira (2004). "Political Institutions, Policy Making Processes and Policy Outcomes" IADB Research Dept.

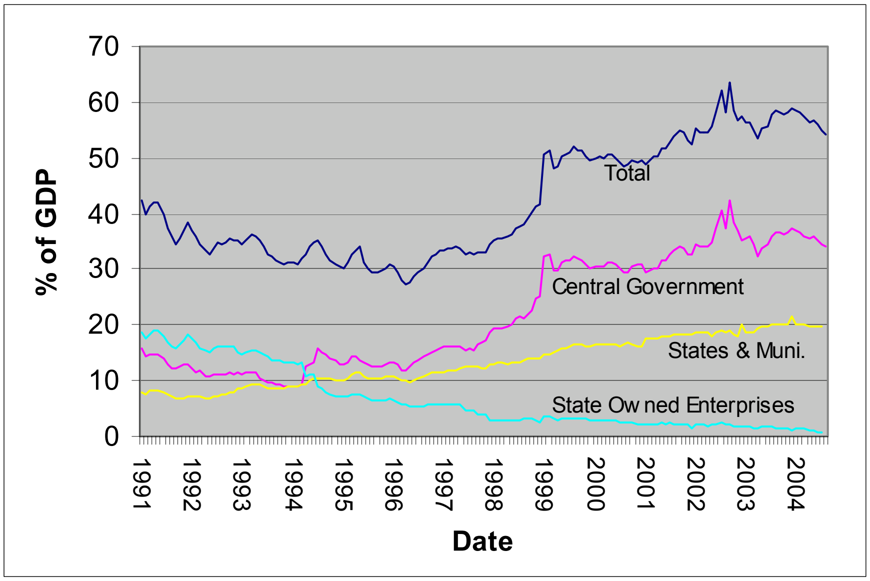
process. However, here we delve in greater detail into the incentives and constraints posed by political institutions and the way in which these specifically affect budgetary outcomes. Whereas the same framework applies, the characteristics of budgetary policy issues present new elements on which we did not elaborate in our earlier study. One example is the restrictions on the President generated by the hardwiring of much of the budgetary expenditures. Whereas these restrictions were identified in the previous study and played an important role in the general framework, there was little information provided on the actual level of those restrictions and the mechanism through which they operate. In this paper we explore these issues in detail. We show that the constraints posed by hardwired expenditures are very large, covering more than 80% of the budget and thus significantly restricting the Executive's choices. We analyze how and why these restrictions are created and how they affect the budgetary outcomes in terms of efficiency, representativeness and sustainability. In addition we analyze how and why the restrictions remain binding despite the high levels of presidential power. That is, what are the institutions that prevent the President from using his dominant powers to change or circumvent those restrictions given that they are truly binding?

In Section II we review the literature on budgetary outcomes in Section III we describe our general framework along with its application to the budgetary process and the hypotheses that emerge. Briefly the idea is that political institutions provide the President with a wide and powerful array of instruments with which to pursue his policy preferences, such as decree and veto power as well as the ability to dispense pork to Congressmen. Most importantly political incentives to care for economic growth and stability influence the President's preferences over budgetary outcomes. In addition global financial markets, which are extremely sensitive to countries' policy choices, provide further incentives for macroeconomic discipline. Furthermore, despite the high levels of presidential powers, these are not absolute. There are a series of constraints that effectively restrict what the President can do. Among these checks are the judiciary, the Constitution and public prosecutors. The result is that having a strong president, subject to incentives to pursue 'good' economic policy within a supporting institutional framework, yields a policy making process that has several merits, among them the capacity to adapt to shocks and the tendency to move toward sound reform, even if at a gradual pace.[2] This is not to say that policy outcomes have been outstanding in Brazil. Clearly economic growth and several other indicators have left much to be desired in the period under study (since the Constitution of 1988). However, over this period much has been accomplished in terms of reform, despite several internal and external shocks. This includes not only more obvious achievements, such as the end of inflation, economic liberalization, privatizations and regulation, but also a less visible process whereby many unsound fundamental Constitutional provisions have been gradually changed over the years, such as the recentralization of the federalist structure, which has been crucial for allowing the President to pursue fiscal discipline. The upshot is a gradual, if bumpy, process through which reform and institutional strengthening mature and generate the basis for future positive economic outcomes.[3]

As with the general policy making process, the same analysis holds for the budgetary process. Despite a laudatory process, Brazil's fiscal history over the past decade places the country with the underperformers and points to the existence of severe fundamental problems. Figure 1 shows the net debt of the public sector as a percentage of GDP from 1990 to 2004, including states, municipalities and state-owned enterprises. Not only has the level of debt been at very high levels throughout the whole period, but the tendency appears to indicate an unsustainable path as the average level for the period since 1999 has increased substantially compared to the average prior to that year. This data certainly does not seem compatible with our claim about the merits of the Brazilian policy making process which this paper extends to the budgetary process.

[2] In Alston, Melo, Mueller and Pereira (2004) we provide examples of the country's adaptation to an economic shock (devaluation of 1999) and a political shock (election of President Lula in 2002). In that paper we also elaborate at greater length as to why the poor economic performance of the past years is not contradictory to our claim that the policy making process is sound.
[3] For a similarly positive assessment of the evolution of Brazilian economic policy in the past years see Giambiagi (2003).

Figure 1 – Net Debt of the Public Sector (% GDP).



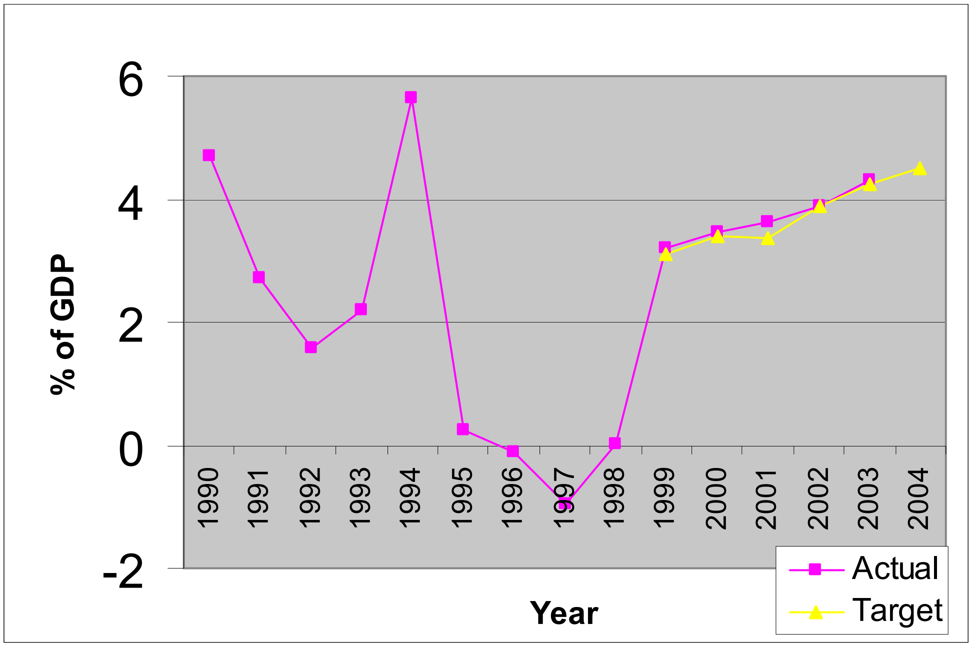
Source: Banco Central do Brasil, Boletim de Finanças Públicas.

However, simply looking at policy outcomes, such as the data in Figure 1, misses much of the underlying context through which policy making has evolved over the period since 1988. The early period since the Constitution and until 1994 was a convoluted time. High inflation made the process of crafting and executing a budget extremely difficult due to the uncertainty of future price levels, though it did facilitate things for the government by depreciating the public debt. In addition combating inflation also absorbed much of the government's efforts. The impeachment of President Collor in 1992 also set back efforts at reigning in expenditures. Nevertheless, even with these diversions Congress and the President implemented important changes to the budgetary process most of which recentralized power which the Constitution, in a reaction to the previous period of military rule, had dispersed to states and municipalities. The budget scandal of 1993 catalyzed the changes and set the stage for a series of reforms to the budgetary process in the subsequent years, as we describe in detail later in this paper. It is important to note that this process of reform did not lead to immediate results. Several severe fiscal problems prevailed and the debt of the public sector remained at dangerously high levels. Nevertheless these changes were necessary steps that had to be undertaken.

With the end of inflation, in the first term of the Cardoso government, fiscal policy became even more lax and the public sector's debt started to grow at alarming rates (see Figure 1). This behavior was clearly unsustainable and exacerbated the perception of Brazil as a fiscal problem case. An overvalued exchange rate and fiscal profligacy lead to several speculative attacks against the currency and after the Mexican, Asian and Russian crisis all bets were that Brazil would be next to succumb. During this period Congress passed several crucial structural reforms and with the end of inflation and increased incomes the President experienced high levels of popularity, allowing him to easily clinch reelection in 1998. In the year before the reelection it was already clear that the fiscal situation and overvalued exchange rate were unsustainable, however they had to be propped up in typical electoral cycle behavior. The important point to note is that once the election was won and the devaluation allowed to occur in January 1999, the government was faced with a very severe credibility problem where the only way to avoid a prolonged and destructive crisis would be to signal to the markets the government's intent and ability to regain fiscal control. Given the country's image as an underperformer in this area, this was not an easy task and most prognoses were pessimistic.

Nevertheless, now that it was absolutely crucial that fiscal discipline be adopted and signaled to the markets, the government met the challenge. Starting in 1999 and lasting to the present day the government has set tough primary surplus targets, accorded with the IMF, and has systematically met those targets (see figure 2). It is important to stress the immense effort that meeting these targets has required of the government. It involves systematically denying expenditures that have been approved in the budgetary process and that have important constituencies. We find it remarkable that the government has not only been willing and able to go through with the unpleasant politics of achieving these surpluses. It is consistent with our framework where the President is the dominant player and faces virtuous incentives. Only by having immense powers to control the budgetary process, in particular in the execution phase has it been possible for the President to overcome the natural resistance to expenditure cuts and assure the primary surpluses. In a particularly telling test to our framework, even President Lula adopted and even intensified the same strategy of pursuing high primary surpluses so as to establish and maintain credibility, despite a history of opposition to exactly such behavior.

Figure 2 – Primary Surpluses – Targets and Actual.



Source: Banco Central do Brasil, Boletim de Finanças Públicas.

The point of the foregoing description of Brazilian recent budgetary history is that political institutions are such that the budgetary process dominated by a strong President has the propensity to yield positive outcomes, even if this has been slow to materialize. The budgetary policy making process has been evolving over time, together with the general policy making process, in a way that should be conducive to more responsible fiscal behavior. An important example of this is the Fiscal Responsibility Law (FRL) passed in the wake of the 1999 crisis. As described in greater detail later, the FRL in Brazil has been effective in constraining federal, state and municipal governments and as such decisively contributing towards fiscal discipline. Once again this is quite remarkable as the simple passage of a law is generally insufficient to change deep-rooted fiscal behavior. In order to understand why the FRL in Brazil has proven to be effectively binding (in its still brief existence) it is necessary to consider once again the political institutions, in particular the dominant role of the President and his interest that the law is binding.

It is important to stress again that we are not arguing that all is well with the budgetary process in Brazil. If we were to suggest an ideal system it would certainly be much different. Even within the more realistic exercise of sticking to the current system there remain several troubling problems that would have to be reformed to allow for a more sensible budgetary process and better outcomes. What we have been arguing instead is that the policy making game behind the process in Brazil is such that the system has been evolving in a positive manner. Whereas it previously seemed a paradigm of unsustainability, now even a Labor Party government places fiscal responsibility above all other policy goals, even those long central to their party line and ideology. Though outcomes are clearly not as representative as could be desired, the system does protect several social interests through hardwiring of a large set of expenditures. Though this is clearly not the best way to achieve some representativeness, as the inflexibility has its own costs, given the extant political institutions it may be better than alternative arrangements. Note that the ability to hardwire policies is not trivial and requires several supporting institutions, especially in the context of strong presidentialism, as the President will frequently be the player that is constrained by those rules. In the absence of the ability to hardwire, outcomes could turn out even less representative.

Similarly the budgetary process is clearly not efficient in the sense that expenditures and use of public monies do not lead to the highest possible social return. While the hardwiring of expenditures protects some laudable expenditures it similarly prevents the government from making changes that could increase the efficiency of public spending, as we show in Section V. These inefficiencies can be seen as the cost of not having political institutions that support the type of inter-temporal political transactions that would allow for better outcomes. A test of our claim that the policy making process in Brazil is evolving positively, if slowly, over time is whether the pressure that is mounting for greater flexibility in several of the most waste-inducing rigidities in the budget.

Another point regarding the efficiency of the budgetary process in Brazil is the need for the President to dispense pork to congressmen in exchange for legislative support. Whereas several authors have identified this behavior as a major source of inefficiency in the Brazilian policy making process we argue that the actual cost of this patronage is very small. Not only is the actual magnitude of these transfers small, but also they often take a form that yields a social return, e.g., often infrastructure projects.

Though this form of allocating public spending is not ideal and often will not lead to the most efficient use of resources, it is similarly less wasteful than many conceivable realistic alternatives, with the advantage of providing the President with a low cost means to purchase legislative support.

We conclude this paper with by examining several reforms to the budgetary process in Brazil that have been proposed by politicians and academics. This will be analyzed in the context of our framework and, to be meaningful, with the extant political institutions as constraints. Finally we present our own policy recommendations.

II – Literature Review on Political Economy of the Budgetary Process

The existing literature on political and institutional variables related to budgetary decision-making can be roughly divided in two groups: The first group of authors considers how differences among electoral and party systems affect the size of budget deficits. The second group focuses mainly on the governmental institutions that regulate the annual budget as well as on the executive's power and dominance on budgetary process. In general terms, the "electoral institutionalists," as they are called by Hallerberg and Von Hagen (1997), argue that coalition governments are associated with larger costs than single-party governments (Poterba, 1994) and that power dispersion increases the chances of fiscal profligacy. In this respect, Roubini and Sachs (1989: 905), for instance, argue that "when power is dispersed, either across branches of the government (as in the US), or across many political parties through the alteration of political control over time, the likelihood of inefficient budgetary policy is heightened. Thus we find that the size and persistence of budget deficits in industrial countries in the past decade is greatest where there have been divided government (e.g. multi-party coalitions rather than majority-party government)." Other scholars argue that expenditures grow as the number of legislators and political parties increase, and that the budget approved by a coalition is larger than the expected budget supported by a single-party majority (Weingast 1979; Shepsle and Weingast 1981). In multiparty legislatures, as the effective number of parties increases, coalitions become unstable and, because the norm of universalism, the size of the budget grows (Scartascine and Crain, 2001). Electoral systems with proportional representation combined with large districts are more likely to produce weaker governments than plurality rule systems (Stein, Talvi, and Grisanti, 1998). This position is shared by Hallerberg and Marier (forthcoming) who point out that "the level of the Common Pool Resource problem in the legislature depends upon the type of electoral system. If states have open list proportional representation systems, then increases in district magnitude increase the problem, while under closed lists increases in district magnitude decrease the problem." Alesina (1987) and Alesina and Rosenthal (1995) also claim that coalition governments face greater difficulties on implementing fiscal adjustments as well as on responding to budget unbalance than unitary governments.

Several case studies on Brazil have lead to similar findings. For example, Amorim Neto (2001) argues that broad and low-cohesive coalition governments should be associated with larger deficits. Thus, the greater the size of the presidential party within Congress, the smaller the side-payments needed to build legislative majorities. According to Ames (2001), given the Brazilian federal structure and its electoral system (open list PR), the president can rarely avoid paying a high price, in pork and patronage, for legislative support. Finally, the political use of public resources in the form of patronage, clientelism, and patrimonialism, according to Mainwaring (1999), not only produces high costs but clearly impedes the addressing of popular preferences and collective solutions in Brazilian politics.

Another strand of the literature ("fiscal institutionalists") puts the emphasis on procedural constraints and agenda control. The presence of a strong finance minister along with a powerful executive, the structure of the budget process itself, how the legislature deals with government's proposed budget, how the budget is implemented and executed, and whether there are any ex-post veto or control are the key elements that force the decision makers (especially in Congress) to take into account "the true benefits and costs of increased spending and taxation" (von Hagen 1992; Alesina, Hauseman, Homes, and Stein 1995). The idea is that delegating authority to a fiscal entrepreneur (i.e. a strong Finance Ministry in the Executive) increases the chances of cooperation. To be effective, this entrepreneur must have the ability to monitor the others, possess selective incentives that can be used to punish defectors and/or reward those who cooperate, and have the motivation to bear the costs of monitoring himself.

Acosta and Coppedge (2001), in a more extensive study on Latin American countries, claim that the presidents' partisan powers have a direct and powerful effect on spending and only an indirect effect on deficits per se. That is, "Latin American Presidents who wished to restrain spending in the 1980s and 1990s achieved this goal to the extent that they could depend on extensive, disciplined support in Congress. However, these same institutions also helped other presidents accelerate spending if that was their goal."

Hallerbergh and von Hagen (1997) put forward that:

> "these two literatures complement one another. Electoral institutions matter because they restrict the type of budgetary institution which a state has at its disposal at the governmental phase. A strong finance minister is feasible in states where one-party governments are the norm, and such states usually have plurality electoral systems. In multi-party governments, which are common in states with proportional representation, the coalition members are not willing to delegate to one actor the ability to monitor and punish the others. Negotiated targets provide an alternative in multi-party governments. They will be credible, however, only if all the parties can monitor and punish each other. Since parties often lack the ability to provide one or the other of these functions, targets are harder to maintain successfully than strong finance minister."

It is interesting that Brazil suffers from almost all institutional 'pathologies' that the first literature has identified as increasing the cost of governing and fiscal deficits. It has a presidential system, federalism; its electoral rules combine open-list with proportional representation; it has a multiparty system with weak political parties in the electoral arena; and it has been governed by an ample and low cohesive coalition in Congress. On the other hand, as argued by Alston et al (2004) the country's governmental institutions and procedures have been conducive to relatively disciplined budgetary and fiscal policies. As described later, the Executive and the coalitional party leaders control the budgetary process in the governmental phase as well as the decision making within Congress - and especially at the appropriation level.

If one just takes into account the electoral dimension described above we would expect all these elements together to generate, if not an ungovernable democracy, at least a very expensive one. In actual fact, however, since the Real plan in 1994 (which decreased the capacity of federal states to interfere in the macroeconomic stability) and especially after the introduction of the Fiscal Responsibility Law in 1999, the government has had qualified success in fiscal policy and inflation control.[4] On the other hand, it would be mistaken to disregard that the Brazilian electoral rules, federalism and other decentralized institutional features are more prone to larger deficits. One of the main challenges of this research project is to analyze the combination of these institutional incentives in order to better understand how contradictory incentives can provide equilibrium in the budgetary game. In other words, this study aims at analyzing the effect of the Brazilian institutional setting to the budgetary policies as well as to investigate to what extent a hybrid political system like this, which assembles majoritarian and consortiative/proportional (Powell, 2000) aspects at the same time, can live together generating incentives for governability, on the one hand, and survival of its players, on the other.

III - Framework for Understanding the Brazilian Policy Making Process

III.1– The General Framework

The current project builds on the framework of the PMP project where we analyzed the policy making process over the entire spectrum of policy areas (see Alston, Melo, Mueller and Pereira, 2004). The framework proceeds by separating policies areas into four categories according to their characteristics. In the first category are policies that are stable and adaptable to shocks. These are basically macroeconomic policies, such as fiscal and monetary policies, that is, those with a direct impact on stabilization and economic growth. The second category involves policies used by the President to provide patronage to other political actors in exchange for support in approving his agenda of reforms, that is, geographically concentrated transfers or 'pork'. The third category includes policies that, having been hard-wired cannot be easily changed and are consequently rigid and less susceptible to economic and political shocks. In Brazil, policies such as education and health are typically hard-wired. These are policies that generate important positive externalities for society that are realized not in the short term but in future periods. Thus there is always a temptation for short-sighted policy makers to

[4] This statement refers not simply to fiscal outcomes, but more broadly to the evolution of the budgetary process. Thus although for the 1994 – 1998 period fiscal outcomes did deteriorate, several positive changes in budgetary institutions were in the process of evolving.

postpone them in favor of policies in the first category, which is why at some point a consensus was reached to insulate those expenditures. The final category we term residual policies, which include issues that are given priority only once the objectives of the policies in the first category have been secured. These are policies related to issues such as security, environment, poverty, land reform, etc. These policies tend to be volatile, oscillating according to political shocks, such as when a new President comes to office. In general we expect that policy with a larger ideological component such as land reform and poverty alleviation will be in this group.

Strong Presidential powers have generally allowed the President to initiate, pursue and approve much of his policy agenda. These powers are checked however by two sets of safeguards. The first check is that the electoral connection for the President is such that he has incentives to pursue sensible macroeconomic policies, as he is seen by the electorate as being responsible for outcomes related to basic issues such a strong economy, economic growth and stabilization. Given the strong Presidential powers, failure in these areas cannot be credibly blamed on other political actors such as Congress or the Judiciary. The second check is that although the separation of powers is clearly biased towards the President, several other political actors with different motivations are able to check the President's actions in different ways.[5] Thus, if an incompetent or ill-intentioned President were to come to power, strong Presidentialism would not mean a blank check to pursue misguided policy.

The upshot is policies with the characteristics given in the four categories described above. The President uses his powers to pursue an agenda of stable and adaptable policies and reforms. Because the separation of purpose inherent in the political institutions has the President pursuing broad national public goods, whereas other actors that also have a say in producing legislation, particularly Congress and to a lesser degree Governors, have more narrow constituencies, there is potential conflict. However, this conflict is diffused by legislative rules that result in trades between Congress and the President of support for patronage (Alston and Mueller, 2006). The President is able to use his powers to control the legislative agenda and to create a stable supporting coalition

[5] See Alston, Melo, Mueller and Pereira (2004) for a detailed analysis of the role played by Congress, the Judiciary, State Governors, the Ministério Público, the bureaucracy and regulatory agencies.

that enables policy reform.[6] Any other coalition, not coordinated by the President would be inherently unstable and occasional, as it would not have any enforcement mechanism to ensure compliance and prevent defections. In addition the President possesses considerable discretion over patronage (such as jobs in the public bureaucracy, appropriation individual budget amendments, voluntary transfers to States and Municipalities, etc.), which, together with the career incentives of the Congressmen, lead to well-institutionalized trade of policy support for patronage. Although these exchanges are often seen as being less than legitimate by the press and much of society, they form the basis of Executive-Legislative relations in Brazil, and we argue that they lead to high levels of governability that allow important reforms to get accomplished. Furthermore we also argue that this comes at relatively low costs to the Executive as political institutions facilitate the trades and the patronage that is dispensed is a very small part of the budget (Pereira and Mueller, 2002 and 2003).

The result is that Congress tends to approve much of the policy reforms proposed by the Executive, yet Congress still holds checks on the powers of the President. It is this interaction that determines the qualities of macro and "pork" policies. Only where the divergence of preferences over specific policy issues between the President and members of Congress is sufficiently high will it be the case that there will be no gains to trade. That is, the cost of the patronage necessary to approve those reforms is higher than the benefits to the President. This may lead to either; i) gridlock over that issue; ii) the President dropping the issue or significantly watering it down; or iii) attempts by the Executive to get around Congress, for example through decree power which may then prompt other political actors, such as the Judiciary or *Ministério Público* to intervene.[7]

Depending on the success in achieving the top priority policy objectives, the President will decide on which and how the residual policies will be pursued. This follows because political institutions in effect give the President control over the legislative agenda and because the President will generally want to secure the national

[6] This is necessary because Brazilian electoral rules (open list proportional system) induce a multiparty system where the Presidents' party alone will rarely hold a majority of the seats in Congress.

[7] Although it has occurred in very few occasions, another possible outcome in this game is the defeat of the Executive's preferences. This happened recently when the official candidate for the presidency of the Chamber of Deputies (equivalent to the post of Speaker in the US Congress) was surprisingly defeated by an unknown legislator representing the interests of backbenchers and the opposition parties within the Chamber.

macro policies in the first place. Thus the residual policies are contingent on there being space in the legislative agenda as well as budgetary availability. These in turn are affected by both economic and political shocks. This implies that many of these residual policies will be characterized by high volatility. Whenever the economic and political conditions are favorable they are given priority and get implemented. When negative shocks occur they are suspended or put on hold to help secure the first category policies. Residual policies thus have a tendency to oscillate unpredictably. Also, because these policies only produce results in the medium and long term, politicians have more leeway to pursue their own visions of what is the right thing to do than is the case with the first category policies, where mistakes are more quickly perceived and punished by internal and foreign markets. Thus, residual policies with a larger ideological component will, *ceteris paribus*, tend to be more volatile. Additionally, political shocks where new politicians come to office tend to result in policy reversals.

Given this inherent tendency towards volatility of the residual policies, political actors may often choose to hard-wire some policies where it is considered that the volatility can be particularly damaging. Much of the hardwiring is done through the budget and as such is crucial for this paper. At some 'constitutional moment' politicians establish impediments to changing these policies by tying the hands of future political actors. This results in rigid policies, which is an advantage when this rigidity constrains opportunistic behavior but at the cost of reducing the ability to adapt to unforeseen future contingencies. The magnitude and nature of the rigidities in the budget will be analyzed in section V.

III.2 – Applying the Framework to the Budgetary Process in Brazil

Having described our general framework, this section shows how this framework applies more specifically to the budgetary process. Though budgetary issues are important elements of the general framework, this section allows us to delve more deeply into those elements related to the budget. In particular, we will focus on how the political institutions determine who are the actors involved in the budgetary process and how they affect the incentives and constraints of these parties as well as their ability to enter into and sustain inter-temporal political transactions.

The Brazilian Executive has several institutional mechanisms to protect its interest in legislative proceedings if the legislators decide to depart from presidential preferences. The rules are such that the Executive run very few risks of seeing his budgetary proposal disfigured by Congress.[8] Not only can the Executive veto any undesirable changes that Congress may inflict on his proposal, but also the Executive has a series of institutional instruments and informational advantages that allow him to safely guide the process through Congress. As if that were not enough, the budgetary institutions further safeguard the Executive's preferences by putting the most important parts of the budget out of the congressmen's reach, since they are only allowed to amend an astonishingly small part of the entire package. Additionally, the Brazilian budget law approved by Congress is not mandatory; in fact, it merely authorizes the executive to execute the budget based on the availability of resources collected during a specific fiscal year. That is, although the budget decision making process within Congress is very open and transparent,[9] there is a great level of discretion for the Executive on the appropriation phase of the budget which, of course, raises doubts about its transparency and accountability.

Despite this high level of Executive control, Congress nevertheless systematically proposes and approves a large number of amendments (collective and individual) to the annual budget. These amendments, however, can only be over items in the investment category, which are typically only a small fart of the entire budget. Table 1 shows the breakdown of the budget in its various categories from 1996 to 2004. The fraction of the budget allocated to investments is consistently very small overtime. Another interesting aspect demonstrated by this table is that Congress tries to increase the original amount allocated by the Executive to the investments on the budget bill (PLO) but the amount in

[8] Perhaps, the only segment of the budget in which the Executive would face risks of being trumped by Congress would be the so called Collective Amendments. This mechanism will be discussed in section VI.
[9] *The Latin American Index of Budget Transparency 2003* places Brazil as one of the countries with the highest positive response rates of transparency by affirming that "the legislature is a privileged actor with authority to modify and approve the budget proposal crafted and sent by the executive". The areas of highest positive responses are information on macroeconomic criteria, the role and participation of the legislature and the quality of information and statistics. However, areas such as citizen participation and accountability are ranked lower in the transparency index.

fact appropriated is smaller than the budget law (LOA) approved by Congress in most of the years. This suggests that the Executive has the prerogative to continuously protect its preferences by strategically adjusting the legislators' intention to modify the bill crafted by the Executive. As a result, as we can see in Table 2, the changes made by Congress in the whole (including all items) budget bill sent by the Executive are extremely small. This table shows, for each category, the ratio of the value Congress-altered bill to that originally proposed by the President. Surprisingly, in two years (1996 and 1999), rather than amending the budget with more expenditure legislators reduced them.

Table 1 - Difference in Expenditure among the Budget Bill (PLO), the Budget Law (LOA), and what was in fact Appropriated (1996 – 2004) *R$ millions*

Specification	Personnel	Interest on the Debt	Local and State Transfers	Investments	%	Capital Investments	Debt Amortization	Total
1996								
PLO	41.346,5	22.262,2	111.097,2	8.122,6	2.64	11.267,0	114.134,0	308.229,5
LOA	39.685,3	22.262,2	104.633,2	8.832,2	2.94	10.927,3	114.134,0	300.474,1
Appropriated	40.900,9	19.492,0	92.392,7	5.706,4	1.98	13.290,7	116.785,3	288.568,0
1997								
PLO	42.576,8	25.252,8	113.654,3	7.747,4	1.83	10.779,2	223.806,1	423.816,6
LOA	45.060,8	25.252,8	113.015,3	9.901,2	2.31	11.519,1	223.806,1	428.555,3
Appropriated	44.530,0	21.033,2	105.764,2	7.537,9	2.22	13.290,7	147.040,0	339.196,0
1998								
PLO	48.172,9	37.162,3	120.440,1	8.353,7	1.92	21.834,1	199.534,1	435.497,2
LOA	48.175,6	37.162,3	119.141,5	11.110,0	2.54	21.122,5	200.187,4	436.899,3
Appropriated	47.946,5	30.812,5	120.384,8	8.284,6	1.66	71.343,9	221.150,9	499.923,2
1999								
PLO	52.170,6	50.323,0	125.154,1	4.934,0	0.91	14.473,0	295.098,9	542.153,6
LOA	50.570,1	50.178,2	120.876,8	7.887,6	1.46	14.169,9	295.243,8	538.926,2
Appropriated	51.571,0	45.355,6	131.408,8	6.955,3	1.18	56.348,8	296.423,3	588.062,9
2000								
PLO	52.116,4	78.123,0	142.063,3	6.756,9	0.67	15.872,6	707.897,7	1.002.829,9
LOA	52.086,8	78.123,0	143.565,0	12.448,8	1.24	11.572,1	709.072,8	1.006.868,5
Appropriated	58.240,6	38.834,8	152.925,5	10.099,1	1.64	11.420,8	344.861,6	616.382,5
2001								
PLO	59.569,6	67.801,5	183.442,8	12.129,8	1.30	14.574,2	594.495,2	932.013,1
LOA	59.483,7	70.299,5	174.649,5	18.268,9	1.93	14.962,9	607.537,0	945.201,5
Appropriated	65.449,4	52.816,4	175.412,8	14.564,9	2.41	20.446,1	274.681,4	603.371,0
2002								
PLO	---	---	---	---		---	---	---
LOA	68.497,8	58.452,2	204.354,5	17.649,5	2.71	16.864,7	277.697,9	650.409,6
Appropriated	75.029,0	55.260,7	208.782,9	10.126,8	1.50	20.936,2	304.792,3	674.928,0
2003								
PLO	76.892,6	93.644,1	213.302,2	7.350,8	0.73	23.054,4	582.315,1	1.009.532,2
LOA	77.046,2	93.644,1	223.972,4	14.180,2	1.37	24.376,3	582.315,1	1.036.056,1
Appropriated	78.974,7	65.706,8	239.237,6	6.452,1	0.74	23.440,7	462.644,6	876.456,6
2004								
PLO	84.291,1	117.829,6	263.291,3	7.823,8	0.54	32.752,8	926.097,6	1.457.686,7
LOA	84.120,0	117.769,8	273.628,6	12.370,0	0.84	33.249,4	925.989,9	1.469.087,4
Appropriated	89.431,6	74.373,4	275.905,8	10.866,0	1.20	21.580,7	436.020,3	908.177,7

Source: Elaborated with data from SIAFI (Sistema Integrado de Acompanhamento Financeiro)

Table 2 - Changes made by Congress in the Budget Bill sent by the President (Proportion between the Budget Law - LOA and the Budget Bill - PLO)

Year	Personnel	Interest Rate on Debt	Local and State Transfers	Invest-ments	Capital Invest-ments	Debt Amorti-zation	Total	Net Result
1996	95,98	100,00	94,18	108,74	96,98	100,00	97,48	-2,52
1997	105,83	100,00	99,44	127,80	106,86	100,00	101,12	1,12
1998	100,01	100,00	98,92	132,99	96,74	100,33	100,32	0,32
1999	96,93	99,71	96,58	159,86	97,91	100,05	99,40	-0,60
2000	99,94	100,00	101,06	184,24	72,91	100,17	100,40	0,40
2001	99,86	103,68	95,21	150,61	102,67	102,19	101,42	1,42
2002	---	---	---	---	---	---	---	---
2003	100,20	100,00	105,00	192,91	105,73	100,00	102,63	2,63
2004	99,80	99,95	103,93	158,11	101,52	99,99	100,78	0,78

Source: Elaborated with data from SIAFI (Sistema Integrado de Acompanhamento Financeiro)

Even though the resources involved are small relative to the whole budget expenditure, it may seem surprising that the Executive, given the instruments at his disposal, would allow his proposal to be moved from its preferred position in such a manner. We argue that the Executive is willing to suffer this cost because it gives the opportunity to use the appropriation of the proposed amendments as a means to obtain support from the members of the presidential coalition in Congress day-to-day voting. That is, the strategic uses of amendment appropriations provide the Executive benefits in terms of support in Congress that more than compensate for the loss of having its initial proposal altered.

This explains why the Executive not only does not use its institutional and informational advantages to stop its proposal from being changed, but it even encourages the amendments by systematically overestimating the level of revenues that it expects to be available. The congressmen are not fooled by this strategy but are willing to go along with this game since it provides means through which the majority coalition is able to coordinate to secure its own political benefits. The parties and the individual members of the coalition benefit by receiving budgetary resources that, though small relative to the entire budget, significantly increase their probability of electoral success and political survival. In the remainder of the paper we describe and analyze the policy making process in Brazilian budgetary procedures focusing on two key issues. The first is the very high level of rigidity built into the budget both on expenditures and on revenues. In Section V we analyze the role of these rigidities in the realization of political transactions and their effect on the nature of budgetary outcomes. The second issue is the use by congressmen of individual amendments to the budget. These amendments are one of the principal means through which the Executive and the Congress trade pork for policy and as such are a key component of the budgetary game. We also analyze the nature of these trades and in particular the increasing use of collective amendments where several congressmen pool together to stake their claim for pork.

III.2 – Hypotheses

Based on this framework, our preliminary hypotheses for our project are:

1) The most fundamental characteristic of the Brazilian political system is strong presidential powers that emerge from political institutions that provide the Executive with an extensive set of instruments to pursue his preferences. This characteristic applies as well to the budgetary process. Therefore the Executive is able to control that process closely and assure budgetary allocations, most of the times, very close to his preferred point.

2) The Executive's preponderance over the budgetary process is achieved at relatively low cost. This is so because political institutions, including those specific to the budgetary process, provide the President with several effective means to guide his proposal through Congress. The ability to selectively execute the congressmen's amendments to the budget is a key power that generously endows the President with a political currency that is used to purchase support.

3) Given that together hypotheses (1) and (2) posit that the President is generally able to get mostly what he wants, the questions are: what does the President want and what are his motivations? We argue that in Brazil the President has political incentives to pursue responsible fiscal and monetary policy conducive to growth and stability. Because the budgetary process should be instrumental to achieving those goals, the President's behavior within the budgetary procedure should be consistent with those objectives.

4) Despite the high level of presidential powers, these are not absolute. Political institutions provide several checks which limit the President's control. These

constraints help to prevent opportunism, facilitate providing credible commitments, but also prevent adaptation to shocks. Where these costs are very large the constraints will be gradually relaxed in a manner consistent with hypotheses 1, 2 and 3, that is, favoring the Executive and being conducive to responsible macroeconomic policy.

IV - The Brazilian Budgetary Rules and Components

IV.1 - Introduction

In this section we describe how the governmental budget is formulated in Brazil, focusing on how the budgetary rules constrain and shape the relative power of Congress and the Executive. It is mostly a descriptive section that provides the details on the formal and informal rules that apply to the budgetary process, including how these rules have evolved over time. There have been significant changes in the budgetary process since the 1988 Constitution that has accompanied the changes in the more general policymaking process. Historically the budgetary process in Brazil has alternated between cases where Congress has effectively participated and defined where and how public resources were allocated with others where it did not wield any direct influence.[10] Currently, even when legislators have an effective role, it is mostly limited to amending the budget bill so as to target their main electoral strongholds with local policies.

The Constitution of 1988 brought about a set of new complex rules to regulate the budgetary decision-making process. The main goal of these innovations was to coordinate the planning of the budget through a sophisticated hierarchical structure that rationalizes this process in a four-year period that does not to restrict the budgetary cycle to the budget bill itself. With these new rules three main institutional instruments became responsible for regulating, planning, allocating federal resources and financial management: the multi-annual plan (*Plano Plurianual – PPA*), the Law of Budgetary Guidelines (*Lei de Diretrizes Orçamentárias – LDO*), and the Annual Budgetary Law (*Lei Orçamentária Annual – LOA*). The key purpose was to reform public sector policy making so as to integrate planning, budgeting and management in a way that balanced

[10] See Serra (1994); Rocha (1997); and Bezerra (1999).

restraints with flexibility. Transparency and accountability were also targets of these reforms introduced in the Constitution.

According to the Constitution these three instruments are hierarchically interconnected at different stages: the PPA is formulated by the Executive four months before the end of the first year of a government and defines the main strategic targets of the federal government in the long-run, serving as a kind of institutional framework for planning expenditures and government action. The Plan must be analyzed, amended and approved by Congress by the last month of the first year of its mandate and is valid until the end of the first year of the next elected government.

The LDO is renewed annually and has to be sent by the Executive to Congress no later than the first quarter of the second year of the government's term. Congress has to endorse it by June of the same year.[11] According to general provisions in the constitution, the LDO should include: a) the goals and priorities of the federal government; b) guidelines for changes in tax laws; and c) the parameters for personnel spending and recruitment, including pay rises and the setting of the value of the minimum salary; and d) setting the policies and objectives of the official federal financial institutions such as Caixa Economica Federal, Banco Nacional de Desenvolvimento Economico and the Banco do Brasil. Despite the short period of time allowed for its discussion (two months), the LDO provides ample opportunity for the Legislature to influence the budgetary process. The fact that Congress is legally required to vote the LDO in order that it can adjourn for its mid-year recess is an important constraint. The stated objective of the LDO, as indicated by the architect of this provision, the Federal deputy during the constituent assembly, José Serra, was to allow legislators to be able to discuss the strategic issues of the budget. In the constitution of 1946, the Legislature had to respond to the executive proposal without having the time or instruments to do so. More importantly, the feasibility of the budgetary amendments could not be established because no information was required to be presented to control spending (tax policies, etc). "As a result of this anarchy the legislature was weakened" (Serra 1989, p. 96). In turn, in the constitution of 1967 (which was enacted by the military), the legislature was

[11] According to the Transitory Constitutional Rules (ADCT) art. 35, the Executive must send the LDO by April 15 of each year and must be returned by Congress to be sanctioned by the executive by June 30 of the same year.

forbidden to amend the budget. The LDO becomes the major institutional device for guiding the formulation of pubic policies because it defines the priorities that have to be taken into account in the Annual Budgetary Law (LOA) in the next fiscal year.

The Executive then uses the targets and guidelines defined by the PPA and the LDO tto formulate the Annual Budget Proposal (*Proposta de Lei Orçamentária – PLO*). It is this budget proposal that estimates the total revenue and expenditures for the next fiscal year. In other words, it details specific programs and activities that must be in accord with the two previous instruments. The President has to send the PLO by August 30 of the same year and the Congress has to amend and approve it by December 15. This is done first in the Joint Budget Committee (Senate and Chamber of Deputies) and then by Congress as a whole. The PLO is then sent back to the executive to be enacted as a law with or without vetoes.[12]

The Annual Budget Law (LOA) is made up of three different budgets: fiscal, social security, and investment. The fiscal budget embodies revenues that will be collected by taxation as well as expenditures for all public administration, including legislature, judiciary, executive, and foundations maintained by the state. The social security budget corresponds to government action in three segments: health, pensions, and social aid. Finally, the investment budget is responsible for the total amount of (non-fiscal) capital revenues that will be invested by public agencies. [13] As we will show this is an important component of the budget because most of the legislative involvement in the PLO, through individual and collective amendments, occurs here. The congressmen's participation therefore depends on the availability of total investment, which is based upon the component capital revenues.

IV.2 - Crafting the budget proposal in the Executive Branch: Preparation Stage

It is the Executive that has the responsibility for coordinating and crafting the Annual Budget Proposal. More specifically it is the Secretary of Budget (SOF) of the Ministry for Planning, Budget, and Management (MP) that has the responsibility for coordinating and crafting the Annual Budget Proposal. The SOF estimates the total

[12] In Brazil the Executive can veto the budget proposal approved by Congress in parts or as a whole.
[13] Revenue is basically classified in two ways: tax, which is consequence of tax collection, contributions, and financial resources; and capital, which is a consequence of credit operation and surplus of fiscal revenue.

revenue and expenditures for each Ministry (staff, social security contributions, debts, etc.), Congress and Judiciary. Subsequently it defines parameters for all other expenditures, including operational and investment spending. After collecting the necessary information the SOF specifies expenditure restrictions for each program that each federal public institution proposes to develop. With those budget constraints, each Ministry and agency sends their proposal back to the SOF, which has the responsibility of reshaping it into a single plan, PLO, which is then sent to Congress.

It is relevant to note that it is at this stage that some legislators, especially the top ranking ones, take advantage of their political networks inside Ministries and public agencies to include their demands and projects in the Executive's. In other words, these legislators can avoid a significant step of negotiation inside Congress, since their demands are already included in the proposal sent by the President. It is at this stage that the trickiest negotiations occur within the Executive branch itself, with each part trying to enlarge its own budget and the Treasury trying to hold back their demands.

The Executive has to send the budget bill to Congress by August 31. Prior to this date several negotiations among executive branches, legislators, and interest groups take place aiming at including projects of their interest within the budget bill before sending it to Congress. This, of course, would improve the chances of having a legislator's project ultimately approved because it does not necessitate an amendment. A very good example of one these inter-branch battles occurred last year when the Lula's administration reached success with his proposal of exempting about R$ 3 billion of investment expenditure from the calculi of the primary surplus with IMF. The justification was the necessity to spend this money with infrastructure projects, especially repairing roads or constructing new ones. The rational response for this extra investment resource was a struggle between spending ministers, who tried to enlarge the definition of an "infrastructure project", on the one hand, and the finance and planning ministers who tried to restrict this meaning for "responsible projects just related to those able to provide growth and to assure profitability" (Guido Mantega, Ministry of planning, 08/19/2004, Folha de Sao Paulo).

Even the Ministry of Health, Humberto Costa, saw this agreement with the IMF as a great opportunity to enlarge his budget. He suggested an increase of 11% for the

2005 budget in order to compensate the loss his Ministry faced in the 2004 budget bill with the government decision to allocate 12% of the Health Ministry's budget to other policy areas not directly related to with Health like the "Zero Hungry" program. The Finance Ministry strongly opposed this idea saying that "the decision to exempt investments from the primarily surplus calculi can not be understood as fiscal irresponsibility that occurred in the past. I will sacrifice the primarily surplus target of 4.25% of GDP" (Folha de Sao Paulo, 08/06/2004).

Another example of an attempt of influencing the Executive to include demands from politicians and interest groups within the budget bill took place in the education policy area. Just one month prior to the deadline to send the budget bill, the Ministry of Education, Tarso Genro, received considerable pressure from unions: the Graduate Education Union – ANDIFES, the Student National Union – UNE, and the National Council of Education – CNE, along with several legislators demanding salary increases in order to compensate for inflation. Tarso Genro publicly agreed with the demands and assured that he would fight directly with the president to enlarge the budget allocated to education. It appears that this political pressure was quite effective since "the ministry of education, among all social ministries, was the one most successful earning 1.6 billion, when compared with the 2004 budget" (Tarso Genro, 09/01/2004, Folha de Sao Paulo).

Even Lula negotiated with his ministers to increase the funding for one of his favorite projects. Eager to make the transposition of the Sao Francisco river, which will provide access to water to five northeast states, as the most remarkable infrastructure achievement of the his administration, Lula decided to double the budget of the ministry of interior from R$ 911 million to R$ 1.8 billion. This makes the Interior Minister Ciro Gomes the champion of public resources in Brasilia.

The budgetary game, however, does not end after the PLO has been approved by Congress and enacted by the president. It can still be changed after these stages through the additional credit mechanism, which allows new amendments that reallocate resources. This institutional device makes the budgetary decision making process endless, turning it into a sequential game in which the Executive and Congress interact in more than one episode. As we show below the Executive plays this game from a very favorable position compared to Congress, as it benefits from asymmetric information and institutional mechanisms that allow it considerable discretionary powers.

There are three types of additional credits: supplementary, special, and extraordinary. Supplementary credits strengthen budgetary allocations that have already been included in the LOA but where the original amount of resources is not enough to complete the original project. If this change is within the boundaries established by the LOA, the supplementary credit basically means a reallocation of resources without the implications of new expenditures. Thus, this credit is simply issued by presidential decree without the need to be approved by Congress. It thus presents the Executive an additional instrument to reward or punish legislators based on their voting behavior.

If the change intended by the Executive goes beyond the authorized limit in the LOA, or if it constitutes a completely new project or activity; that is, spending that does not have the associated budget allocation, then a special credit is necessary. In this case, a bill must be submitted to and approved by the Joint Budget Committee in Congress. The committee, however, has neither the power to change the allocation of resources nor the right to change the amount of the credit. In addition the special credit must be approved by the floor in Congress by simple majority, which is generally not too difficult for a government that has a comfortable majority, as is often the case.

Finally, the extraordinary credit is used only in cases of urgent and unforeseen problems such as war or natural disasters, and is issued by Provisional Decree (*Medida Provisória*). To summarize, therefore, while the supplementary credit resets expenditures within the LOA's constraints, the special credit reconfigures the budget. Moreover, the latter requires a longer procedure to be approved and, as a consequence, requires more negotiation with legislators. Resources to be allocated as additional credits come mainly from cancellations of previous spending in the LOA, excess tax collection, and from loans. Note that the Executive has an informational advantage regarding the availability of these resources.

IV.3 - Decision Making in Congress: Approval Stage

The involvement of legislators in the budgetary cycle occurs predominantly in the Joint Budget Committee (*Comissão Mista de Planos, Orçamentos Públicos e*

Fiscalização – CMPOF).[14] Rocha (1997, 108) compares the number of amendments approved by the CMPOF and by the Floor of Congress. He points out that congress does not substantially modify the report approved by the committee. According to that author, the CMPOF is the main decision-making locus regarding the budget within Congress. It is the largest committee of the Brazilian Congress, with 84 effective members and 28 substitutes, 63 of which are deputies and 21 senators. The composition of the committee is based on the proportional number of seats that each political party holds in Congress. Therefore the larger parties have greater representation within the committee. According to the internal rules of Congress, party leaders are responsible for appointing committee members. In addition party leaders have considerable influence over the yearly choice of the president of the committee and its three vice-presidents. These hierarchical positions and that of *rapporteur* are alternated each year between representatives of the Senate and of the Chamber of Deputies. Given the importance of these positions, the prerogatives of the party leaders in shaping the committee constitute an important means for them to control the budgetary process as well as to reward and punish their members.

The CMPOF is composed of thematic standing subcommittees with a maximum of seven legislators. Each subcommittee has a sectoral *rapporteur* whose responsibility is to compile a partial report with the amendments approved by its members. The CMPOF's general *rapporteur* then consolidates these pieces. The positions of sectoral and general rapporteurs are highly influential and are appointed by the president of the committee subject to the restriction that the appointments must follow party proportionality.

When a bill reaches the Joint Budget Committee the general *rapporteur* submits a preliminary statement based on negotiation among party leaders. One of the most important aspects of this preliminary report is the definition of parameters and deadlines for legislators to submit collective and individual amendments. This is why there is such fierce competition among legislators to become members of this committee, and especially to be appointed to high hierarchical positions, such as *rapporteur* or sub-

[14] The Federal Constitution, Art. 166, § 1 defines as attributions of the CMPOF: "I – to examine and deliver a report on the projects referred to in this article [PPA, LDO, LOA and additional credits] and on the accounts presented annually by the President of the Republic; II – examine and deliver a report on the plans and, national, regional and sectoral programs established in this Constitution and to monitor the execution of the budget, without exclusion of the actions of the other committees in the National Congress and its houses, (...)"

rapporteur. These positions allow the legislators to propose specific resource reallocations, since the process of approving amendments is centralized on the *rapporteur*'s positions. Furthermore, only committee members are allowed to headline legislators' amendments during the voting process in the committee floor.[15]

Although legislators have the right to amend bills that are exclusively introduced by the President, they can only do so if those amendments are compatible with the multi-annual plan (PPA) elaborated by the executive, as well as with the law of budgetary guidelines (LDO). Moreover, Congress may not authorize expenditures that exceed budgetary revenues. The rules regarding amendment of the PLO have varied considerably in the past years. In 1992 and 1993 only individual legislators could propose amendments. In 1993 collective amendments by 'state bloc' (*bancadas estaduais*) and other groups of legislators were permitted. For the annual budgets of 1994 and 1995 four types of amendments were accepted: standing committees, political parties, state blocs and individual legislators. Since 1995, under Resolution nº 2/95-CN, standing committees, regional bloc, state bloc, and individual legislators can make amendments.

Collective amendments have a greater probability of being approved, because they have the support of not only an individual legislator, but also a group that was able to come to an agreement. However, the introduction of collective amendments does not mean that individual ones have faded out or lost importance. Agreements among local, state, and national politicians to include individual amendments disguised as collective ones are not rare.

Until 1993, there was no limit regarding the number of amendments that each legislator could make to the PLO.[16] Resolution nº 1 of 02/06/93 restricted the number of amendments for each legislator to fifty. This was an attempt to rationalize the process by giving priority to collective amendments thus reducing the large number of disputes among legislators to ensure approval of their amendments. In 1995, Resolution nº 2/95-

[15] The competition among legislators to take part in the Joint Budget Committee has lead to frequent increases in the number of seats in the CMPOF. In 1988 there were 60 effective members (45 deputies and 15 senators) and today there are 84 members (63 deputies and 21 senators). According to Serra (1994), the increase of the number of seats within CMPOF was the way party leaders found to cope with different legislators' pressures, as the mere presence in the committee significantly boosts the chances of approving amendments.

[16] In 1989, for instance, the number of individual amendments was 11.000; in 1990, 13.000; in 1991, 71.000; in 1992, 76.000; 1993, 13.000; 1994, 23.000 (Rocha, 1997).

CN further reduced the number of amendments to 20 and set a ceiling of R$ 1.5 millions as the total amount of amendments per legislator. Recently, legislators decided to increase the value of this quota to R$ 2 millions and at the time of writing is R$ 3.5 million.

Resolution nº 2/95-CN also established new rules for collective amendments: 5 per standing committees; 5 per regional bloc; and 10 per state bloc. However, even with limited number and value of amendments, legislators do not have any guarantee that their amendments will be approved by the committee; thus, they still have to negotiate with *rapporteur*s and party leaders to have their demands approved in the LOA, since many amendments are simply set aside.

Another important institutional change introduced in 1995 was the decentralization of power within CMPOF, giving more autonomy to subcommittee-*rapporteur vis-à-vis* the general one that lost the prerogative to initiate the so-called *rapporteur*'s amendment (*emenda de relator*) and the right to reissue rejected amendments. It is worth noting that the distribution of power inside the committee and the subcommittees is not even and depends on the amount of resources available. Thus, subcommittees responsible for the definition of resource allocation in education, health, and infrastructure are extremely disputed. Frequently legislators can count on the support of their Mayors and Governors to lobby for their demands within Congress.

The changes in the committee's rules toward decentralizing, empowering sub-*rapporteurs*, and establishing limits on amendments had the purpose of reducing transaction costs and problems of collective action among legislators, especially as a consequence of the budget scandal that took place in 1993-1994. The budget committee triggered the scandal by its improper allocation of resources to municipalities. Institutional change emerged as a response to the political scandal. The response came in the form of new rules which redistributed powers within the Legislature to allow more equal access to resources, thus increasing the chances of mutual approval of amendments via logrolling especially on collective amendments. This event is key in understanding the evolution of current budgetary rules.

IV.4 - Budget Execution under Executive Discretion

All the steps and complex negotiations to approve amendments inside Congress do not assure that a project once approved and enacted by the president will be delivered. It is the Executive that is responsible for budget execution, including the legislators' demands. Although legislators have the right to propose individual and collective amendments to the annual budget, it is the executive, who is entitled to determine which amendment will be executed, making the budget contingent on the amount of resources in the national treasury. The great majority of legislators make use of their prerogative to amend the budget to push through projects oriented to benefit their main electoral base of support. That is, the process is used to realize pork barrel politics and maximize their future electoral and political career. Therefore, it is plausible to expect that the Executive, who has huge discretion in executing the annual budget, will take advantage of this power to constrain legislators' behavior (Pereira 2000; Pereira and Mueller 2004), especially on individual amendments when the Executive can identify the author and the target of the amendment rewarding them accordingly.

It is the absence of synchronization between tax collection and expenditure that has allowed the executive to act strategically by making the execution of amendments contingent on the availability of resources. That is, the Brazilian budget is not mandatory but just authoritative. As a result the Executive has had extreme flexibility and discretion when negotiating with legislators, and does not apply a homogeneous criterion when deciding which amendments to execute. We have strong evidence that demonstrates that the Brazilian President rewards those legislators who most vote for his interests by executing their individual amendments to the annual budget and, at the same time, punishes those who vote less for his preferences, simply by not executing their individual amendments (Pereira and Mueller, 2004; Alston and Mueller, 2006). In addition, it is also argued elsewhere that, *ceteris paribus*, the greater the amount of individual legislator amendments executed by the president, the higher will be the probability of that legislator's re-election (Pereira 2000; Pereira and Renno, 2001).

In other words, with this institutional design it is not surprising to observe legislators who consistently give support to the executive's initiatives, aware of the effect this has on the probability of seeing their individual demands met by the president. On the other hand, legislators who do not frequently follow the executive's preferences in Congress have less chances of delivering local polices to their constituents.

It is important to recognize, however, that for collective amendments this rewarding/punishing mechanism, which characterizes the gains from trade between Executive and congressmen in Brazil, is difficult to be implemented, especially because the Executive branch can not fully identify who is benefiting from the execution which is based on legislative performance. Nor can the executive identify who can claim credit for the appropriation since these amendments have no individual author and are wide-ranging in scope. In other words, the Executive has no conditions to base his decision to appropriate or not a collective amendment by differentiating the faithful from the unfaithful legislators. This applies to both the opposition (which would be more inclined to oppose presidential preferences), and to members of the governing coalition in Congress (and are not so loyal to the Executive). Instead of considering the institutional innovation of collective amendments as if it was the intention of legislators to diminish the discretion of the President on the budgetary appropriations (as a functionalist approach would claim), we rather argue the result was an unintended consequence (Alston, 1996) of reducing transaction costs and solving collective action problems in the wake of a scandal

Paulo Bernardo, the current President of the Joint Budget Committee, and who was also member of the committee at that time of the reform that introduced the institutional innovation of collective amendments supports our interpretation. According to Bernardo:

> the collective amendments did not have as their motivation the restriction of the discretionary powers of the Executive. Actually, they aimed at bringing more transparency to the budgetary process by limiting the number of individual amendments, which represented the parochial interests of legislators, and, at the same time, reinforcing collective ones, which would have a broader profile mostly on infra-structure projects. Currently, however, the collective amendments' original intention has been distorted with several particularistic and private deals known as *rachadinhas* (interview on February 24, 2005).

IV.5 – Control Stage

Compared to the preparation, approval and execution stages, there is relatively little literature on the control stage of the Brazilian budgetary process. Although it is a less visible part of the budgetary process, the control stage is nevertheless an important component as it contributes to shaping the incentives of the agents in those previous stages. In recognition of this both the IMF and the World Bank have recently produced reports on fiscal control and transparency in Brazil (Fundo Monetário Internacional, 2001; Banco Mundial, 2002). Both of these reports conclude that the country's budgetary institutions are well prepared to perform this monitoring function:

> Brazil possesses a high standard of governance indicators and fiscal transparency. The coverage of the targets and fiscal statistics is admirably extensive. Recent reforms in the budgetary process substantially improve the realism and the transparency of the federal budget, as well as its consistency in relation to macroeconomic restrictions and its efficiency in allocating resources. Mechanisms of internal and external control are generally well developed, and highly suited for evaluating, not only the fulfillment of the formal legal requirements, but also the quality and the cost-benefit relation of public expenditures. Fiscal statistics at the federal level are of high quality, punctuality and detail. Brazil is at the forefront of the countries at a comparable level of development in the use of electronic means for: dissemination of fiscal statistics, and tax & budgetary legislation and regulation; performing government services and facilitating the scrutiny by society over governmental programs (Fundo Monetário Internacional, 2001: 1)[17]
>
> The conclusion of this evaluation is that the Brazilian system of public finance administration provides trustworthy information. There are adequate systems to manage and monitor the transfer and use of resources at the national level, and there is a high level of fiscal transparency (Banco Mundial, 2002: 10).[18]

Although the structure is in place for monitoring and control of budgetary procedures, what is missing are the incentives for the agents involved to use that structure for that purpose. The Constitution (article 49) establishes that Congress is the responsible for oversight and control of all acts of the Executive, including the budget. However, as we noted above Congress does not fully exert this control, having in a sense delegated this control back to the Executive. As noted by Banco Mundial (2002: 10) "… although Congress is greatly involved in the elaboration of the budget, it seems to be somewhat uninterested in following issues related to budgetary execution." This behavior is consistent with the incentives attributed to Congress in the general framework that underlies our analysis (see Section I). The Executive is the dominating player and is able to coordinate and maintain a governing coalition by, among other things, distributing

[17] Translated from Portuguese by the authors.
[18] Translated from Portuguese by the authors.

patronage through individual and collective amendments to the budget. In this game the supporting coalition is very much interested in the elaboration of the budget, so as to assure the size and shape of that patronage, but has no real incentive to dedicate resources to ex-post control of the process. Given that a majority of Congress is not motivated to pursue those functions, it is not surprising that the control stage remains in the background, despite the existence of the logistical means to be more active. In order to substantiate this assessment of the nature of the control stage of the budgetary process in Brazil, the remainder of this section focuses on the *Tribunal de Contas da União* - Auditor General's Office- (TCU). This organization possesses the means, in terms of enabling legislation as well as resources, to perform the monitoring and control functions required by best practices. However, its formal link to the legislative branch has meant that, in the end, its actual performance has not had as big an impact on the budgetary process as could be expected.[19]

In Brazil the TCU monitors the accounts of administrators and others responsible for federal resources (money, goods and values), as well the accounts of any other person or entity that leads to a loss, detraction or other irregularity that results in a loss to the public treasury. It also investigates and tries any person or organization, public or private, which uses, collects, safe-keeps, manages or invests federal resources or those for which the Union is responsible. Its official mission as stated in the Constitution involves the monitoring of the Union and entities of the direct and indirect administration by: (i) examining the yearly accounts of the President; (ii) examining the accounts of public administrators and others responsible for public money, goods and values; (iii) performing inspections proactively at the request of Congress; (iv) monitoring the use of resources passed on to the states and municipalities; (v) examining the legality of public sector hiring and retirement; (vi) monitoring the privatization process; (vii) investigating allegations and charges of irregularities made by any citizen, political party, association or union; and several other powers.[20]

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[19] Analysis of the Fiscal Responsibility Law, which is an important component of budgetary control, is done in the next section.

[20] See Rocha (2003) Annex I for a full list of the constitutional attributions of the TCU and Annex II for a list of the infra-constitutional attributions.

An institution that has the constitutional mandate to pursue these objectives clearly has the potential to have an important effect on the policymaking process. It could, for example, constrain the way the President executes the budget as one of its functions to see if legislative budgetary authorizations are followed. Also, with the new Law of Fiscal Responsibility of 2000 the TCU has started making individualized reports of the accounts of not only the President, but of the Senate, the House, the Supreme Court, other Federal Courts and the head of the *Ministério Público*. What role the TCU actually plays in Brazil, however, depends on its structure and process, in particular the resources and legal/political instruments it possesses. In addition it depends on the motivations of its members and the restrictions imposed by other political players.

Most countries have some kind of external control over public administrators, though the names and forms of organization vary greatly. In Brazil external control is constitutionally attributed to Congress, which delegates that task to the TCU.[21] It is composed of nine ministers who decide each case in a joint session by majority vote.[22] The rules for nomination of the ministers is designed so that the board is highly politicized, which has important consequences on the TCU's impact on the policy making process. Six of the ministers are chosen by Congress and three by the President. The President has one free choice of minister and the other two must be chosen, alternately, from a list of three elected among themselves by (i) TCU auditors and (ii) members of the *Ministério Público* outpost in the TCU. Congress's six nominations are distributed three for the Senate and three for the House, with the final choices being subject to political negotiations among the parties, so that the majority party in each chamber usually has precedence. All nominations have to be approved by the Senate. The positions are lifetime (until mandatory retirement), prestigious and provide a coveted pension. Nevertheless the politicized nomination process debases the prestige somewhat as some ministers are often clearly technically unprepared for the job.

In addition there is a large staff that performs the investigations, informs the ministers and makes recommendations. Jobs are filled by open public examinations and are one of the best-paid public jobs, so highly competent people are attracted. The staff is

[21] The TCU is the federal external control organization. In addition there are 27 state courts (including the Federal District) six municipal courts plus one for São Paulo and one for Rio de Janeiro.
[22] There are some cases which are reviewed by a subset of the nine ministers.

highly motivated to have an impact on public administration. They pride themselves when their investigations uncover wrongdoings by public administrators that lead to arrests, impeachment of elected officials and retrieval of embezzled public money. Even more so they take pride when they are able to affect the policy-making decisions of other political actors, such as forcing the minimum price of an auctioned public company to be revised upward.[23] This kind of intervention, which goes beyond simply checking accounts and plays a more proactive role, is being advocated by many within the organization (Zymler, 2002). This view interprets the Constitution as giving the TCU a role that extrapolates the traditional function of an Auditor General's Office. In addition to the regular external control over the use of public resources it would enter into the merit of the actions taken and results achieved by each administrative unit. That is, it is not enough that a unit's actions be legal, they must also be effective. This interpretation has already led to several interventions with direct consequences. For example, the TCU (at the behest of the Ministério Público) noted that although a 1997 law required a National Energy Policy to be elaborated by the National Council for Energy Policy, this council did not formally exist, which left the energy sector regulatory agencies (ANEEL and ANP, respectively electricity and petroleum) free to occupy that function. The TCU intervened in 2000 and the Council (headed by the Ministry of Energy) was instituted. Also in the electricity sector the TCU intervened in the process of tariff revisions questioning criteria used by ANEEL, which lead to a downward reformulation of the initial tariff revisions. This intervention had a direct impact on future tariff revisions.

These examples show that the TCU at times plays a role in the policy making process that goes beyond that of monitoring and enforcing. However, the extent to which this is currently the case is limited. Regarding its regular function of checking the accounts of over 2,600 federal entities the TCU is criticized for not presenting more results and especially for the low level of recovery of resources. Though the number of cases of corruption that have been uncovered has been growing, including some high

[23] For example, the TCU `managed to postpone the auction for the privatization of the State Bank of Maranhão in June 2002 after disagreeing with the procedure used by the Central Bank to set the minimum price. The auction was only allowed after the minimum price had been revised.

profile scandals, nobody doubts that many more get through the TCU's scrutiny.[24] In the same manner its role as a constraint for the actions of other political actors has been limited. In its yearly examination of the President's accounts, for example, the TCU has systematically recommended approval, though it typically adds a list of problems and warnings such as noting the increase of the internal debt or criticizing governmental programs that were discontinued due to lack of resources. In effect these reports are to a large extent innocuous as the politicized nature of the decision-making process acts as a barrier that filters decisions that may be troublesome for Congress and for the President. The process of nomination of the nine ministers assures that the majority coalition in Congress will generally have control of the decision making process in the TCU. Furthermore, the relationship between the President and Congress implies that the majority coalition will generally not have an interest in having the TCU create problems for the President.

In 2003 there were 24 proposals for constitutional amendments and 25 other proposals going through Congress related to the TCU. These involve such things as changing the nomination process, increasing the court's jurisdiction and changing its institutional links to other powers. If this pressure for change results in a more independent TCU and one with the proper incentives to monitor spending, it has the potential to may become a more important political actor in the Brazilian policy making process.

IV. 6. The Fiscal Responsibility Law

Enacted as Complimentary Law 101, of May 4, 2000, the Fiscal Responsibility Bill Law (FRL) is the main piece of legislation in the area of budget and fiscal control. Although the budget fiscal control are not limited to the application of this law, The FRL represents - along with its companion law, the so-called the Fiscal Crimes Law, the FRL represented the apex of a relatively successful set of measures to constrain fiscal behavior

[24] There is a controversy between the Judiciary and the TCU concerning the Judiciary's right to try a politician whose accounts have been accepted by the TCU. Many public administrators accused of corruption cite the approval of their accounts by the TCU as evidence to the contrary. The Judiciary reserves the right to try such cases, whereas the TCU claims to jurisdictional monopoly over these cases Rocha (2003).

and control the state governments' indebtedness.[25] The FRL illustrates the kinds of policy outcomes that reflect the national executive's ability to implement its policy preferences in the political game discussed in the previous sections. Furthermore it reflects a learning process on the basis of a repeated game between the federal government and the states. Unlike other similar laws promulgated in Latin America, the FRL is applicable to the federal as well as the state and municipal governments. Moreover, unlike its counterparts in the region (e.g. Argentina), this single federal law sets parameters for all levels of government and thus represents a top-down approach to fiscal rules and budgetary control (Webb 2004). The FRL provides ex ante and ex post controls on both borrowers and lenders. The FRL specifies in great detail the budgetary and fiscal rules governing public sector indebtedness, credit operations, and public account's reporting. The law prohibits the federal government from financing sub-national governments therefore eliminating the possibility of bailouts as well as any changes in the financial clauses of the existing debt-restructuring agreement.

In addition to the Executive branch, the Senate is a key player in the "sub-national budgetary and fiscal game." Article 52 of the constitution stipulates that it is up to the Senate to approve global debt ceilings for the three tiers of government. It should be mentioned however that the President has the prerogative to propose these limits. In addition, the Senate sets the ceilings and conditions pertaining to all issuances of securities by the federal as well as sub-national governments as well as any federal government warranty for credit operations, both external and internal. These constitutional provisions were reinforced by the FRL that imposes debt ceilings for each level of government. Although the debt–net revenue ratio differs markedly among subnational governments, the Law requires the same ceiling for the states and municipalities. Through Resolution 40, of December 2001, the Senate defined the criteria for the application of the rules. It authorized state and local governments to adjust the limits within 15 years, requiring an annual adjustment equivalent to 1/15 of the difference. Therefore, despite having the same target (the ceiling), each subnational government will have its own path depending on the initial conditions.[26]

[25] At the end of 2003, the states were producing a surplus of 9% of their net revenue and representing 1% of GDP (Afonso 2004).
[26] Undoubtedly this was a compromise in order to pass the FRL.

The Law stipulates that in the context of economic instability or drastic changes in monetary or exchange rate policy, the federal government can submit to the Senate a proposal for changing these limits. These circumstances will trigger an extension in the time limit for debt adjustment. The conditions are: a) if the economy contracts by one percent or more over the last four quarters; b) if a state of siege is declared or a condition of national catastrophe is approved by Congress.

Any excesses to the limits are to be eliminated within one year, otherwise new financing and voluntary transfers from the central government are prohibited. Other sanctions include withholding federal transfers by the federal government, denial of credit guarantees and banning of new debt.[27] In addition, the FRL contains a golden rule provision for capital spending (i.e. annual credit disbursement cannot exceed capital spending). The FRL also granted constitutional status to a number of existing rules and introduced new ones. These include the following a) personnel expenditures (including pensions), capped at 50% of net revenues for the federal government and at 60% for sub-national governments; b) new, recurrent expenditure commitments require specification of their full funding for the year in which they become effective and for the two consecutive years; c) prohibition of spending commitments that exceed one budgetary period during the last year of tenure of the executives at any level of government d) tax and fiscal exemptions and abatements have to be specified in the budget together along with the instruments to offset their impact on the budget for two consecutive years; and e) public financial institutions at all levels of government are not allowed to lend to their main shareholders.

Two additional features are important. In addition to the institutional penalties called for in the LRF, the new Law 10028 known as the *Lei de Crimes contras as Finanças Públicas* - Public Finance Crimes Law, of October 2000, which was presented to supplement the LRF, stipulates a number of legal sanctions applicable to individuals. These include fines, loss of public employment, prohibition for holding public office for a maximum of 5 years and imprisonment (Nascimento and Debus, n/d, 102). The FRL provides for detention of up to four years for public officials who a) engage in credit

[27] In order to guarantee transparency in the implementation of the rules, a list of the sub-national governments that exceed the limit has to be published by the Treasury Secretariat (STN) on a monthly basis.

operations without prior legislative authorization or in breach of the ceilings set; b) incur in expenditures commitments in the last two quarters of his term of office that cannot be paid within the current fiscal year, or without cash balances; c) incur in non-authorized expenditure commitments; d) extend loan guarantees without equal or higher value collateral; e) increase personnel expenditures in the 180 days prior to the end of her term of office; f) issue unauthorized unregistered public debt. The *Lei de Crimes* is highly significant because a new institutional actor enters the game: the criminal justice system. By individualizing sanctions, the *Lei de Crimes* helps overcome the loopholes created by institutional penalties thereby inhibiting opportunistic behavior. This is illustrated in cases in which individuals incur behavior that produces payoffs for himself while generating collective bids.

The other important feature is that on the lending side, the National Monetary Council (CMN) ordered the Central Bank to limit each bank's total lending to the public sector and to prohibit bank lending to any state that is in violation of the debt and deficit ceilings of the Senate Resolutions or in default the federal government or to any other bank. [28] The CMN resolutions specified penalties for any bank that violated the rules (Webb 2004). More importantly, debt and labor contracts in violation of the FRL are not legally valid, with the implication that lenders may incur losses if they engage in operations contrary to what is stipulated in the Law.

It is too early to assess the effects of the FRL. The real test will take place when the TCU and the National Treasury examine the fiscal accounts of the incumbent mayors in the period 2000-2004. This will take place during 2004 and, because of the possible litigation in the Judiciary, take even a few years before the full impact of the law can be assessed. Another important watershed is April 2004, which is the deadline, set by a new Senate resolution in 2002, for the sub-national fiscal adjustment. For the national level, an important test for the FRL has been the regime change at the national level. Despite its strong criticism of the Law during its legislative discussion and its implementation, the Lula government, inaugurated in early 2003, has shown a strong commitment to the new fiscal rules. One additional problem in assessing the effects of the Law is that it is

[28] The FRL requires SNGs seeking loans first to apply through the Ministry of Finance. Moreover, any borrowing in violation of the ceilings established by the senate is required to be repaid in full, not including interest, which is a penalty to lenders as well as borrowers (see Webb 2004, 8).

difficult to isolate its effect from the broader changes that occurred in the economy and polity, and from previous measures taken before, particularly since 1997. Currency stabilization and the privatization of state banks contributed greatly to undermining the ability of states to engage in populist fiscal behavior.[29] In addition, the support of a great majority in Congress helped Cardoso implement his agenda. Furthermore, as mentioned earlier, it is necessary to disentangle the Law's effect from those of other rules, such as the President's ability to withhold transfers to the states and municipalities.

Nonetheless, the FRL helped produce a major change in the approach to fiscal issues. Among other things, by requiring major procedural changes in budgetary matters, the law generated new stakeholders in fiscal issues, such as the *Tribunais de Contas* and other watchdogs (the reasons underlying this cooperative outcome are discussed later in this section). As discussed in earlier sections, the fiscal record of the three tiers of government has been impressive, with increasing primary surpluses produced at the state and national levels. The consolidated public sector changed from a deficit of 0.3% of GDP in 1997 to a surplus of 4.25% of GDP in 2004. More importantly, the individual fiscal performance of the states has also improved significantly. As shown in Table 3, 18 out of 27 states improved their primary fiscal result between 2000 and 2002. 8 states moved from a deficit to a fiscal surplus in the same period. Only two states – Santa Catarina and Pernambuco – still had fiscal deficits in 2002. In 2003, only Santa Catarina violated the ceiling plus the small states of Roraima and Tocantins.

[29] The Real Plan represented a shock that re-enforced the power of the President. Its effects included a) the fact that it laid bare the states' fiscal imbalances; b) it made it impossible for the states to resort to floating and other financial mechanisms to finance their fiscal deficits; and c) it caused a further deterioration on the deficits because of the sharp increase in interest rates

Table 3. Effects of the Fiscal Responsibility Law on the states (Primary deficit/surplus 2000-2002)

State	2000	2001	2002	
AC	(12.816)	158.116	87.380	▲
AL	103.170	899.476	146.813	
AM	495.487	(216.407)	305.788	
AP	83.863	130.278	205.050	
BA	76.064	170.920	642.037	
CE	21.392	328.184	433.684	
DF	108.252	219.461	137.524	
ES	(29.776)	637.159	626.955	▲
GO	(44.906)	372.907	532.442	▲
MA	271.324	(77.911)	57.316	
MG	(315.347)	270.555	448.875	▲
MS	(72.073)	207.907	380.389	▲
MT	29.726	360.482	408.808	
PA	114.210	123.847	134.631	
PB	253.512	(23.364)	259.975	
PE	(486.581)	(442.781)	(227.494)	
PI	(138.102)	(160.087)	259.079	▲
PR	2.520.608	643.313	778.572	
RJ	1.096.659	721.296	255.808	
RN	71.227	138	59.579	
RO	167.581	86.724	49.490	
RR	(61.909)	596.265	926.042	▲
RS	455.044	(294.643)	(64.528)	
SC	(17.289)	720.275	(151.848)	
SE	(28.671)	(56.224)	150.311	▲
SP	1.606.756	2.556.917	3.011.269	
TO	140.916	161.139	85.645	
Total	6.408.321	8.093.942	9.939.592	
Total/GDP	0,58%	0,67%	0,75%	

Source: Guardia and Sorden 2004

▲ Improved primary surplus and moved from deficit to surplus (8 states)

Improved primary result (10)

Worsened primary result (9)

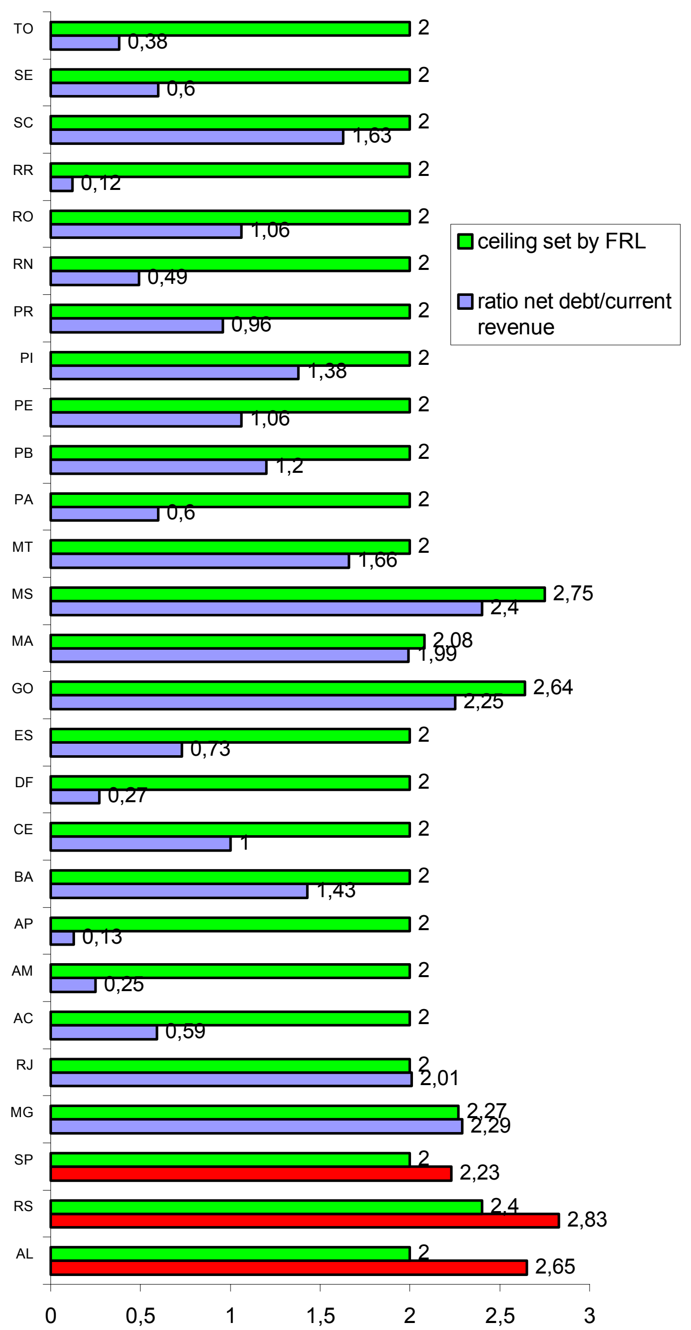
According to the most recent data available, the overwhelming majority of states were meeting the targets stipulated by resolution 40 for the ratio of net debt to total net revenue (See Figure 3). Only three states – São Paulo, Rio Grande do Sul and Alagoas – were above the stipulated ceiling, whereas 2 states – Minas Gerais and Rio de Janeiro – were close to no compliance. Because these states are among the largest and most powerful politically of the Brazilian federation, their situation may evolve into strong pressures for changing the Law. All but one – the municipality of São Paulo -of the capital cities are below the ceiling (see Figure 4). Because of the sheer size of its debt (R$29 billion) and political significance – it was governed by the PT from 2001 to 2004- the municipality of São Paulo provides an important test for the Law. [30] Despite the fact that the PT administration has left debts to be paid by the successor, the Federal Treasury punished it in 2002 (with a rise in interest rates to 9%) because it defaulted in that year.

It is significant that in spite of the FRL provision that the Federal Government should have a ceiling (2.45 in 2004) for the ratio net consolidated debt to total net revenue, the Senate has not imposed such a ceiling. This underscores the fact that the law is primarily an instrument of the Federal government to control sub-national spending. This is consistent with the interpretation in this paper about the preponderance of the executive in the budgetary and fiscal game.

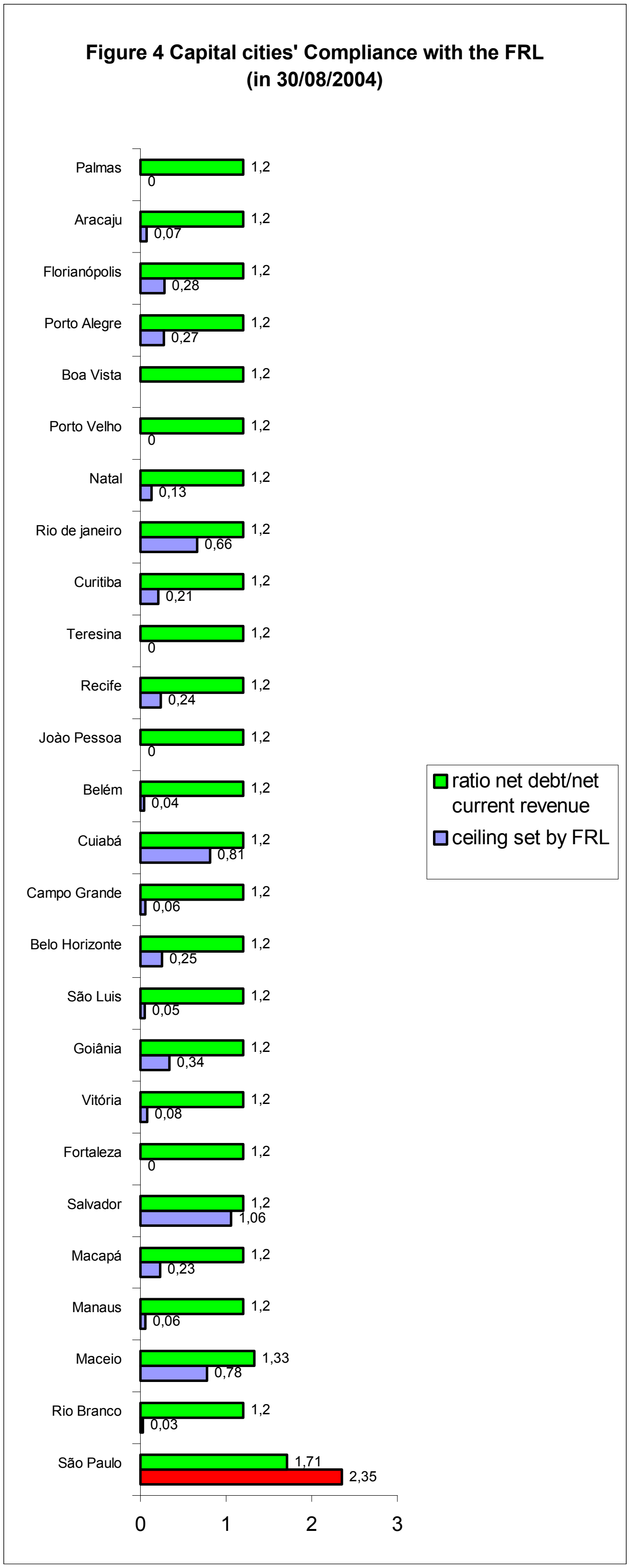
There has been intense pressure by state governments for a change of the index used in the debt refinancing agreements. The contractual index (IGP-DI) is affected by the fluctuations in the exchange rates, and most of the revenue is pegged to the IPCA index. This led the Senate in 2002 to relax the FRL requirement for an annual target (equivalent to 1/15 of the difference between the ceiling and current situation) until April 2005. It is too early for an assessment of how credible the targets are.

[30] The newly elected mayor of São Paulo, José Serra, ran against Lula in the 2002 presidential elections. He and his closest advisors were actively involved in the preparation of the FRL in 2000.

Figure 3. Compliance with FRL by Brazilian states
(in 30/08/2004)



Source: National Treasury and *Valor Econômico*



Source: National Treasury and *Valor Econômico*

In its turn, the behavior of personnel expenditures shows improvement; 18 out of 27 states reduced the share of personnel expenditures to total expenditures between 2000 and 2002. Of these 5 states which were above the limit of 49% reduced expenditures to below less than 49%, whereas only three states had personnel expenditures in excess of the ceiling of 49%. In 2003, only this trend continued – only three states were not meeting the target – but the state of Minas Gerais, which showed the highest unbalance, had a downward trend (See Figure 5). The other two small states of Paraiba and Piaui violated the ceiling, and presented a risky upward trend since 2000. Overall, the reduction in the share of personnel expenditures for all states showed a decline from 2000 (48.8) to 2003 (45.3).

The political sustainability of the FRL

As Braun and Tommasi (2002) point out, fiscal rules to be enforced require self – enforcement by the players (states) or an external enforcer with the power to ensure compliance. We argue that the Brazilian case approximates self-enforcement case. The executive had the enforcement technology and that the law is has been an effective commitment device. This argument contrasts with Webb (1994) who takes the external enforcement view. He argues that the passage and sustainability of the FRL was made possible primarily because of the cooperation of key large states and their governors (such as São Paulo).[31] As discussed at length in Alston et al (2004) the current depiction of the Brazilian political system as a federal structure in which governors wield vast powers is inaccurate. In fact, the circumstances that produced the former status quo that favored the states were unprecedented and extraordinary: a Constituent Assembly in which the Federal Executive played a minor role; the political conjuncture of transition to democratic rule, in which fiscal decentralization and increased social spending were important banners; and the specific sequence through which the political transition (democratic elections) occurred first at the state level (1982) and subsequently at the national level, converting the governors to key political figures in the transition.[32]

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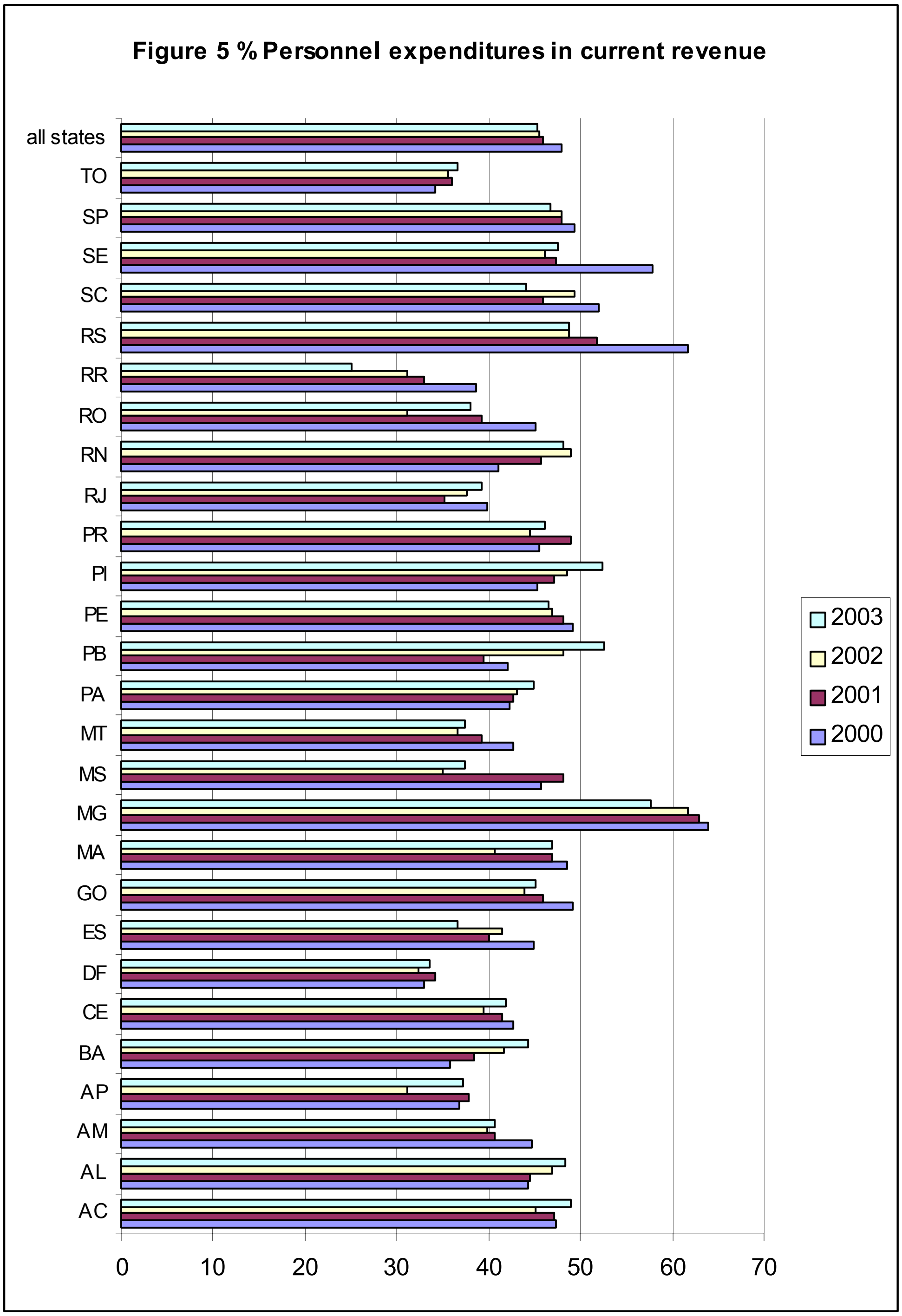
[31] His conclusion we believe was inspired by the Argentine case during the Menen and De la Rua administrations. Webb does not sufficiently note the institutional differences between Argentina and Brazil.
[32] Current views on fiscal rules fail to recognize these crucial differences and categorize Brazil and Argentina as examples of the same perverse fiscal federal game (Melo 2004 a). These contributions fail to



The President had the capacity to impose his fiscal preferences because: a) it could exchange BNDES advancements in exchange for fiscal reforms, including privatization of state banks and utilities; b) it had agenda powers and other legislative

recognize the great preponderance of the Executive in the fiscal game. For analyses of the Brazilian case along these lines see Braun and Tommasi (2002), Webb (2004), and Rodden (2003).

prerogatives to implement its agenda; and c) it was also helped by the approval of the reelection amendment, which strengthened not only the President vis-a-vis governors but also helped extend the time horizons of governors; (19 governors ran for reelection), thus introducing some element of self-enforcement in the fiscal game. Without the reelection amendment, incumbent Governors would have an incentive to exacerbate the common pool problem by leaving the fiscal problem to future governors. In addition, due to the devastating impact of hyperinflation in the mid 1990s, the President's policies were viewed favorably by a great part of public opinion, which became strongly inflation averse. We argue that the sustainability of the current fiscal situation is therefore not dependent on the state's cooperation. Although the FRL could be reversed, we note that there is some rigidity in it as a majority of 3/5 in two rounds of votes in the two chambers is required for a change in the Law.

The political process that led to the passing of the Fiscal Responsibility Law is illustrative of the preponderance of the Executive in the policy-making process. The bill draft (*anteprojecto*) was disclosed shortly after the exchange rate crisis in 1999. The bill reached Congress in April 1999 and was approved in May 2000. The executive resorted to a sequential strategic maneuver, approving the FRL Bill first (in May), and only then putting the *Leis de Crimes Fiscais* to a vote (in October). The second was more conflictual because it imposed individual penalties, including imprisonment, to mayors and the upper echelons of the executive at the three levels of government. The bill was approved six months before the municipal elections of 2000, and was particularly opposed by mayors who feared that the immediate enforcement of the bill would jeopardize their chances of winning the elections.

The *rapporteur* of the bill in the Lower House rejected all of the 100 amendments that were proposed both by opposition and pro-government legislators. 93 of these amendments were discarded in totum whereas 23 specific provisions were partially incorporated into the bill – some of which had the endorsement of the Ministry of Planning and Budgeting[33]. During the vote in the Lower House, leaders from the government coalition convinced their party members to withdraw 129 individual proposals for the separate vote of specific provisions of the bill (*destaques*). These

[33] O Estado de São Paulo, 13/12/2000.

included a provision from the Brazilian Association of Municipalities calling for the introduction of a transition period before the law could be put into force.[34] Despite the demonstrations and protests organized by the Brazilian Association of Municipalities, the bill was approved by a landslide - 385 votes for the government and 86 against it.[35] In the Senate, 13 amendments from the Floor were rejected by the rapporteur also with the objective of speeding up the process.[36] The government's proposal was approved by a majority of 60 votes in favor of the bill, 10 against and 3 abstentions. The final version of the bill contained a few changes in relation to the original bill. Governors managed to introduce spending threshold ceilings for the state Legislative Assemblies. Penalties were also reduced for violation of the upper limit of personnel spending (the years of imprisonment were reduced from a minimum of 2 to a maximum of 4, to a minimum of 6 months to 2 years, thus opening up the possibility of community service and fines). Moreover, the venue for evaluating the fiscal crimes was transferred from the Legislative to the Judiciary.[37] The President's promulgation of the bill took place only several weeks after its legislative approval in order to allow for the last renegotiation of sub-national debt – the bill banned further renegotiations - to complete.[38]

Although we argue that the executive has the upper hand in the executive-legislative relations, particularly in fiscal and budgetary matters, the interests of sub-national executives are relevant to explain the highly successful implementation of the law.[39] In order to understand the interest of governors in the law, one has to consider governors as rational actors seeking political survival. Governors have an interest in fiscal expansion because this would help them achieve this goal. However, in the context of highly indebted and fiscally vulnerable states (as a result of the measures described

[34] "Lei de responsabilidade fiscal é aprovada", Gazeta Mercantil, 26/05/2000.
[35] "Governo aprova o que quer na Responsabilidade Fiscal", O Globo, 02/02/2000; "Acordo para implantação imediata da regra passa, apesar de pressão contrária dos prefeitos," Folha de São Paulo, 26/01/2000; "Lei de responsabilidade fiscal é aprovada", Gazeta Mercantil, 26/01/2000. According to this report the rapporteur "did not compromise a millimeter with the mayors".
[36] "Lei de responsabilidade fiscal é aprovada, mas deputados aliviam penas," Gazeta Mercantil, 12/04/2000.
[37] "Pressão derruba pena de prisão na Lei Fiscal," O Estado de São Paulo, 13/04/2000; "Governadores conseguem mudanças na lei fiscal", Gazeta Mercantil, 09/02/2000.
[38] These included the controversial renegotiation of the debts of the municipalities of São Paulo and the state of Alagoas.
[39] The Brazilian experience with the law has received favorable evaluations by the IMF and the World Bank. See Webb (2004).

above), governors also have an interest in shifting the blame of austerity measures to other actors. This calculation is however affected by the future electoral chances of governors. In highly polarized states in which governors face close elections, governors would have an interest in "stacking the deck" of the future governor, and curb his "fiscal powers". In case the incumbent is in the second term of office – and therefore barred from competing in the next election –she would also have an interest in the law. This interest would be stronger in case of polarization. But the incumbent would also benefit from the law because he/she would have an excuse to say no to demands from his own constituency, and particularly for pay hikes. Fiscally, governors will always support such laws (it is their dominant strategy), but this support would be stronger in cases of polarization. We hypothesize that the more vulnerable fiscally a governor the higher the attractiveness of the "shift the blame strategy" and this support would increase the higher the polarization and political uncertainty over electoral outcomes.[40] It is the subjective evaluation of the value of blame shifting versus binding the hands of the competitors that will determine the governors' preference intensity. Based on impressionistic evidence, in 1999 and 2000, most governors were in a situation of great fiscal vulnerability and most of them would not be able to run for office again (in 1998, 19 governors had been elected and would not be allowed to run for a third time).

This explains the high level of support by governors to the law. This support was not sufficient or even maybe necessary as suggested by the approval of many initiatives that directly impinged on sub-national interests (including FSE, DRU and FEF, discussed in the next sections of the paper). Nonetheless they help explain the smooth and successful *implementation* of the FRL. The FRL and the array of initiatives for the fiscal control of sub-national governments who ignore the executive's ability to overcome party fragmentation cannot explain these outcomes without resorting to implausible

[40] Interview with a senior councilor from a major Tribunal de Contas, who talked about the law both as a "shield" (permitting to evade responsibility and shift the blame) and as a "sword" (that can be used to bind the hands of the political competitors). Webb (2004, 8) also found evidence of this: "SNG executives seem to be using the FRL and its companion as an excuse to say no to demands for special interest expenditures and transfers that would violate the FRL. Some state governments have put up posters telling the penalties, as a reminder of why they are turning down special requests".

arguments.[41] Although the effects of the FRL from a fiscal point of view are positive, the extensive use of threshold ceilings and controls generates a system which is difficult to adapt to external shocks and changes in the economic and political environment. Furthermore, they lead the actors involved to see them as targets to be met (as opposed to thresholds), encouraging time-inconsistent behavior that ultimately cancel their intended effects. Ultimately, the extensive controls and limits which are contained in the law can be understood as a second best solution to fiscal and budgetary pathologies. Fiscal rules ideally should have elements of self-enforcement through market mechanisms and hierarchical control (Ter-minassian and Craig 1997; Rodden and Eskeland 2003). In the Brazilian context, we argue that the relative success of the hierarchical control is due to the preponderance of the executive in the policy-making process.

V. The Rigidity of the Budgetary Process in Brazil

V.1 - Introduction

One of the most striking features of the Brazilian budgetary process is the rigidity that has been built in through earmarking of tax revenues and hardwiring of expenditures. Although all countries have such rigidities, the Brazilian case is particularly severe. This characteristic is of central importance to our analysis because these rigidities are a means through which inter-temporal political transactions are sealed. Under ideal (zero transaction cost Coasean) institutional arrangements, there would be no earmarking or hardwiring as the use of tax revenues for public expenditures would always be efficient, in the sense of yielding the highest level of social welfare, with side-payments compensating those who are made worse off. Under imperfect institutional arrangements, however, locking in resources through earmarking and hardwiring can be a means for political actors to provide commitment to certain actions or to constrain other actors in the future. This allows some political transactions to be realized but comes at the cost of loss of flexibility. For the budgetary process that cost may come as a reduction of

[41] One such argument is provided by Webb (2004, 8): " A lack of horizontal accountability between the legislatures and the president, coupled with the president's inability to rely on a supportive coalition in the congress, fueled expectations that the FRL's measures could be easily amended – or even aborted – in the future; *this in turn made it possible to muster the legislative votes needed for its passage, notwithstanding high levels of political party fragmentation.*" According to this argument, the approval and successful implementation of the FRL is viewed as a paradox that can only be explained as a non-anticipated development.

efficiency, representativeness and/or sustainability, though it may be the case that one of these characteristics may trade-off with the other. In the case of Brazil, for example, we will show that the rigidity may have increased representativeness at the cost of efficiency and sustainability.

In the first part of this section we describe, quantify and characterize the level of rigidity in the Brazilian budgetary process and analyze its evolution over time. In the second part we examine in detail some specific cases where rigidity was put in place or was removed (or attempted to be removed) in order to analyze the process through which this occurs and how it changes over time. That is, we look closely at events when actors struck political transactions imposing rigidities. This allows us to understand the motivations of the actors, the mechanisms that are used, and costs and benefits involved. In particular, we want to understand how and why these mechanisms constrain the Executive and their impacts in terms of the efficiency, representativeness and sustainability of the budgetary process.

In the second part of this section, we take the Constitution of 1988 as a point of departure to discuss the evolution of the political transactions that produced the rigidities identified in section 1. The constitution is viewed as an external shock that generated reactions whose cumulative effect produced a specific pattern of rigidities in the budgetary and fiscal arenas. The third part of this section provides an illustration of the sectoral dynamics of earmarking.

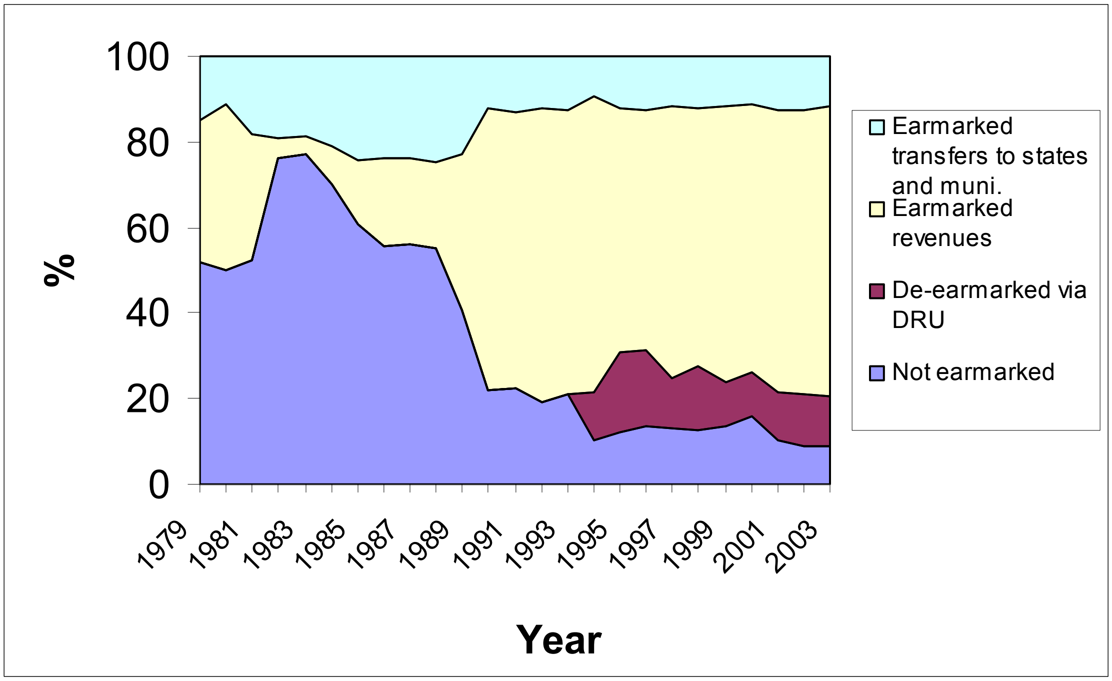
V.2 – The Nature and Magnitude of Budgetary Rigidities in Brazil

Figure 6 shows the evolution over time of the composition of tax revenues in Brazil classified in terms of whether and how they are earmarked. It can be seen that the Constitution of 1988 lead to a marked increased in the proportion of revenues that were earmarked and a corresponding decrease in the proportion of revenue which could be freely used, which reduced from an average of approximately 60% of total revenues in the 1980s to an average of about 16% in the 1990s.[42] The Constitution of 1988 established the following earmarking of revenues: i) at least 18% of all taxes should be

[42] We speculate that the hard-wiring of the budget through the constitution was in part due to a lack of trust that emerged from the authoritarian military rule. In the graph non-earmarked budgetary revenues are those that do not have a destination specified in any law and are not transferred to sub-national units (Brasil-SOF, 2003).

spent on development and maintenance of education (article 212); ii) a series of social contributions earmarked for social security (art. 195); and iii) automatic transfers to states and municipalities (Brasil- SOF, 2003).

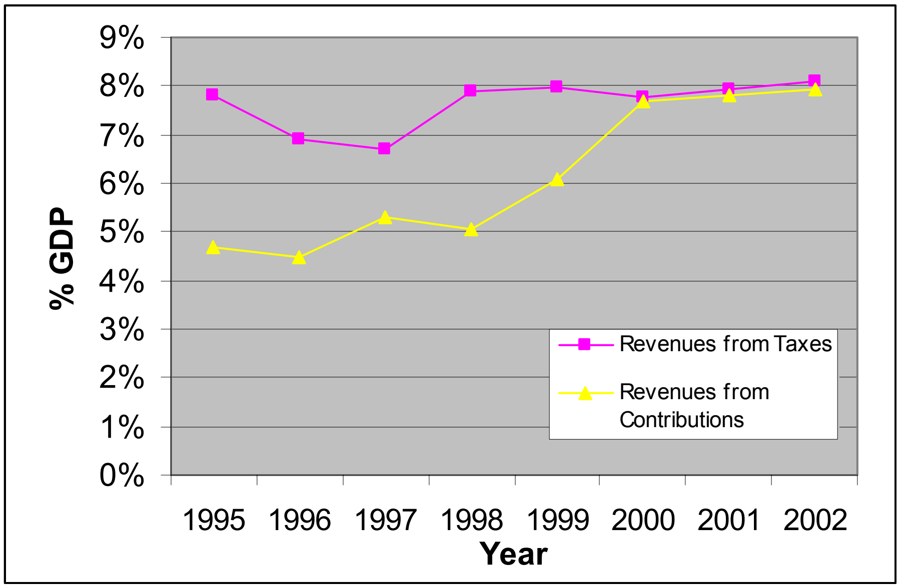
Figure 6 – Evolution of Earmarking of Budgetary Revenues, 1979-2003.



Source: Brasil. Secretaria de Orçamento Federal. (2003) "Vinculações de Receita dos Orçamentos Fiscal e da Seguridade social e o Poder Discricionário de Alocação de Recursos do Governo Federal" - Volume 1, N.1, Brasília, SOF, pg. 6. This graph does not include revenues from government bonds or privatization.

After the Constitution there were several other instances where further earmarking of revenues took place such as the creation of the CPMF (Provisional Contribution over Financial Transactions) instituted in 1996, which was destined for health expenditures; and CIDE, a contribution over fuels, instituted in 2001 and destined for transport infrastructure, subsidies for alcohol-fuel and environmental projects related to the petroleum industry (Brasil-SOF, 2003). Despite its name, the CPMF has not been provisional, having been not only renewed twice (in 1999 and 2002) but also increased from 0.20% to 0.38%, though its use has been broadened to include social security and a poverty relief fund. In addition, CIDE has been used by the government to pay the salaries of civil servants of the Ministry of Transports (Reis and Valadares 2004), which is an example of an attempt to relax the earmarking restriction, showing that it is in fact a binding constraint. The use of “contributions,” specific earmarked taxes sheltered from disbursement to state and local governments, has been a favored means of raising and earmarking revenue as opposed to taxes.[43] The creation of contributions, generally associated with social expenditures, has been a major instrument in the government's fiscal adjustment strategy. As a consequence the amount of revenues raised through contributions has increased markedly in the past decade, almost reaching the same level as the revenue derived from taxes (see Figure 7).

Figure 7 – Tax Revenue versus Contribution Revenue, 1995-2002.

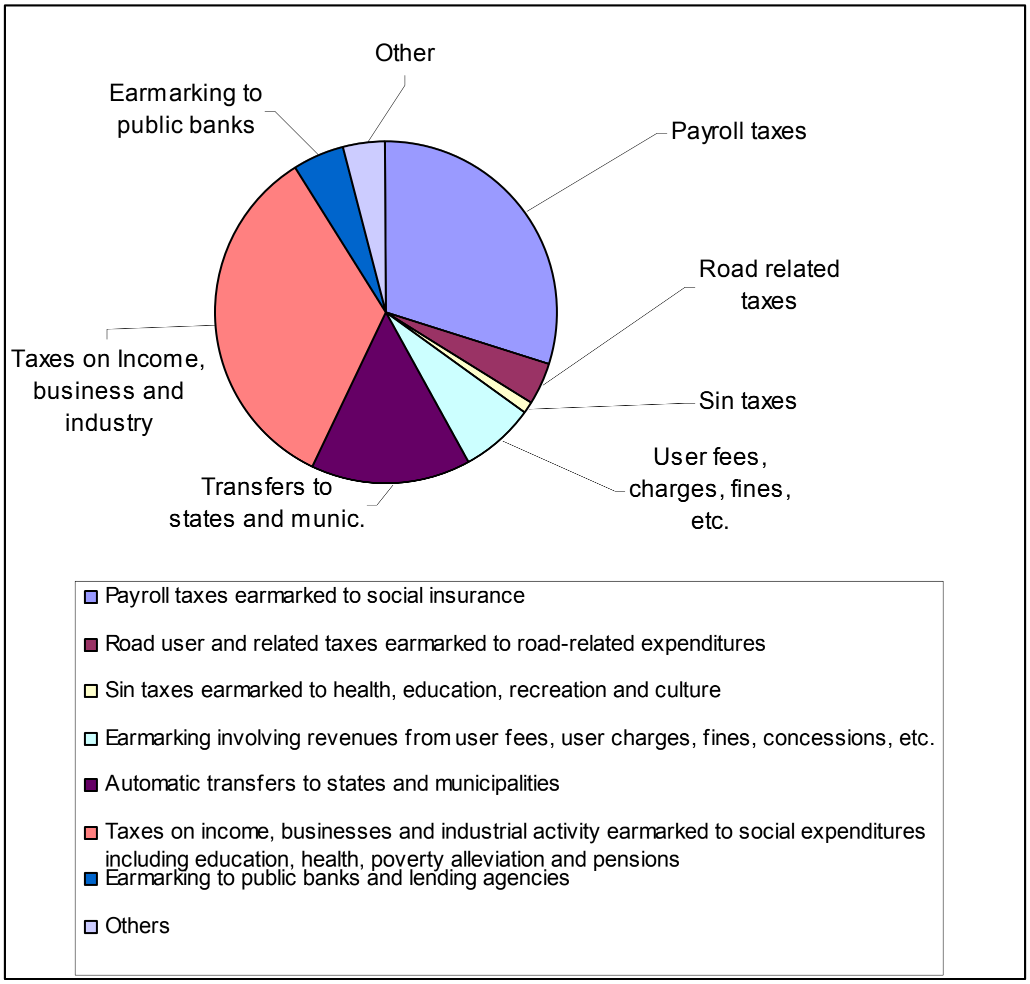


Source: Brasil. Secretaria de Orçamento Federal. (2003) "Vinculações de Receita dos Orçamentos Fiscal e da Seguridade social e o Poder Discricionário de Alocação de Recursos do Governo Federal" - Volume 1, N.1, Brasília, SOF, pg. 9.

Figure 8 shows the breakdown of the areas to which earmarked revenues were linked in 2002. It can be seen that the main recipient of ear-marked revenues is social security with 38.9% of total revenue. Over time the trend has been for an increase in the participation of social security, with a rise from 31% in 1994 to 46% in 2002 (Brasil-SOF, 2004).

[43] The Brazilian tax law makes a distinction between taxes (*impostos*), which are used for general purposes; fees (*taxas*), which are charged for specific and individualized purposes that are usually associated with the state's taxing power (e.g. licenses); and contributions (*contribuições*), which are a controversial category that are also associated with certain purposes of a social or economic nature. There are two major types of contributions: social (*sociais*) and economic (*intervenção no domínio econômico*). Payroll taxes paid by employers and employees are also called contributions for training and leisure and are collected by parastatal bodies (SESI, SENAI, etc) and not by the government. The Constitution requires that only the federal taxes are shared with the sub-national governments.

Figure 8 – Earmarked Revenue by Area for 2002.



Rajkumar, A.S. 2004. Presentation at World Bank office in Brasilia, May 19, 2004
http://www.obancomundial.org/index.php/content/view_folder/1956.html

The earmarking of revenues can entail several benefits, such as preventing opportunism by politicians and thus insulating some prioritized expenditures. This can be an important means of assuring the representativeness of budgetary outcomes. In addition it can be used to increase the generation of revenues.[44] However, there are also several problems that arise from the earmarking of revenues. Reis and Valadares (2004:18) cite three perverse consequences that have arisen in the Brazilian case. The first is the fact that earmarking implies that the increase in revenue derived from the increase in the GDP will automatically feed into increased expenditures as they can't be destined elsewhere.

[44] See Rajkumar (2004) for an analysis of earmarked revenues in Brazil that includes a series of principles that distinguish the circumstances when earmarking can be beneficial or detrimental.

Secondly, because earmarking assures an inflow of revenue, there are fewer incentives for policy makers to strive towards higher efficiency in allocating expenditures. Finally, there have been incentives for several governmental bodies to try to protect their resources from cuts for primary surplus purposes (*contingenciamentos*) by first spending expenditures that are not protected, leaving those that are for later in the year. Clearly this is a strategy that may often lead to efficiency losses.

The straightjacket imposed by revenue rigidity and the constraints it imposed for the government to pursue its policy making preferences were felt soon after the 1988 Constitution. In reaction to these constraints the government created in 1993 a fund called the Social Emergency Fund (FSE) which received resources that were de-earmarked from 20% of all taxes and contributions received by the Union. The idea was to create a temporary source of flexibility to allow the government to address the problem of inflation, until fiscal reforms that could provide a definitive solution. However, when the FSE expired it was substituted by a similar fund with a different name (Fund for Fiscal Stabilization) which in turn gave way to the DRU (De-linking of Budgetary Resources) in 1999. According to Brasil-SOF (2003:19) the existence of the DRU meant that in 2003 19.7% of total revenues were not earmarked, whereas without the DRU the figure would be 12.9%. Thus it does provide some flexibility, but only a limited amount. The evolution of the amount of resource freed by de-earmarking mechanisms over time is shown in Figure 6. Each of these events imposed changes on how budgetary resources could be used. As such they represent situations when important political transactions transpired. In the following subsection we examine some of the instances in which these changes were decided upon and implemented, so as to better understand the underlying political process. First, however, we turn to the rigidities on the side of budgetary expenditures, which complement those on revenue.

In addition to the earmarking of revenues described above, the Constitution of 1988 instituted a series of rigidities into how budgetary resources could be spent. These rigidities are of two basic kinds; i) limits on the minimum amount that must be allocated to certain areas; and ii) mandatory expenditures. The two main minimum-limit restrictions are health, where expenditures must equal those of the previous year plus an amount equal to GDP growth;[45] and education, which must receive at least 18% of total revenues. The main mandatory expenditures are civil service salaries, social security benefits, judicial sentences, unemployment benefits and social assistance benefits. The result of all these limitations is that there is very little discretionary expenditure left in the budget with which the Executive can pursue other objectives. Table 4 shows that in the budget for the Union for 2003, discretionary expenditures tallied only 6%. All other expenditures, the two main areas being social security and wages, are hardwired.

Table 4 – Union's Budget for 2003.

Expenditures	**R$ (billion)**	**%**
Social Security	107	33
Civil Servants, Wages, Benefits	79	24
Transfers to States and Municipalities	57	18
SUS (Health System)	23	7
Unemployment Benefits	8	3
Subsidies and transfers	6	2
LOAS (Social Assistance)	5	1
Kandir law (export tax rebates)	4	1
Other expenditures	34	11
Discretionary (subset of 'other expenditures')	±20	6

Source: Lima, Edilberto C.P. (2004) "Algumas observações sobre orçamento impositivo no Brasil" Brasilia, Consultoria Legislativa da Camara dos Deputados, Mimeo.

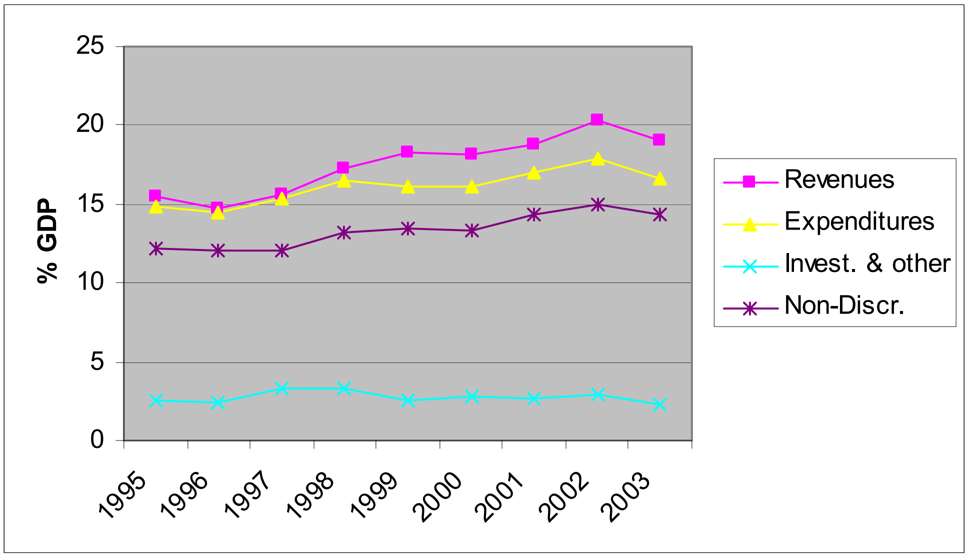
This pattern of rigidity is a direct consequence of the Christmas tree-like nature of the 1988 Constitution where a gamut of different groups managed to insert their own provisions and insulate them from future policy makers. In addition, many of these items were justified as the need to repay the "social debt" to groups that had been marginalized during the previous decades, such as rural workers, those who had no access to health services, and retirees who had had their pensions systematically eroded by inflation (Velloso, 2004:27).

Figure 9 shows the evolution of revenues and expenditures from 1995 to 2003, including the breakdown of expenditures into discretionary and non-discretionary (investment & others) components. The data show that expenditures as whole have been increasing over time and that the non-discretionary expenditures have been increasing at the expense of a compression of the discretionary expenditures.[46]

[45] This is stipulated by constitutional amendment 29 approved in 2000.

[46] The fall in expenditures from 2002 to 2003 is due to extraordinary (one-shot) revenue realized in 2002.

Figure 9 - Revenues, Expenditures and Primary Surplus, 1995-2003.



Source: Velloso. R. (2004). "Ajuste do Gasto Público e Retomada do Crescimento" Rio de Janeiro, FIRJAN.
Non-discretionary = Salaries, Social Security, Unemployment benefits, LOAS, Health and Poverty.
Invest. & other + Non-discretionary = Expenditures.
Revenues - Expenditures = primary surplus.

The increase in expenditures over time is to a large extent endogenized by hardwired components whose natural dynamic is to grow over time independent of the evolution of GDP, in particular social security benefits and social assistance. The biggest problem is by far social security. The 1988 Constitution not only hardwired these expenditures, but also greatly increased them by granting full retirement benefits at the level of the last wage to over 400,000 civil servants who had not contributed effectively towards the system (Velloso, 2004: 29). In 2000 the number of active workers in the Union was surpassed by the number of retired workers and pensioners. In the period from 1991 to 2002 the total number of pensioners and beneficiaries has doubled while the number of active workers reduced by approximately 16%. This has implied a deficit of R$ 12.8 billion in 2001 and R$ 17 billion in 2002 (Velloso, 2004:31). These deficits have arisen despite the fact that: i) Brazil still has a very young population profile (8% over 60 years vs. 16% for the US and more for the OECD in 2002); ii) Brazil has the highest level of social security contribution over wages in Latin America and smaller only to Portugal in the OECD; and iii) since 1998 retired workers have been contributing 11% of their benefits back into the system. Velloso (2004:31) argues that the persistence of the social security deficit is due to a series of subsidized welfare transfers of a non-contributory nature, such as rural pensions and urban retirement by age, where no contributions had been made.

Most of these benefits are at the level of one minimum wage and as such may be seen as a desirable form of income redistribution that leads to more representative budgetary outcomes. Nevertheless these expenditures do contribute crucially to the deficits of the social security system and must be financed. In 2001, for example, social security contributions, paid basically by active urban workers receiving more than one minimum wage, came to R$ 63 billion, thus covering the R$ 45 billion in benefits to retired urban workers over one minimum wage. However, the benefits to rural workers and others who receive one minimum wage and do not contribute required another R$ 30.4 billion, thus leading to a deficit of R$ 12.8 (Velloso, 2004:31). Despite its magnitude, the real problem is that in other to cover part of the costs of non- contributory pensions the government has increasingly used the funds from payroll contributions, instead of using funds from general taxation. As a result, payroll rates have escalated to an unsustainable level producing severe distortions in the labor market. This has occurred systematically since 1996 and given rigidity to the budgetary process. Given the natural dynamic of the social security system, the problem will persist and aggravate over time. The pension reform initiated by the Cardoso administration and completed by the Lula administration will only reduce these pressures gradually over time.

In addition to the assistance nature of benefits in the social security system, one may be tempted to interpret the hardwiring of the other regular benefits, such as pensions in the civil service, as desirable from the point of view of representativeness, as they impede opportunistic raiding of those resources by politicians. However, this argument becomes less compelling when one considers that within these beneficiaries there are several privileged groups who receive the bulk of the benefits at the expense of the majority. The hardwiring of these expenditures protects these benefits from changes that could make the system more representative.

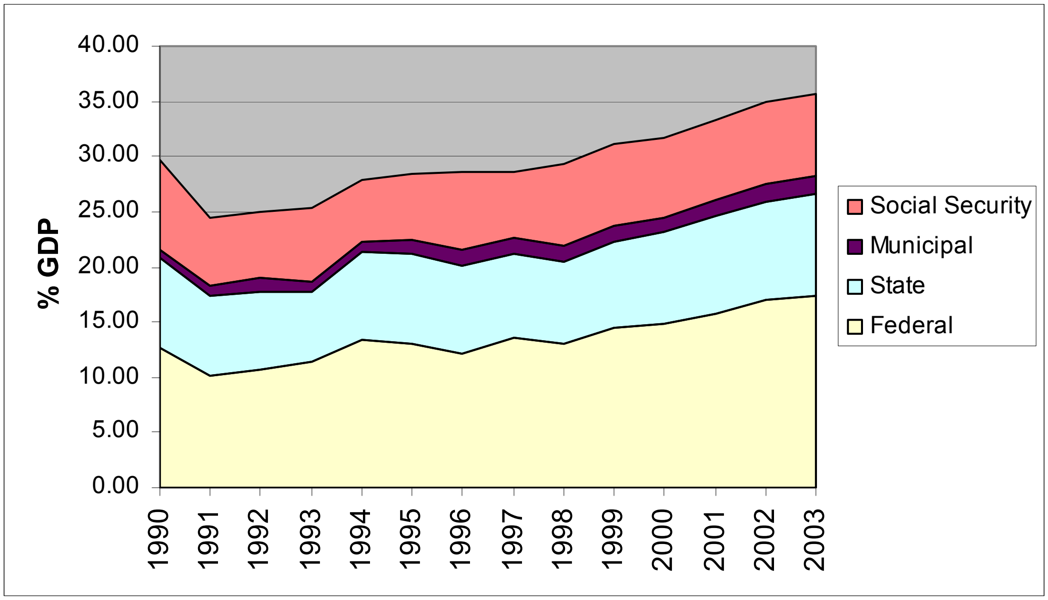
When one considers together the rigidities over revenues with those on the side of expenditure, it becomes clear that the government has very little space to maneuver when setting the budget and formulating policy. The expenditure rigidities compound the limitations on the use of revenues because approximately 55% of the free revenues have had to be used in hardwired expenditures in recent years (Brasil-SOF, 2003). This lack of freedom is all the more troublesome when one considers how it constrains the government in the task of dealing with its most important macroeconomic problem, the public debt. As can be seen in Figure 1 (in the introduction) the public debt/GDP ratio has increased sharply in the first FHC term. When the *real* suffered a sharp devaluation in 1999 this ratio was clearly on an unsustainable path and there was great skepticism in international markets that the country would be able to regain control in an orderly fashion. Nevertheless, contrary to expectations the government initiated a trend of responsible fiscal policy based on the achievement of primary surpluses that has stabilized the debt/GDP ratio and started to change the perception of Brazil as a fiscal profligate. This same behavior has been continued by the Lula government.

The primary surpluses that have been achieved since 1998 are shown in Figure 2 as the distance between revenues and expenditures. In order for the debt/GDP ratio to remain constant it is necessary for the primary surplus to equal the difference between the interest rate on the debt and GDP growth, times the initial level of the debt/GDP ratio.[47] The fact that the government has managed to pull this off is all the more remarkable when one considers that these surpluses were achieved under the most unfavorable of conditions. This was a period of high interest rates, undervalued exchange rate, low GDP growth, high country risk and the political shock of a left-wing president being elected, all of which have a negative impact on the debt/GDP ratio. When one adds to these difficulties the rigidities of budgetary revenues and expenditures, the feat of achieving successive primary surpluses becomes even more notable. That this was accomplished is evidence of the extraordinary powers held by the Executive, which have allowed successive increases in tax revenues while at the same time further compressing the already narrow margin of discretionary expenditures. Figure 10 shows that since 1991 the tax burden has consistently increased, to the point where it has reached over 36% of GDP, considerably higher than the Latin American average of 20.5% (average in 1997-

[47] That is, (real implicit interest rate – ΔGDP) · (Debt/GDP) = primary surplus. Whenever the left hand side of this equation is greater than the right hand side, then the Debt/GDP ratio will increase, and inversely, when LHS < RHS it will decrease. The primary surplus targets set with the IMF since 1998 have basically been the level that would keep the Debt/GDP ratio constant (Velloso, 2004:10).

2002). The high level of taxes has been increasingly denounced by business and by some pundits; however the government has had little difficulty holding that course.

Figure 10 – Evolution of Tax Burden, 1990 – 2003.



Source: IPEADATA. http://www.ipeadata.gov.br/.

On the side of expenditures the Executive has been limited to working with those items where it is not constrained by rigidities from making cuts, which is approximately 5% of total expenditures and encompasses mostly investment. The main instruments used by the Executive for this purpose have been the "impoundment decrees" (*decretos de contingenciamento*), through which expenditures that have been approved in the budget are suspended, integrally or partially, and made contingent on the evolution of the fiscal situation. As the year progresses the expenditures can be "un-impounded", but more frequently remain suspended to help achieve the primary surplus targets. The notion that expenditures have been impounded has become part of day-to-day life for many Brazilians, particularly those who work for or with the government, as many of these expenditures befall the functioning of the governmental machine. Another important victim has been infrastructure, with the consequence that the past decade has witnessed a growth-threatening depreciation of roads, other modes of transport, ports, and energy generation.[48] Velloso (2004: 25) shows that from 1987 (before the current Constitution)

[48] Note that the infrastructure projects that are frequently the object of the impoundments are also the essence of the individual budget amendments through which the Executive negotiates pork with

to 2002 there has been a fundamental restructuring of the budget, with the pension bill growing 380% above inflation, other social security expenditures 271%, health 115% and a host of new social assistance expenditures being introduced, while capital and maintenance expenditures (basically investment and governmental machine) have fallen 41%. This change has consolidated a posture in budgetary procedures where human capital is privileged in detriment to traditional capital. Therefore, much of the budget is used to simply transfer resource to certain groups and individuals without providing any investment-like externalities, except to the extent that education and poverty alleviation can be viewed as investments in human capital. This obviously is not the case for pensions.

As time goes by it becomes increasingly difficult to achieve the required primary surpluses, as budgetary rigidities tend to expand over time and increases in the tax burden become ever more resisted.[49] As this happens the Executive will have increased incentives to try to remove some of the rigidities that constrain its budgetary strategy so as to allow more leeway to pursue its fiscal policy. It is interesting that while the Executive has had powers to be dominant within the budgetary rules, it has been slow to attempt to use those powers to change the rules themselves. Apart from the fund de-earmarking 20% of revenues (successively named Social Emergency Fund, Fund for Fiscal Stabilization and De-linking of Budgetary Resources) there have been few attempts to address the source of rigidities. We suspect that as primary surpluses become more and more difficult to be realized, further changes will be attempted. The government has, for example, been pressuring the IMF to remove from the calculus of the primary surplus investment in infrastructure. Another example was the government's attempt in 2003 to count expenditures in sanitation as being health-related so as to ease the restriction of minimum health expenditure. The government retreated from this idea when the head of the *Ministerio Publico* (Public Prosecutor's Office) warned the president that the move was unconstitutional and he would take the issue to the Supreme Court.

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congressional representatives. Therefore, as budgetary rigidities increase the trade of pork for policy becomes more difficult. This may be another source of reduced governability.

[49] It is true, however, that the recent (2004) improvement in the macroeconomic situation, if sustained, may provide some respite and allow an easing of the fiscal effort.

The constitutional amendment which imposes the restriction (*Emenda Constitucional* 29) establishing the amount of resources destined to health expenditures must be redefined by complementary legislation every 5 years. In 2005 the rule that health expenditures must increase with GDP will be substituted for an earmarked percentage to be defined at that time (Reis and Valadares, 2003: 19). If a complementary law is not forthcoming the current rule continues in place. Thus, there will be an occasion when these rigidities will be re-discussed. It is in such instances that the political transactions that this project focuses on are established (or not). In the next subsection, we look at some such events so as to understand how these transactions are realized in the Brazilian budgetary process.

V.3 –Political Transactions and Budgetary Rigidities

In this section, we discuss the evolution of the hardwiring game and its political dynamics. We proceed as follows. First we distinguish two types of rationale for these kinds of institutional rigidities: hardwiring as pre-commitment device and hardwiring as spin-offs of opportunist interaction. Then we provide a narrative of this evolution.

The narrative of the political process of hardwiring presented below underscores two sets of issues addressed in the literature. The first issue is the use of hardwiring as a pre-commitment or self-binding device. Faced with the problems of time inconsistencies in their behavior, actors may rationally decide to bind their own hands.[50] This is the rationale for the delegation of authority to a third party by credibility-seeking political actors. Constitutions are typically the most used institutional device for political actors to guarantee that their actions are binding. Constitutions are sticky because several procedural elements guarantee inertia. These include: 1) supermajority requirements; 2) special and complex voting mechanisms (e.g two or more rounds of vote); 3) votes by the two houses in bicameral polities; 4) ratification by third parties (by citizens in referendums; or special legislatures, e.g. state assemblies); and 5) delay mechanism requirements that a legislature has the prerogative to propose a change to be voted by future legislatures.

[50] For an extensive treatment of these issues see Elster (1979) and Elster (2000). For a discussion of balanced- budget constitutional amendments, see Elster (2000: 142-143).

Hardwiring can also be the unintended consequence of the inability of a polity to generate inter-temporal political transactions (Spiller and Tommasi 2003). This is likely to occur when institutions are weak and unable to secure inter-temporal political transactions. This is associated with the combined effect of lack of trust and of enforcement technologies. In these circumstances, because the likelihood of opportunism is high, actors discount the future heavily, and inefficient social outcomes prevail. To defend themselves from ex post opportunism, actors produce institutional devices that impose costs on opportunistic behavior, or just make it impossible to renege on promises or contracts.

In the following we find evidence that confirms both uses of hardwiring. We argue that in certain cases hardwiring appeared as a result of meta-preferences by the actors for a certain outcome. This is exemplified in the hardwiring for education and health care. This is also the case when actors used hardwiring to protect themselves from pressures in blame shifting strategies (exemplified by the Fiscal Responsibility Law, which was used by actors as an excuse to say no not to special demands from their own constituencies). But most of the instances of hardwiring are the result of the second type identified above. The extensive hardwiring of sub-national fiscal practices has been the product of mutual opportunism between sub-national governments and the federal governments.[51] A history of opportunism by the Federal Executive that used its institutional prerogatives to impose losses to the sub-national governments led to countervailing measures by sub-national actors that expanded the fiscal and budgetary powers of sub-national governments in contexts in which they were able to react. As discussed below the constitution of 1988 was one of these exceptional moments. The history of post 1988 constitutional reforms can be read as a series of counter measures taken by the executive – to de-constitutionalize issues - to re-establish its preponderance in the Brazilian federalism (Melo 2004b). The political dynamics of constitution-making and constitutional reforms are very different. In the former process, the interests involved managed to introduce provisions that typically generated diffuse costs and concentrated benefits. Because of the history of opportunistic behavior of authoritarian governments in

[51] For a similar process – but with much more perverse effects - in Argentina see Saiegh and Tommasi (1998). For a discussion of the contrasts between the cases Brasil and Argentina, see Melo (2004a).

the past, the constitutional text is one of the longest and most detailed of existing constitutions. It included detailed hardwiring to protect pensions, sub-national finances and public sector employees. The end result of this process has been a very distorted tax system (but capable of extracting 37% of GDP) and at the same time, severe and chronic fiscal problems.

In contrast to this Christmas tree dynamics, constitutional reforms have entailed the opposite, thus generating intense resistance form organized interests. However, despite the procedural hurdles involved, because of the preponderance of the executive in the polity, there have been extensive constitutional changes – 4.1 amendments per year (Melo 2002; Melo 2004b). These changes were made at a surprisingly low economic cost (Pereira and Mueller 2004), but have certainly concentrated the political energies of the country to the detriment of other issues.

Analytical Narrative of post 1988-Hardwiring:

The preceding section has discussed how the rigidities in the budget constrain executive discretion in the budget making process. The rigidities identified were of two types. The first type is associated with expenditures that have a dynamic that is largely independent of the political process. These include for example social expenditures whose expansions are determined by exogenous factors. The largest components of the budget fall into this category: social security, personnel expenditures and payment of interest rates. Factors such as aging of the population and higher life expectancy have an impact on the social security budget. Similarly, personnel expenditure tends to rise as a result of the combination of promotion policies and aging of the workforce (raising the number of and value of age-related fringe benefits). In turn, interest rates are largely determined in international markets as a function of country risk. The other types of rigidities are produced by the active strategic interaction among the various political actors involved. Hardwiring in this case is the result of purposeful action. Rigidities of this type are constrained by those of the first type described above. Many of these also produce unintended perverse effects over time.

The political transactions around the hardwiring game in the last decade can be seen as a reaction against the state of affairs produced by the Constitution of 1988. As indicated before, the Constitution was written under unique circumstances, the most important of which was the fact that the Executive played virtually no role in the process. Furthermore, the sub-national actors, in particular governors, were the key actors in the constitution-making process. Because the first direct elections during the political transition were the gubernatorial elections, in 1982, governors acquired great legitimacy and became the guarantors of the new regime, actively negotiating the transition with the military regime. The constitution making process was therefore marked by the strong influence of sub-national interests and of interests of the opposition forces which were organized around a number of principles, including "redeeming the country's social debt" and professionalizing the bureaucracy.

The Constitution produced short-term fiscal impacts and introduced a number of fiscal rigidities. First, it mandated a new distribution of the public revenue, to be fully implemented in five years, in which state and municipal governments (particularly the latter) augmented their share in tax revenue. In addition, the sub-national governments saw their tax base expanded. Second, the Constitution set the minimum value of pensions at the level of the minimum salary, guaranteed the real values of social security pensions (pension and survivors pensions) over time - explicitly prohibiting the inflationary erosion of any pecuniary benefits -, and also equalized the level of urban and rural pensions.[52] In addition, it expanded the range of welfare benefits to rural workers, which in the past were a fraction of those of urban workers. Third, with the stated goal of professionalizing the public bureaucracy, the Constitution upgraded public employees with CLT contracts to Civil Service Status (RJU regime). In practice, this would entail that public employees would lose their right to severance pay but would be granted tenure, and most importantly would be entitled to the rules governing civil servant retirement. These included a 100% replacement rate – sometimes even higher that that – and special retirement rules. The new rules took effect after Congress approved the enabling legislation in the early 1990s. For social security, two organic laws were passed in 1992 and 1993, whereas the RJU was implemented in 1991. The laws of 1992 and 1993 had the impact of creating an estimated 250 thousand public employees – a large number of which delayed their retirement to 1992. The new law also entitled urban

[52] Previously, rural pensions were calculated as 50% of urban pensions, and more importantly rural pensioners would not be entitled to family allowances nor to an array of welfare benefits paid to their urban counterparts.

benefits to an estimated 2 million rural workers, raising expenditures in the short term. Last but not least, pensions and social security allowances were protected from inflation.

The fiscal game in the 1990s reflected, to a great extent, the reactions from the federal Government to this state of affairs. Starting in the Collor Administration (1990-1992), an array of measures was carried out. The administration's refusal to readjust pensions in line with inflation produced a huge social mobilization of pensioner's unions, which appealed to the Supreme Court. The case was settled by a ruling by the Supreme Court that ordered the Ministry of Social Security to raise pensions by 147% (Melo 1999). This episode provides strong evidence of the extent to which the constitutional rigidities are effectively enforced by the judicial system. The federal government also reacted to the new fiscal federalism by resorting to a two-pronged strategy. The first one – which involved the line of less resistance – was to raise social contributions; a significant percentage of the ten percentage increase in the tax/GDP ratio between 1992 and 2002 is due to raises in the rates of social contributions. This explains why these highly distortionary forms of taxation came to represent half federal tax revenue. Social contributions are cascading taxes which in many cases exploit similar tax bases.[53] In sum, the rigidity imposed by the Constitution caused the federal government to resort to an increasingly inefficient tax system.

The second strategy required changes in the Constitution. It required withholding funds mandated for distribution to sub-national governments. We have already described these initiatives in the preceding section. It started with the proposals by the Collor administration in 1992 – the so-called "*emendão*." Collor set up a special committee for fiscal reform (CERF), which came up with proposals that were very similar to those implemented or proposed by Cardoso's government. These included the de-linking of resources earmarked as transfers to states and municipalities, a tax on financial transaction, a federal IVA, and the elimination of the special employment regime for civil services (RJU). This reform package was not approved because of the impeachment of Collor, but the proposal to withhold sub-national funding re-emerged during the constitutional revision of 1993-1994. Approved as Constitutional Revision Amendment

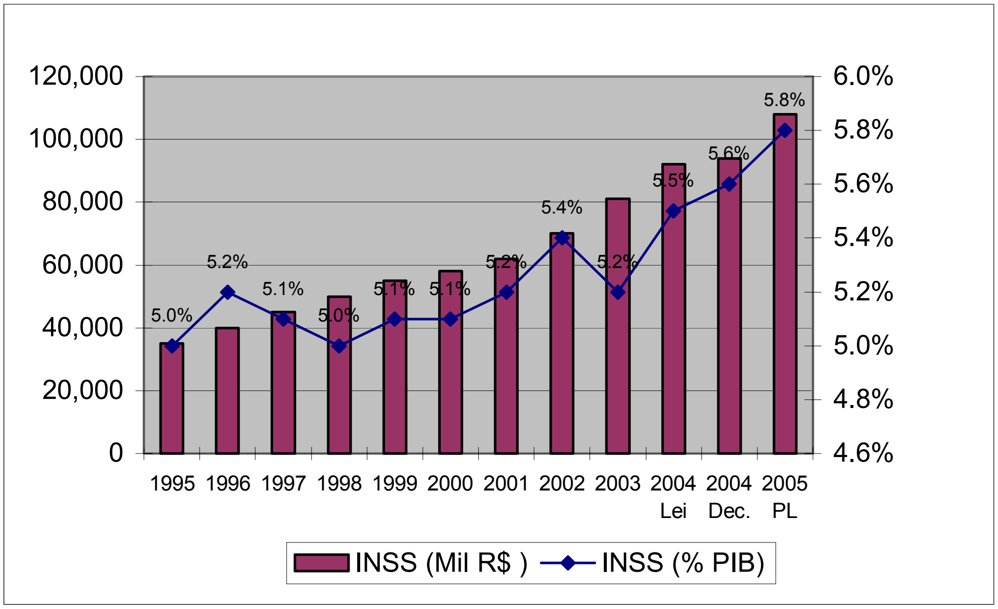
[53] Lula's mini tax reform has finally eliminated the cascading effect of the largest social contribution, the Cofins.

1, in 1994, it was named the *Fundo Social de Emergência* (ER no. 1). It should be noted that new contributions were also proposed by constitutional amendments. The most important new one – on financial transaction - was approved as a constitutional amendment (EC 3, of 1993). In its paragraph 3, it says explicitly "that the proceeds from this tax cannot be shared with any other entity of the federation".

The government proposed two additional reform amendments that are of a comprehensive nature. The first was constitutional amendment 20 in the area of social security. The reform package aimed at eliminating distortions caused by the inexistence of a minimum retirement age along with a number of special privileges enjoyed by specific categories. This package approved represented a parametric reform, particularly in the private sector sub-system, that introduced changes in the most dramatic distortions of the system. It did not amount to a structural reform modeled at the three-pillar system. Rather it replicated some initiatives implemented in some OECD countries, which aims at adjusting pensions to length of working life, past contributions to the system and life expectancy (using a virtual or notional accounting system based on an algorithm, the pension "factor"). Amendment 20 also eliminated other distortions in the civil servants sub-system.[54] Nonetheless, as the previous section makes it clear, the budget rigidities in the area of social security financing have remained considerable. This can be explained primarily by the effect of two shocks.

[54] These include among other things changing the rules for acquiring civil servants pensions to former workers in the private sector. Before the reform, an individual working in the private sector would be entitled to a full civil servant pension (full replacement rate) if he had spent only 5 years in the public sector. This encouraged the migration of private sector workers to the public sector when they approached retirement age.

Figure 11 – Social Security Revenue



First, the shock to the system represented by the granting of civil servant status to 250,000 employees in 1992 could not be readily accommodated even with substantial changes. As the record shows many changes were significant. It should be mentioned that the constitutional reform of the public administration eliminated the RJU and consequently employees' tenure. Second, the shock represented by full status granted to rural workers. This was a huge shock because welfare allowances (LOAS) and rural pensions, which represent over 40% of pension benefits, are financed by payroll contributions of current workers. Real rises in the minimum wage and increasing coverage explains the upward trend showed in Figure 11. Although, this represents a major factor accounting for the rigidity of the social security system, it should be viewed as a shock generated outside the social security system. As Velloso (2004) shows, if these two types of benefits (LOAS and rural pensions) are eliminated from the expenditure side of the social security system, it becomes clear that the executive has been able to implement reforms which have addressed the problem, although at the cost of producing distortions in the labor market).

The changes described above are successful attempts by the executive to respond to the state of affairs created by the Constitution and to rigidities associated with independent causal factors. The interpretation we offer is that the Constitution should be seen as the point of departure for a new fiscal game. Following its enactment, the Executive started reacting to the state of affairs it created. The changes we described reflect the ability of the Executive to impose its agenda but not necessarily to solve the fiscal and budgetary problems. Many measures have been proposed as temporary and are "sunshine legislation". However, the Federal executive has managed to successfully reenact them.

Congress has not been inert. The legislature has increased its role in the process. In fact, many of the proposals should be seen as reflecting an exchange between the Legislative and the Executive. In the game described in this paper, the executive has strong preferences for fiscal stability and congress for social spending and pork. The constitutional amendments creating the tax on financial transactions, the fund for fighting poverty and the Fundef, reflect the perceived need by the executive for new taxes or higher rates. In exchange, the Executive agreed to some hardwiring – in other to constrain sub-national fiscal behavior, and at the same time Congress gets more resources in the social sectors, particularly in areas where there is great societal support. Two examples include: the creation of the fund for fighting poverty and the reenactment of the tax on financial transactions (CPMF). While acknowledging the gravity of the poverty situation, the Cardoso administration opposed the idea of a fund for poverty alleviation because it would imply "budget rigidity." The original legislative proposal contained several sources of revenue for the fund, including a bill taxing individual wealth and assets. The proposal – which became Constitutional Amendment 31 - was approved in a compromise. The main source of income would come from the existing tax on financial transactions (CPMF). As indicated before, this tax was introduced in 1993 by a 'sunshine legislation' – a transitional clause in the constitution, which was legally valid for two years. The government endorsed the legislature's proposal and accepted that an increase in the tax rate would be earmarked for the fund.[55] The Cardoso government approved the

[55] Constitutional amendment 12/1996 created the CPMF with a rate of 0.25%. The tax was earmarked for health care and was valid for two years only. Constitutional amendment 21 extended the validity for three additional years. The rate was raised to 0.38 in the first year and to 0.30 in the remaining two years – but the proceeds would be earmarked for social security. The Fund for Poverty Eradication guaranteed that the 0.38% rate was maintained. The fund created some rigidity because should the yearly proceeds collected not reach 4 billion Reais, the national government was to provide the difference with general tax revenue.

constitutional amendment and extended the time for expiration of the tax by additional 2 years. Because the fund would last for 10 years, further extensions would be 'locked in'.

The prima facie attempt to introduce rigidity in the budget for the purposes of poverty alleviation can be understood as part of logrolls between the executive and legislative branches. The executive maintained fiscal stability by increasing taxes and in return Congress received some poverty alleviation programs sheltered from discretionary executive budget cuts.[56] This is consistent with the political game in our paper. The executive prefers hard wiring sub-national spending and at the same time to expand the scope of discretion at the national level. The gains from trade between Congress and the executive is that the latter is primarily interested in raising taxes and the former seeks to expand social expenditures and funding for pork. To allow the executive to extract resources from society – a move, which produces significant political costs to legislator's constituencies – congress has increasingly demanded that some of the resources are hardwired to the social sectors. Many of these are also in the interest of the federal executive – they are meta-preferences, in the sense used above - and therefore the political market is "cleared" in this exchange.

V.4. The Sectoral Dynamics of Hardwiring

In this section we provide a case study of an illustration of the argument that there is a specific sectoral dynamics in the politics of hardwiring. In the previous sections we argued that hardwiring has taken place mostly in the social sectors. Presidents have insulated the core ministries of the social sector (in contrast with transportation, and other infrastructure areas, or the rest of the periphery of the federal machinery which became part of the spoils of office) or the Finance and planning core bureaucracies. By contrast to appease to the demands of low maintenance constituencies[57] in Congress, Presidents have played the budget execution game described in detail in the next section. These have included mostly projects in the area of infrastructure. This development can be explained by the fact that infrastructural investments are capital investments and require further borrowing and have fiscal implications for indebted municipalities and states; and because current predominant

[56] The amendment prohibits the *desvinculação* (withdrawal of earmarking) of the fund's resources.
[57] See Gibson and Calvo (2000)

view in development circles gives emphasis to human capital investments. In contrast to the areas of education and health care infrastructure, including urban infrastructure was severely affected. These areas became the loci of political deals. They are also more amenable to patronage games because they are typically geographically concentrated and legislators can claim credit from them. These projects however have significantly been the ones most subject to impounding (budget cuts). This trend suggest that the scope for the budgetary game described in the next section has been shrinking, and that perhaps other clientelistic mechanisms – such as job politics – has been used more intensively.

The data for a major housing program is illustrative of the increasing clientelistic use of infrastructure projects. Budget amendments by legislators in this area are so extensively used that the Ministry of the Cities have virtually no programmatic role in the allocation of resources. Table 5 shows data for the "origins of funding" for the *Morar Melhor* program. It is highly significant that only 5% percent of the funding is freely allocated by the Ministry of the Cities. In contrast, 95% are legislative amendments from individual legislators or groups of individual legislators (collective amendments). This state of affair undermines any technical rationality that the Ministry pursue in its strategic planning. On the other hand, it is interesting that these areas are the ones most likely to suffer impounding (Table 6).

The severe crisis in infrastructure is the other side of the coin of the professionalization and universalization practices found in Education and Health. They should be interpreted as the other side of the hardwiring game. They are the area where no hardwiring occurs. But as mentioned before they also reflect the prevalence of a concern with fiscal stability. In this view infrastructure represent investments and contribute to fiscal instability. By contrast, cash transfers; education and health spending are mostly recurrent expenditure. Finally they also express the prevalence of a human capital approach to social development. It was for this reason that the Federal Executive could agree to the hardwiring of resources for these two areas. Hardwiring for Health Care and Education reflects equilibrium in so far as they are also supported by public opinion, legislators and the World Bank.

Table 5
Federal Housing Program – 2003 budget by origin of funding
in million of Reais

Origin	Value	%
Individual amendments	73	24,60%
Collective amendments	207	69,70%
Discretionary application by Ministry for the of Cities	17	5,70%
Total	297	100,00%

Source: Tribunal de Contas da União (2004)

Table 6
Budget execution for Housing

Year	*Planned in budget law*	*Executed*	*Executed/planned. (%)*
1994	285,	5, 9	2.1
1995	134,8	0,8	0,6
1996	388,1	197,5	50,9
1997	393,7	305,5	77,6
1998	490,1	218,0	44,5
1999	189,4	118,4	62,5
2000	424,9	235,8	55,5
2001	294,6	74,1**	25,2**
In millions of Reais; ** until September			

Source: Câmara dos Deputados (2001).

VI – Political Transactions in the Budgetary Process: The Role of Budget Amendments.

The exchange of policy for pork is an important component of our general framework as it allows the Executive to successfully pursue his macroeconomic objectives. One of the key instruments through which these exchanges take place is the use of individual amendments by congressmen to the budget proposal by the Executive as it passes through Congress. As described in Section IV.4, the Executive not only has the power to veto these amendments, but more importantly can chose whether or not to execute (appropriate) those amendments with extreme discretion.

Pereira & Mueller (2002, 2003, and 2004) and Alston and Mueller (2006) have shown that the execution of individual amendments is used strategically by the Executive to garner support. In Alston, Melo, Mueller and Pereira (2004) we showed the econometric exercise in Pereira & Mueller (2002, 2003, and 2004) using data roll call and amendment data from 1995 to 1998 which provides evidence of this strategic behavior. Table 7 below shows a similar result from Alston and Mueller (2006) using data from 1998 and focusing on a specific event related to pension reform. The percentage of the total value of each deputy's amendments that were executed in 1998 was regressed on a series of variables that should affect the President's decision whether to execute those amendments. The explanatory variables are: i) *Votes* - the percentage of times the deputy voted favorable to the President's position in the 1995-1998 period; ii) *Exec. Amend. 1997* - the percentage of the total value of individual budget amendments that were executed in the previous year, 1997, to control for inertia in the execution of amendments; iii) *Position* - a dummy that equals 1 if the deputy held a powerful position within Congress during that year, such as speaker, party leader, committee president or *rapporteur*; iv) *N^0 Amendments* - the number of amendments submitted by the deputy that year; and v) *Seniority* – the number of terms served by the deputy.

Table7 – Strategic Use of Individual Budget Amendments

	Dep. Var.: Executed Amendments 1998
Constant	-4.822
	(-1.17)
Votes	27.341 ***
	(5.54)
Exec. Amen. 1997	0.106 ***
	(3.15)
Position	-0.458
	(-0.22)
N^0 Amendments	0.428 *
	(1.61)
Seniority	-0.189
	(-0.22)
No to Yes	11.373 *
	(1.78)
Yes to No	-5.479 *
	(-1.63)
R^2	0.08
N	426

t-statistics. in parenthesis. Significance: ***1%, **5%, *10%.
Instrumental variable squares estimation.
Covariance matrix is White's robust, heteroscedasticity corrected matrix (White 1980).

In addition there are two dummies that refer to two specific votes in 1998 related to pension reform, where the Executive had a crucial proposal rejected on May 6 and then tried again on May 23 after additional distribution of pork through individual budget amendments, successfully passing the bill. The dummies indicate those deputies who switched their vote from *no*, against the President's proposal to *yes* in favor of the President's proposal; and 2) those deputies who switched their vote from *yes* in favor of the President's proposal to *no*, against the President's proposal.[58]

The results show that those deputies that provided more support through their voting behavior in Congress had more of their amendments executed by the Executive.[59] Also those deputies that switched their votes in favor of the Executive's proposal were additionally rewarded and those that switched contrary to the Executive were punished.

The evidence shows that individual budget amendments are an important means through which political transactions are realized. However, many of the changes made to the Executive's budget proposal are not in the form of individual but rather collective amendments, where several congressmen pool together to add a claim to the budget (almost always in the form of pork). Despite the fact that collective amendments represent more expenditures than the individual amendments, they have not been extensively studied in the literature. The purpose of this section is to examine if collective amendments are similarly used in a strategic manner in the realization of political transactions in the general and budgetary policy making process in Brazil. In other words, we examine to what extent does the collective amendment game resemble the individual one?

The rules regarding budget amendments have varied considerably in the past years. Prior to 1993 only individual legislators could propose amendments without restrictions regarding the number and the value of amendments a legislator could make to the annual budget bill introduced by the Executive. Perhaps, as one of the most important consequences of the budget scandal that took place in Congress that year, a set of institutional changes were initiated including the introduction of collective amendments via Resolution nº1 06/93-CN, allowing standing committees, regional blocs, and state

[58] Considering abstentions and absences as strategic did not significantly alter our results.
[59] The endogeneity in the *Votes* variable was taken into account through instrumental variable estimation.

blocs (*bancadas estaduais*) to also amend the budget bill.[60] For the annual budgets of 1994 and 1995 four types of amendments were accepted: standing committees, political parties, state bloc and individual legislators. Later, Resolution nº2 2/95-CN specified that political parties could no longer collectively amend the budget but preserved the right of standing committees, regional bloc, state bloc, and by individual legislators to continue amending the budget bill. This Resolution also established new rules for collective amendments restricting to 5 per standing committee; 5 per regional bloc; and 10 per state bloc.

This self-restriction by legislators, in the direction of reducing the capacity of individual legislators to amend the budget bill, can be interpreted as an attempt to rationalize and better coordinate the process by giving priority to collective amendments and thus reducing the large number of disputes among legislators to ensure approval of their proposals, especially from the governing majority coalition. In other words, in a crisis situation provided by the budget scandal, legislators were called to take the initiative to give a clear signal to their electorate and, at the same time, preserve their ability to keep amending the budget. The choice at that moment was: "to lose their rings but preserve their fingers" on the budgetary process. It is true that they are currently more constrained by the Resolutions that restricted their ability to individually amend the budget. But, at the same time, they found a way of safeguarding their ability to interfere in the budget process via collective amendments where, theoretically, the Executive would face more difficulties in reproducing the discretionary rewarding and punishing of legislators based on their behavior.

It is assumed that collective amendments have greater probability of being approved as they have the direct support of more than one legislator (Figueiredo & Limongi 2004). They represent approximately 80% of the total discretionary resources that have been allocated by Congress. According to the data from the Joint Budget Committee of the Brazilian Congress from 1996 to 2002, the amount of resources

[60] This Resolution nº 1 also restricted the number of individual amendments for each legislator to fifty. Resolution nº 2/95-CN further reduced the number of amendments to 20. The preliminary budget report made by the General Budget Committee Reporter set a ceiling of R$ 1.5 millions as the total amount of amendments per legislator. Recently, legislators decided to increase the value of this quota to R$ 2.5 millions and this year they decided to increase this ceiling to R$ 3.5 millions Reais for each legislator.

allocated as collective amendments (state block amendments) was about R$ 2.8 billion per year on average.[61]

As in the case of individual amendments, having a collective amendment approved in the annual budget law does not necessarily guarantee that it will be appropriated, since the appropriation of these amendments is a prerogative of the Executive. Only 78% of the collective amendments approved were executed in this entire period. Therefore, it is reasonable to consider whether a relationship similar to that which we found on individual amendments could also be established between legislators' support for the presidential agenda and appropriation of state block collective amendments. This analysis also aims at investigating if there are agreements among state politicians to combine individual amendments disguised as collective ones – which are called as *rachadinhas*. According to the Deputy Sergio Miranda (PC do B-MG), "almost 40% of the collective amendments have been systematically used in the form of *rachadinhas* to benefit electoral strongholds of individual legislators (*Folha de São Paulo*, November 13, 2001)." One similar complaint was offered by the current president of the Joint Budget Committee, Deputy Paulo Bernardo (PT – PR), who said that "several legislators are using state block amendments as if they were individual ones in order to deliver resources to their electoral bailiwicks. I have no doubt that it is a kind of distortion of the original purpose of this collective instrument." (*Correio Braziliense*, December 20, 2004). More recently, Deputy Paulo Bernardo pointed out that "the state block amendments became large camouflaged individual amendments" (*Valor*, January 14, 2005).

The usual procedure to have a collective amendment approved in the budget law requires that it be supported by at least 2/3 of signatures of Senators and Deputies of each state block. That is, without the compliance of the majority of state legislators there is no collective amendment approved. With rare exceptions, legislators from a state block put forward a collective amendment that reaches the budget bill. As the size of the pie is larger on collective amendments than individual ones, there is no incentive for a legislator to stay out of the state block. The choice of collective amendments that will be

[61] The choice to focus this analysis only on state block amendments is just for practical reasons. We believe however that the same rationale is applicable to standing committee and regional block amendments as well.

included in the budget bill is made in a meeting when state block members also choose who will be the Coordinator of the block. This is a key position since she will be in charge of demanding the inclusion of legislators' amendments in the report of the Budgetary Joint Committee, and during the phase of budget execution as well. That is, as soon as the Executive decides to appropriate a collective amendment it is the State Block Coordinator who informs to the proper Executive branch how a wide-range amendment should be allocated. In other words, as soon as the Executive opens the gate by determining the execution of the collective bill the President loses control about which legislator would be the lucky one with conditions of claiming the credit for delivering the policy.

Another institutional peculiarity of collective amendments has to do with the decentralized process of reporting budgetary bills, including collective amendments, in the Joint Budget Committee. The distribution of bills among committee members follows the rule of proportionality of the number of seats each political party holds. That is, not only faithful members of the governing coalitions have the prerogative of reporting a budget bill, but any member of the committee could do this. According to the Deputy Paulo Bernardo, "it is not uncommon to see members of the budget committee pressing for a favorable report regarding a budget bill because it incorporated individual demands of legislators."

These are some reasons that suggest why the Lula administration has been offering clear signals that it intends to revamp the existing rule about collective amendments. A very good example of this was provided by the President of the Worker's Party – PT, Jose Genoino, in a recent interview to a national wide newspaper:

> State Block amendments are extremely valuable in terms of resources; however, they have no 'Social Security Number' neither 'Identification Number'. Thus we cannot identify the author. It is true that individual amendments are problematic, especially because they pulverize resources, sometimes in an inefficient way. Nevertheless, their value is small and, most importantly, they do have a 'social security number', which makes them easier to control. Before the Inquiry Parliamentary Committee – CPI which investigated the budget scandal in 1992, the individual amendments were even more problematic since there was no ceiling in the value or limit in the number of amendments a legislator could craft. The Congress thought, at that time, that state block amendments would be an alternative. However, they turned out to be today as big of a problem because

> individual deputies have been exploited this opportunity to use collective amendments privately (*Valor*, 02/18/2005).

Another indication suggesting that the Executive has been extremely concerned about controlling collective amendments is the determination of Lula's administration to shut off the appropriation of R$ 7.8 billions from collective amendments that have been already authorized in the 2005 budget law. On the other hand, the government behaved in a different manner concerning the individual counterparts. The government decided to appropriate R$ 2 billions of individual amendments (*Folha de Sao Paulo*, 02/22/2005). Possibly, the Executive realized that unfaithful legislators from his coalition and from the opposition parties were exploiting the opportunity of this collective instrument ho have access to public resources without paying back with their political support.

In the investigated period (1996 – 2002), about 80% of state block collective amendments were concentrated in six governmental agencies: Departments of Roads (about 20%), Secretary of Urban Development (around 20%), Ministry of National Integration (around 20%), National Fund of Health (around 15%), and Ministry of Transportation (around 5%). They were typically oriented to government programs in the areas of transportation, health, and urban infra-structure in the form of umbrella amendments[62], in which there is no geographical location for the investment, unlike the vast majority of individual amendments. This characteristic along with the absence of an author makes it more difficult for the Executive to trace the interests involved and identify which legislator would benefit from the appropriation of such collective amendments.

Although Resolution nº2 stipulates up to 10 collective amendments as the maximum number by each state block, there is no rule establishing either a maximum or a minimum value. According to our data, state block amendments have broadly ranged from R$ 1.5 million to R$ 100 million. This tremendous variation suggests that the legislators' room for budgetary maneuver and autonomy on collective amendments is extremely high.

In future extensions on this topic we plan to test econometrically whether the President strategically uses collective amendments, as in the case of individual

[62] Similar to what Shepsle called Omnibus amendment.

amendments, or whether the pooling of deputies allows them to evade the President's grip. If, as expected, we find that there is no relation between the legislator's support for the President and the value of collective amendments executed, then this would suggest that the budget process mirrors the hybrid aspects of the Brazilian political system suggested earlier. While some proportional and inclusive features (PR + open list, federalism, multiparty, coalitional government, and so on) decentralize and fragment the system, other majoritarian aspects (presidential powers, congress organization, strong party leaders, etc.) work centralizing the same system. In other words, while the individual amendments would express the majoritatian features of the Brazilian political system working as an important source of governability by 'greasing the wheels' (Evans, 2004) of the governing majority coalition, the collective amendments would allow a broader bulk of consortiative and diverse representation of interests to have access to the budgetary game, not only from the majority of the faithful members of the governing majority coalition, but also from their unfaithful members as well as from the opposition legislators.

VIII – Concluding remarks and recommendations

Having analyzed how the budgetary process in Brazil works we conclude by considering the merits of and problems with the process in order to derive policy recommendations. Some politicians have advocated that the budget passed by Congress should become mandatory thereby eliminating the current power of the President to appropriate the budget. In particular many politicians do not favor the discretionary execution of amendments, especially its investments portion where are located the individual and collective demands from legislators. Our working hypothesis is that such a law might severely limit the means of the President to pursue responsible economic policy. There is a trade off between governability and the strengthening of the legislative body that would result from reforming the budget rules. It is important to keep in mind that there is no ideal political system. The institutional setting that emerged from the 1988 Constitution was a consequence of legislative choice, which decided to delegate a large share of agenda powers to the Executive, including the power of unilaterally executing the budget. The underlying rationale for this was to prevent institutional instability between Congress and the Executive which was prevalent during the previous period of democratic rule, from 1946 to 1964. The majority of legislators learned from the 22 years of dictatorship that an institutionally weak president could not last without some sort of governing capacity to enforce his agenda. Congress decided not to change electoral rules, that is, not to reform the PR open list system in the new constitution, because it would be too risky for legislators' electoral survival; the choice thus was to transfer institutional powers to the Executive to ensure governability.[63]

The most important consequence of this institutional design was that all elected presidents so far have been able to build reasonably stable post-electoral majority coalitions within Congress, with a high level of governability, by means of strong party discipline within the presidential governing coalition. In fact, Brazil has not yet faced a truly divided government under the current political institutions. This is not coincidental, given the extent of institutional powers and resources held and selectively distributed by the Executive. The combination of provisional decree, vetoes, urgency petitions, and budget dominance provides the executive an impressive set of instruments to control Congress' agenda by blocking legislation that it does not like as well as enforcing its own legislative priorities. In other words, the coalition-based presidential system in Brazil affords incentives for the aggregation of interests and political parties around the Executive's governing coalition within Congress.

While many pundits criticize highly discretionary budgetary powers concentrated in the hands of the President as evidence of usurpation of democratic power, this institutional feature plays a key role in ensuring institutional capacity. The game involving the President and legislators is an exchange of pork for policy that allows the President to achieve even more favorable outcomes than would be possible using only his other institutional powers. The congressional representatives also benefit because the patronage and transfers received increases their utility (chances of political survival) more than it is reduced by their policy concessions. As we stated earlier, the budgetary rules in Brazil allow gains from trade for a set of players. Therefore, without other reforms such as electoral reform that would provide, for instance, pre-electoral partisan

[63] An alternative, though not mutually exclusive, explanation is that the military government still had considerable agenda control and favored strong Presidential powers.

power and ideological consistency to the Executive, it is unthinkable to make budgetary decisions taken by Congress as mandatory as has been demanded by the media and some politicians. It is simply too risky for the governability of the young Brazilian democracy. In other words, reforming budgetary rules cannot come alone. It must occur along with other compensating institutional mechanisms able to provide party cohesiveness. However, as the majority that gravitates surrounding the Executive seems 'satisfied' with the current equilibrium there is little grounds to believe a comprehensive reform like this would take place.

> "Rules are, at least in good part, devised in the interests of private well-being rather than social well-being. (…) Hence, only when it is in the interest of those with sufficient bargaining strength to alter the formal rules will there be changes in the formal institutional framework (…) Although the institutional constraints may not be ideal or efficient for a set of individuals involved in a particular exchange and therefore those parties would like to restructure the institutions, the same set of institutions for other sets of choices may still reflect as efficient a bargain as it is possible. Moreover, it is the bargaining strength of the individual and organizations that counts. Hence, only when it is in the interest of those with sufficient bargaining strength to alter the formal rules will there be changes in the formal institutional framework." (Douglass North, 1990, pp. 68)

Another aspect that has to be considered in this discussion has to do with private versus public regardness of budgetary policies in Brazil. The current rule which allows an individual legislator to allocate, based solely on her preferences, about R$ 3.5 million of public resources mostly to pork via individual amendments does not necessarily cater to the public interest.[64] To what extent is this manner of distributing public resources efficient? In addition to considering the economic efficiency of this mechanism, many people argue against its legitimacy. Whether these types of transactions will push outcomes towards inefficient or efficient policies, cannot be determined without consideration of the player's preferences. Although there is a general presumption that dealings among politicians serve illegitimate purposes, this need not be the case. When the parties to the exchange have preferences for more efficient policies, political transactions may increase welfare. Whether or not the key players' preferences pull towards efficient policies depends, to a large extent, on how political institutions shape their incentives. In the case of collective amendments, for example, there is no guarantee that a decision made by a group of legislators will be more representative than that made

[64] We also note that a lot of pork goes into infrastructure projects which have a public good purpose even though regionally or locally specific.

by single one. The findings of this paper suggest that collective amendments can also be privately appropriated. As in a PR open list system where candidate selection, election campaign, and electoral survival are perceived as dependent on personal records and individual initiatives, legislators will have few incentives to change a rule that allows them to deliver individual policies which will have a direct impact in their political career.

As for the rigidity in the budgetary policies, we have extensively argued that residual policies in Brazil tend to be very volatile. In order to deal with this inherent tendency towards volatility, politicians have often chosen to hard-wire some policies where it is considered that the volatility can be particularly damaging for them. Again, there is a clear trade-off here. At some 'constitutional moment' politicians establish impediments to changing these policies by tying the hands of future political actors. This results in rigid policies, which is an advantage when this rigidity constrains opportunistic behavior but at the cost of reducing the ability to adapt to unforeseen future contingencies. This pattern of rigidity is a direct consequence of the Christmas tree-like nature of the 1988 Constitution where a gamut of different groups managed to insert their own provisions and insulate them from future policy makers. When one considers together the rigidities over revenues with those on the side of expenditure, it becomes clear that the government has very little space to maneuver when setting the budget and formulating policy. This lack of freedom is all the more troublesome when one considers how it constrains the government in the task of dealing with its most important macroeconomic problem, the public debt.

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