FISCAL RULES AND FISCAL POLICY IN BRAZIL

Ana Teresa Holanda de Albuquerque[*]

The Brazilian fiscal framework, set from 1997 to 2001, played an important role in the macroeconomic consolidation and allowed the Government to adopt countercyclical measures to tame the financial crisis of 2008. The fiscal framework can be summarized in five steps: i) a large-scale privatization program; ii) recognition of extrabudgetary unrecorded liabilities; ii) subnational debt restructuring program; iv) achievement of public sector high primary surplus targets, in order to redeem net debt in the long term; and v) the institution of fiscal rules by the Fiscal Responsibility Law, which comprises general targets and limits for selected fiscal indicators. In 2003, the central government decided to raise the primary surplus, and therefore when the crisis arrived at the end of 2008, the public sector net debt had already fallen from 60.6 per cent of GDP to 38.4 per cent of GDP. During that time, the decision to expand the allocation in allowances provided to low-income families proved an important cushion when the crisis came. In 2009, the net debt shifted to 42.8 per cent of GDP due to loss of revenues, tax deductions and subsidies to companies through low interest rates loans provided by the national banks. Moreover, mandatory expenditures kept increasing, contributing to boost government dissavings. In the near term, the primary surplus is due to increase again, offsetting the net debt recent rebound. However, important fiscal policy challenges still remain.

1 Introduction

The paper provides an overview of the Brazilian fiscal policy undertaken during the past 16 years, since the launching of the Real stabilization plan in July,1994. It also discusses the active fiscal policy and recent outcomes after the financial crisis in 2008 and the main challenges to be tackled in the near term.

The fiscal framework built throughout the mid-'90s, as a response to the impact of the Real stabilization plan aftermath on fiscal accounts and to the international economic turmoil, provided the background for the favorable fiscal stance after 2003 and was an important means to supporting the fiscal policy undertaken in 2009, aimed to offset the impact of the recent financial crisis. It can be summarized in four steps: i) a large-scale privatization program, aimed to transfer to the private sector the activities unduly undertaken by the public sector, to reduce the public debt and to finance a major part of the external unbalance; ii) recognition of quasi-fiscal or extrabudgetary unrecorded liabilities; iii) subnational debt restructuring program conditioned to fiscal adjustment programs, intended to stop recurrent intra governmental bail-outs; and iv) the institution of fiscal rules by the Fiscal Responsibility Law in 2001, which sets a fiscal framework, ceilings for selected indicators and rules towards governance and transparency. Moreover, other efforts towards administrative, social security and civil servants' pension reforms were gradually addressed. From 1996 to 2002, the net debt soared from 30.7 per cent of GDP to 60.6 per cent GDP, respectively, due to the impact of international crises, high interest rates and the amount of liabilities recognized in the net debt during the period of fiscal adjustment. In 2003, the central government decided to increase the primary surplus, so as when the 2008 financial crisis erupted, shrinking the external credit and putting downward pressure to exchange rate depreciation, the public sector net debt had already

[*] Chief economist of the Ministry of Planning, Budget and Management, Brazil.

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fallen to 38.4 per cent of GDP. During that time, the decision to increase the allowances provided to low-income families was an important cushion to the economic impact of the recent financial crisis.

Going forward, the paper estimates that the public sector net debt to GDP rate tends to fall in the near term, due to: high primary surplus targets, lower level of interest rates than in the past years and expected economic growth in the following years. High primary surplus will still be necessary to contribute to foster domestic savings and to reduce long term real interest rates. Besides, the government will have to take measures towards the control of current expenditures, in order to allow an increase of the public investment share on total expenditure, and to make a step forward in the fiscal reform agenda.

The paper is divided in four sections: the first presents the main fiscal measures undertaken in the Plano Real aftermath and their impact on net debt; the second addresses the impact of the Fiscal Responsibility Law (FRL) on sub-national goverments' fiscal accounts; the third refers to the management of fiscal policy from 2003 to 2008 and the recent countercyclical measures taken after October, 2008; the last section addresses the near-term challenges. The FRL main features are treated in a specific Annex.

2 Fiscal consolidation background

In spite of the Real Plan success in controlling inflation, the public finances were still to be tackled in 1994. After the price stabilization, the governments were not able to adjust their finances by inflation as before, mainly by adjusting expenditures below the inflation rate. Besides, the public sector had lost the ability to invest, and the SOEs were running high deficits or were inefficient, with mismanagements and political interference.[1]

From 1994 to 1998 the fiscal stance was also affected by the policies aimed to tame inflation and to defend the currency under an exchange rate-based stabilization plan, through the sterilization of liquidity caused by foreign inflows and the increase of the Selic target interest rate, which indexed most part of government's bonds. During this time, the government decided to enhance the privatization process in place since 1990. While the privatization proceeds were meant to redeem public debt, the foreign inflows also helped to delay the Real devaluation until 1999.

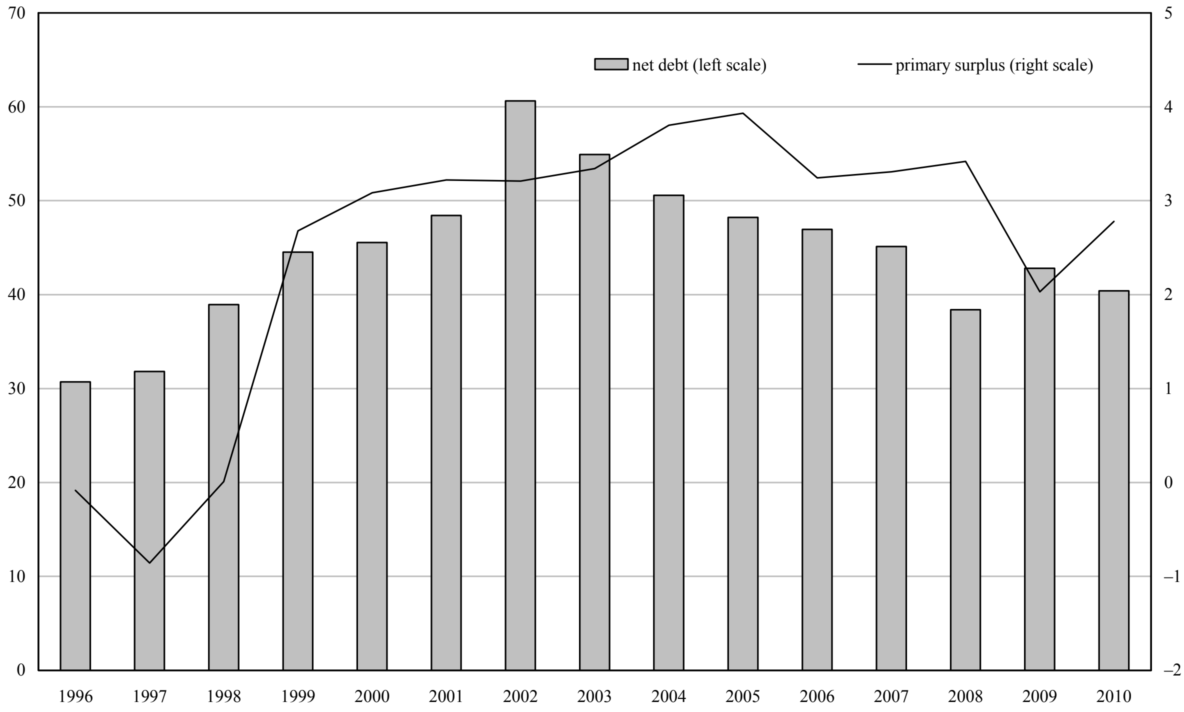
The currencies devaluation in Asian developing countries during the financial turmoil in 1997 led to a huge loss of international reserves, putting downward pressure on the Real domestic currency in 1998. The major setback of global credit, particularly into the emerging markets, urged the government to an acceleration of the fiscal adjustment. As a response to the crisis, the government made an US$ 41 billion preventive agreement with the IMF and other multilateral agencies to regain credibility in the international financial markets, which among other measures, settled a fiscal adjustment beginning at the end of that year. Therefore, the government created the Fiscal Stabilization Plan, which set increasing primary surplus targets along with structural measures, with the intention to build a definitive fiscal consolidation.

The Plan encompassed 2 initiatives: i) a Plan of Action 1999-2001, to be tackled in the near term: setlement of fiscal adjustment agreements with the states, sanitation and privatization of state banks and the control of sub-national and SOEs borrowings, along with public sector primary suplus targets of 2.6 per cent of GDP in 1999, 2.8 per cent of GDP in 2000 and 3.0 per cent of GDP in 2000; and ii) a working agenda towards administrative, social security, civil servants' pensions, tax and labor reforms, along with the institution of a fiscal responsibility law.

[1] SOEs: state-owned enterprises.

Figure 1

Public Sector Net Debt and Primary Surplus
(percent of GDP)



Source: Central Bank.

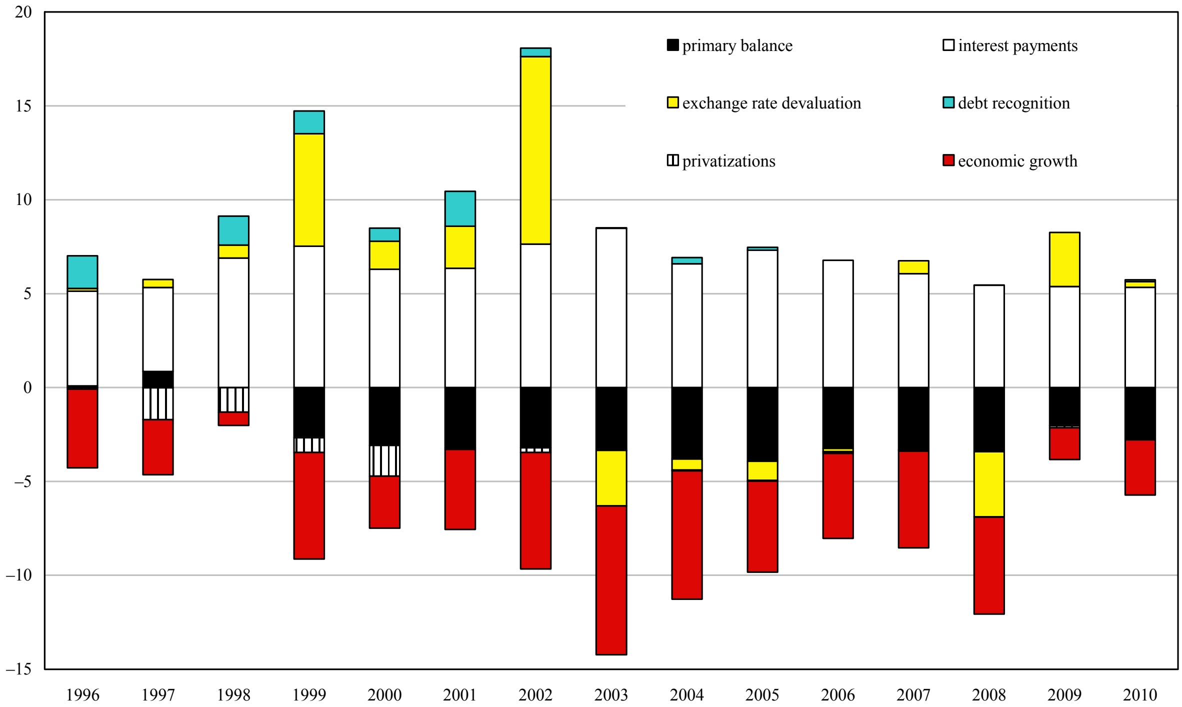
In January 1999, the real was devaluated and the government changed its policy from fixed exchange rate regime to inflation targeting with flexible exchange rate. Hitherto, the large-scale devaluation and continuously high interest rates contributed to boost the net debt, which kept increasing until the electoral year of 2002, after the impact of another crisis of confidence related to Lula's new administration (Figure 1).

Those factors were determinant to slower economic growth throughout the years until 2003. A new stand-by agreement was made in 2002, which included another primary surplus target increase, from 3.35 to 3.75 per cent of GDP, and structural reforms, as the creation of a pension fund for civil servants and a tax reform proposal. Therefore, although the primary surplus contributed to lower the PSBR from 6.8 per cent of GDP in 1998 to 4.4 per cent of GDP in 2002, the net debt rose from 38.9 per cent of GDP to 60.6 per cent of GDP in 2002 in the same period, mainly due to the impact of broad exchange rate devaluations. After 2003, the primary surplus target was raised again to 4.25 per cent of GDP.

The macroeconomic policy, based on inflation targeting with flexible exchange rate regime and fiscal adjustment, was determinant to restablish stability and regain confidence, which allowed the country to benefit from the favorable international environment after 2003, fostering economic growth with lower inflation. As a consequence, the annual target interest rate fell from 19 per cent to 13.75 per cent and the net debt fell from 60.6 per cent of GDP to 38.4 per cent of GDP between 2002 and 2008. It also allowed a more favorable Treasury bonds' maturity and composition, with the gradual decrease of issues linked to overnight interest rates and to exchange rates.

Figure 2

Net Debt Main Factors
(percent of GDP)



In the external sector, all solvency indicators showed a great improvement, led by the international reserves accumulation policy, increasing commodity prices and boosting foreign investment. The government's external net debt became negative and reached 2.1 per cent of GDP in 2005 from a positive 15.7 to GDP rate in 2002, due to joint measures of international reserves accumulation and Treasury repurchases of its external debt. The reversal from current account deficits to surpluses after June, 2003 and the improvement in the other macroeconomic fundamentals resulted in the country risk to reach its lowest level in the international markets and in a virtual cycle of an average economic growth, from 1.9 per cent between 1999 and 2003, to 4.8 per cent between 2004 and 2008.

Although the Fiscal Stabilization Program underlines all the period of policies adjustment towards economic stabilization, from 1994 to 2003, they were not sufficient to overcome the resulting impact of currency devaluations, high interest rates and slower economic growth in the fiscal stance during most of the adjustment period (Figure 2). The impact of the Program may only be seen after 2003 and in a long-term perspective, in terms of the provision of efficiency gains to the fiscal and monetary policies.

2.1 The privatization program

The privatization program undertaken in the 90s was one of the largest in the world: from 1991 to 2002, it transferred the control of 119 firms – being 84 held by the central government – and minority stakes in a number of companies to the private owners. The auctions produced US$ 87.8 billion in revenues, plus the transfer of US$ 18 billion in debt (Table 1). This amount

Table 1

Brazilian Privatization Program
(US$ billion)

Program	Revenues	Debt Transferred	Total Proceeds
Federal level	59.8	11.3	71.1
telecommunication	*29.0*	*2.1*	*31.1*
others	*30.8*	*9.2*	*40.0*
State level	28.0	6.7	34.7
Total	87.8	18.0	105.8

Source: BNDES – National Social and Economic Development Bank.

encompasses US$ 6 billion shares of firms that remained SOEs, US$ 10 billion from new concessions of public services to the private sector, and US$ 1.1 billion in minority stakes in various private companies owned by the National Social and Economic Development Bank – BNDES.

The privatization program had three components: i) the National Program of Privatization (PND) at the central government level, which started in 1991 with the privatization of several industrial companies, ports, railroads, the Vale mining corporation in 1997 and public concessions in the energy and telecommunication sectors; ii) similar programs at the state level, launched in 1996, which had it picks in 2000 with the privatization of Banespa bank, owned by the state of Sao Paulo; and iii) the privatization of the telecom industry, in 1997, which accounted for 30 per cent of the total proceeds.

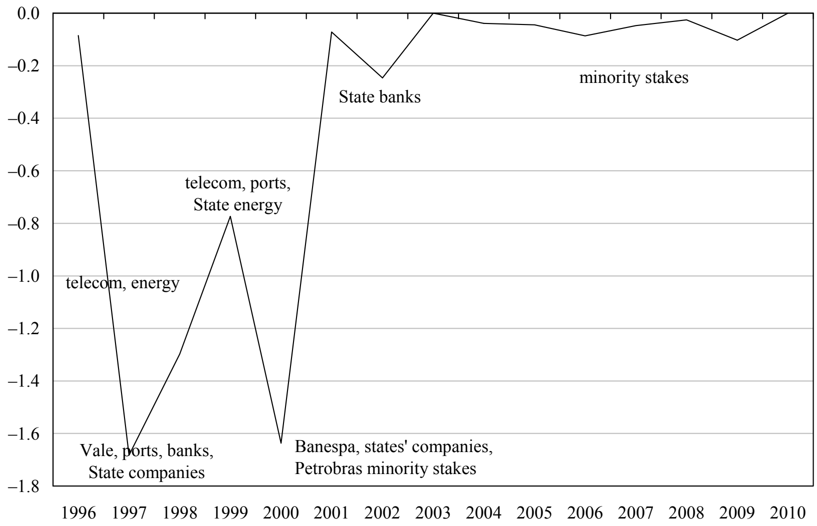
In spite of its positive impact of 6.1 per cent of GDP on fiscal accounts, the Program was not sufficient to compensate the sharp public net debt boost during the period, even when the Program reached its highest levels in 1997 and in 2000 (Figure 3). In fact, it was more effective in attracting foreign direct investment, which helped to maintain the foreign imbalance and to delay devaluation, which came only in early 1999, after the privatization program had slowed down. Therefore, because the program was developed in a context of macroeconomic policies aimed to tackle the inflation and to defend the currency under an exchange rate-based regime, the intended goals of reducing debt in order to open room to lower interest rates in the economy could not be seen hitherto. Other goals, such as stopping SOEs' deficits once and for all and improving economic efficiency were much clearly perceived.

Macedo *et al.* (2003 and 2005) examined the changes in performance of those companies after the privatization, comparing their annual financial statements (balance sheets, income statements and cash flows) years before and after privatization. They found that the results indicate an improvement in profitability and in efficiency.

In the case of the companies owned by the states, 40 were privatized and 15 had their minority stakes sold to the market, in the context of the states' debt restructuring with the federal government. Among them, state banks were privatized with the objective of not only addressing their chronic public debt problems, but reducing the participation of local governments in banking activity. In fact, the two problems were related: state banks were the main purchasers of the local governments' bonds. Debt restructuring packages were offered for those who agreed to applying their banks to the following purposes: a) to liquidate it; ii) to privatize it; c) to transfer it to the

Figure 3

Privatization of SOEs
(impact on net debt to GDP)



central government for future privatization; or iv) to transform it in a development agency.[2] In 1998, the state banks represented over 17.4 per cent of total domestic banking credit and 10.1 per cent of total deposits. The state financial system encompassed 25 commercial and multiple banks, 2 saving banks, 5 development banks and 32 other financial institutions. By 2002, 14 financial institutions had been liquidated, 20 had been privatized by the states, 11 had being transferred to the central government, being 7 privatized, and 10 development agencies had been created. The 4 remaining banks held by the central government were privatized between 2003 and 2005. Nakane and Weintraub (2003) found that in the case of the banking sector the program has had a positive impact on productivity.

2.2 Recognition of quasi-fiscal or extrabudgetary unrecorded liabilities

From 1996 to 2001, several off-budget liabilities were registered in the net debt, mainly as a consequence of SOEs' debt transfers to the central government due to the privatization program – most of them related to employees' legal claims – or through the transfer of bad performance loans as part of a large-scale capitalization of state-owned financial institutions. The liabilities also encompass the net fiscal impact of the private banking system restructuring from 1995 to 1997.[3]

From the total of 8 per cent of GDP of liabilities recognized, 51.7 per cent was due to capitalization of state-owned banks at the central government level in 2001. Moreover, the process of sanitation and privatization of state banks and SOEs resulted in the recognition of several asset losses or assumption of debts, which represented 20.9 per cent of the total debt recognition. Finally, 16.9 per cent were interest rates subsidies on housing loans registered in the banks' balance sheets as credit against the central government. Those assets are still being audited by the National Savings Bank (Caixa Economica Federal – CEF), as part of the process of debt recognition, and being exchanged by long-term market tradable government bonds, called Certificate of Wages Variations – CVS. In December, 2010, over R$ 56.1 billion of CVS (1.7 per cent of GDP) were registered in the net debt, from the total liabilities of R$ 150 billion (4.8 per cent of GDP).[4] The

2 Those measures were set by the "program of incentives for the reduction of the public sector presence in the financial activity", called PROES, launched in 1996.

3 PROER – Program of incentives for the restructuring of the national financial system, launched in 1995.

4 The housing subsidy created in 1967 called Fundo de Compensação de Variações Salariais (FCVS) aimed to guarantee remaining families' debts to the financial system, brought up by government subsidies throughout the years, mainly by adjusting the debt service payment to the wage rate of growth. Those credits were registered in the banks' balance sheets for future payment by the central government.

Figure 4

Liabilities Recognized by the Central Government
(impact on net debt to GDP)

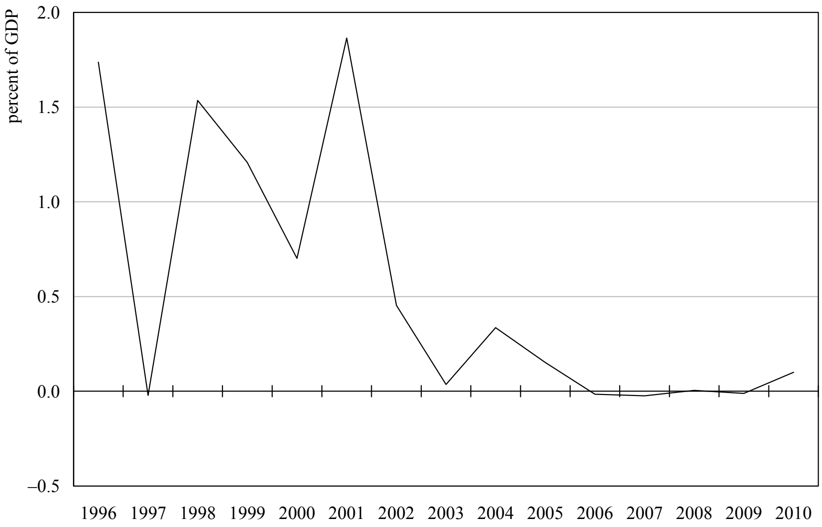


Table 2

Liabilities Recognized by the Treasury from 1996 to 2001

Liabilities	Percent of Total
Privatization and liquidation of public enterprises	20.9
Housing subsidies	16.9
Capitalization of federal financial institutions	51.7
Others	10.4

Source: Ministry of Finance.

remainder is still being recognized, in a slow average yearly pace of 0.02 per cent of GDP. Other liabilities include the net impact of Central Bank loans to private banks under the Proer restructuring program (Table 2).

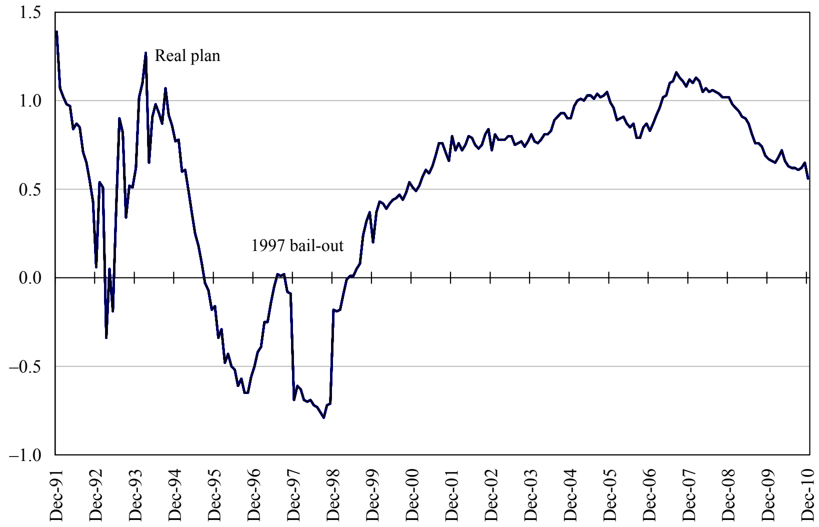
2.3 Sub-national debt restructuring program

Since the 1988 Constitution, Brazil has gone through a period of remarkable decentralization in both fiscal and political terms. State and local governments have become responsible for the execution of a larger portion of the budget, with correspondingly greater autonomy with respect to fiscal decisions.

Before the debt restructuring program that took place in 1997, the deterioration of the states fiscal performance was the major factor behind the decline of the public sector primary balance after the introduction of the Real Plan in the mid-1994. The difficulties faced by the local governments in 1995 can be traced back to the states' sluggishness in adjusting to the new low-inflation environment and to the fact that their finances were severely hit by the very high interest rates maintained in most 1995. From 1994 to November 1997, the subnational governments' net debt increased from 9.9 to 11.1 per cent of GDP. As a result, many of them started to have cash flow problems and had to rely more heavily on short term loans at market interest rates. Throughout 1995, arrears were incurred to suppliers and public employees and on loans to their own banks. At the end of that year, short-term loans were falling due and as salary payments had to be disbursed, a severe fiscal crisis emerged in the states (Figure 5).

Figure 5

Sub-national Governments' Primary Surplus
(percent of GDP)



In 1996, as a response to the states' financial crisis, the central government undertook debt restructuring plans, in conjunction with fiscal adjustment programs which were eventually consolidated in 1997. In parallel to that, state banks started to have serious difficulties and many of them were put on federal intervention. The central government was forced to refinance the state of Sao Paulo debt to its state bank Banespa to prevent major financial crises. Therefore, while debt negotiations were taking place, the central government decided to create a program to reduce states involvement with banking activities.

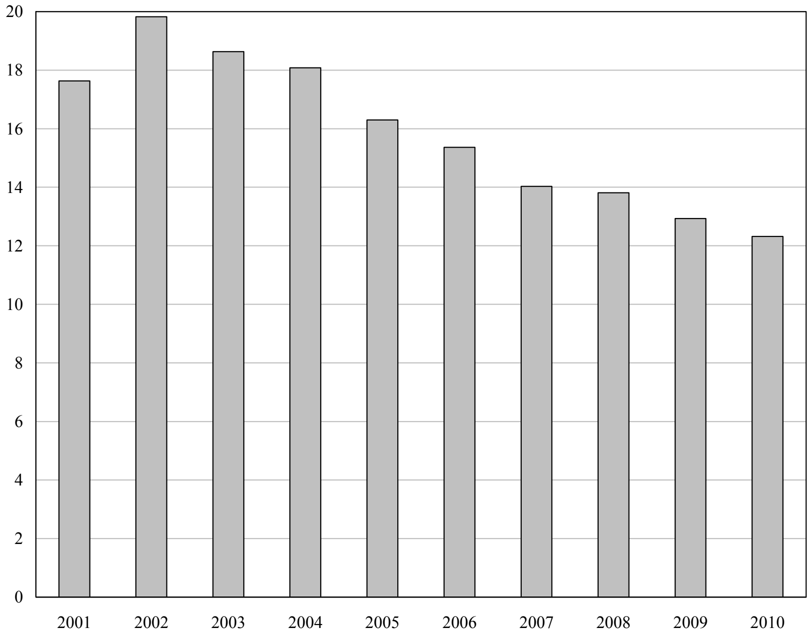
The debt restructuring plans involved a comprehensive restructuring of the local governments' net debt, with both up-front subsidy and interest rate subsidy. In November 1997, the net debt amounted to 12.1 per cent of GDP, 34 per cent of which belonging to the State of São Paulo. Even after the restructuring, the net debt continued to increase until April 2003, when it reached 19.7 per cent of GDP, due to assumptions of SOEs' debt under the privatization program and to the gap between the interest charged and the amount paid off, considering the cap of 13 to 15 of net revenues in debt service payments (Figure 6).

The restructured debt was divided in two parts: i) 20 per cent of it had to be redeemed with the proceeds from the privatization of state assets; and ii) the remaining 80 per cent had maturity up to 30 years and an annual interest rate of 6 per cent, plus monetary correction. Since the 6 per cent real interest rate was lower than the real interest rates at which the federal government was likely to finance its debt during the contract period, the agreements involved a subsidy to the restructured debt. A cap of 13 to 15 per cent of net revenues was established for the annual debt-service ratio and all debt service exceeding this cap was automatically capitalized under the contract. And, finally, as a guarantee to the federal government for the service of the restructured debt, the state government pledged their federal transfers and their own revenues, which could be withheld in the event of non-compliance.

The 1997 bail-out was conceived to be a once and for all measure, in order to stop the fiscal inertia brought by recurrent bail-outs. Therefore, in order to achieve that, the agreements between the central government and the states included: i) fiscal adjustment programs, with primary surplus targets and spending ceilings; ii) payment of services warranted by their current revenues; iii) prohibition to apply for new borrowings until their debt to net revenue equaled one to one; and iv) prohibition of bail-outs among levels of governments, set by the Fiscal Responsibility Law (FRL). Later, the government issued general rules for restructuring also the municipalities' debt on similar conditions as for the states program.

Figure 6

Sub-national Governments' Net Debt
(percent of GDP)



2.4 *The Fiscal Responsibility Law (FRL)*

In 2000, the government enacted the FRL, which comprises the fiscal management framework aiming at the consolidation and the maintenance of macro-economic stability. It is considered as the final and definitive part of a broader initiative of the Fiscal Stabilization Plan started in the '90s. Instead of fixing fiscal targets, the Law provides the mechanisms that allow the compliance of the fiscal targets proposed by the executive to the legislative, the control of fiscal aggregates, transparency and the stimulus towards fiscal consolidation, in all levels of government.

The Law defines ceilings for payroll and debt to net curret revenue (NCR) ratio for each level of government. Figures 7 and 8 show that, in the case of the state governments, those indicators have declined along the years. The fiscal ajustment programs undertaken by the states under the restructuring plans have paved the way for the law compliance.

Figure 7

State Governments' Payroll-to-NCR Ratio
(percent)

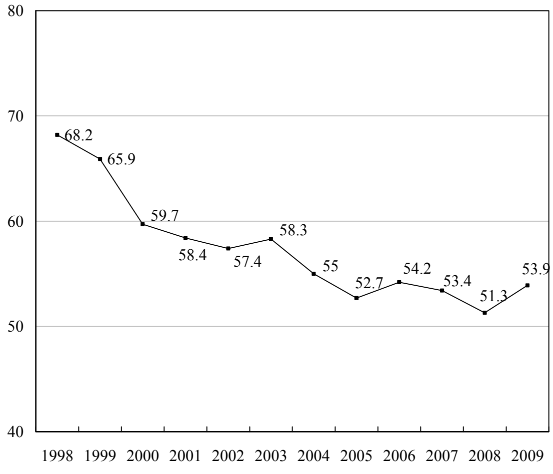
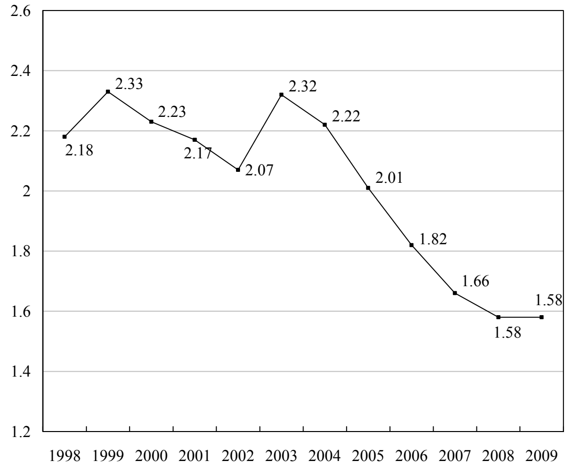


Figure 8

State Governments' Debt-to-NCR Ratio
(percent)



One of the most important drivers of fiscal governance brought by the Law is the prohibition of intra-governmental financing. Before the privatization of state banks and the 1997 bail-out, the states borrowed extensively from their banks and from domestic capital markets through the issue of bonds. Besides, because of the perception of the increased risk, the states used to pay interest rates higher than the ones paid by the federal government, which ended up reflecting higher returns in the context of a low risk investment. The repeated crises and bail-outs before 1997 suggest, at first glance, that the federal government was simply providing a soft-budget constraint to states that increased moral hazard problems and led them repeatedly to fail, and the central government was unwilling to change the incentives. In this sense, the fact that the government had been able to keep this rule unchanged for 10 years helped to build a better perception of the soundness of the states' finances and to lower the political pressures to change the Law.

3 High primary surpluses policy and the response to 2008 crisis

Since 1999, primary balance targets have been raised in response to several crises, aimed to reduce medium term net debt but also as a way to regain market confidence. From 2004 to 2008, primary surpluses have stayed above 3 per cent of GDP, leading the net debt to a persistent fall.[5] The favorable economic environment, which contributed to boost GDP medium real growth rate in 2003 onwards, helped to move the tax burden to a shift of 34.4 per cent of GDP in 2008, from 28.7 per cent in 1999. The central government provided the greatest contribution of 24.1 per cent of GDP in 2008 from 19.9 per cent of GDP in 1999. Therefore, primary surpluses were driven mainly by revenues growth, since spendings increased as well (Figure 9).

In 2008, current expenditures reached 20.9 per cent of GDP, being 10.7 per cent transfers to families, and continued increasing in 2009. Table 3 shows that the government has promoted an active policy of fostering those transfers throughout the years. The policy of adjusting the minimum wage above inflation explains most of the increase on social security and social assistance benefits, which totaled 8.5 per cent of GDP in 2009.[6] The government also expanded the Bolsa Família program – allowances to low-income families, conditioned to their children's vaccination and attendance at school – from 2.6 million families in 2002 to 13,1 million families in 2010.[7] Moreover, it promoted a large-scale restructuring of civil servants' wages by adjusting them above inflation, along with a policy of hiring teachers, doctors, regulatory affairs specialists, engineers and workers as an exchange for the ones hired through temporary contracts. The high pace of retirement flow (one per cent of total civil servants per year), the relatively low average age to qualify for retirement (60 years men and 55 years women) and the adjustment of civil servants' pensions at the same rate of civil servants' wages, as demanded by law, explains the pace of retirement payments throughout the years.

The social indicators released by the Brazilian Institute of Geography and Statistics (IBGE) show that the Bolsa Familia program might have produced an important social cushion to the impact of 2008 crisis, by helping to keep the demand growth in a positive pace. The indicators show that, from 2004 to 2009, real earnings have grown faster in the northeast region, where

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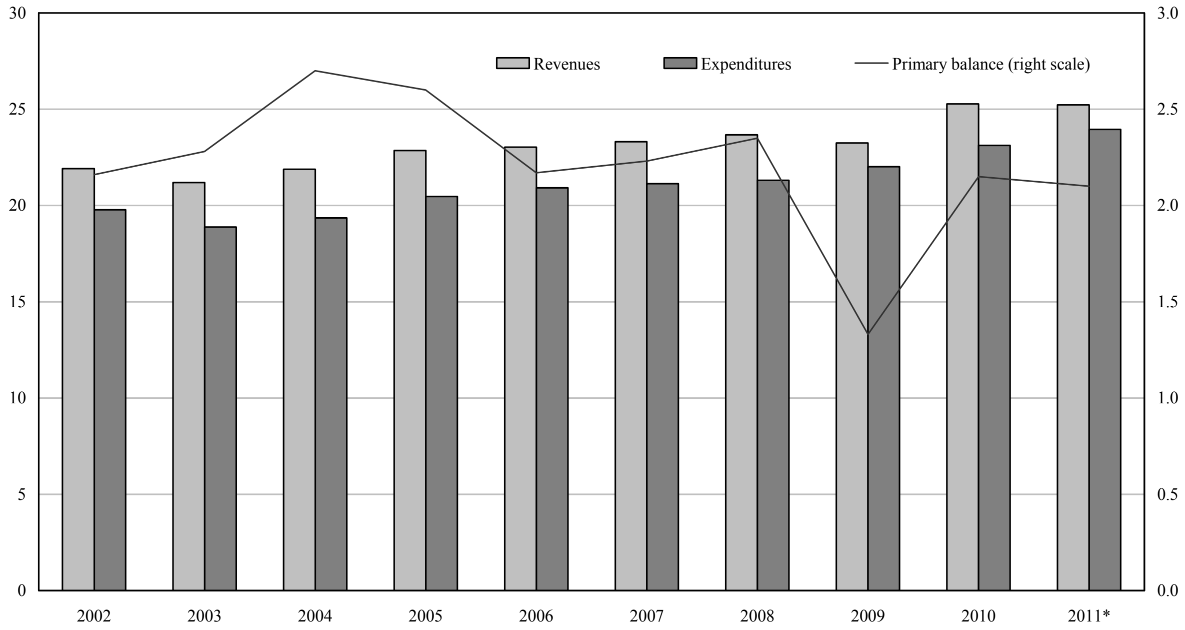
5 After the GDP methodological review by IBGE in 2006, the primary surplus target of 4.25 of GDP set in 2004 was recalculated to 3.8 per cent of GDP.

6 The bottom limit for social security and assistance benefits is the minimum wage, defined annually by the congress, after an executive proposal. For several years, the executive had proposed a minimum wage adjusted by previous year's inflation plus per capita GDP growth. From 2010 onwards, the adjustment proposed has changed for previous year's inflation plus GDP real growth from 2 years before that.

7 The amount transferred by Bolsa Família depends on the family income (maximum by US$ 70 a month), and the quantity and age of the children. The benefit varies from US$ 10 to US$ 100 a month per family. In 2008, the children's top age to qualify for the benefit was raised from 15 to 17 years old.

Figure 9

Central Government Primary Balance
(percent of GDP)



* Budget.
Source: Ministry of Planning.

Table 3

Central Government Current Expenditures-to-GDP Ratio

Expenditures Except Interest Payments	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
Transfers to other levels of government	**4.6**	**4.9**	**5.3**	**5.0**	**5.0**	**5.7**	**5.6**	**5.7**	**6.1**	**5.9**
Transfers to families	**8.8**	**9.3**	**9.6**	**10.0**	**10.1**	**10.6**	**11.1**	**11.0**	**10.7**	**11.8**
Social security benefits	5.5	5.8	5.9	6.3	6.5	6.8	7.0	6.9	6.6	7.1
Social assistance benefits	0.7	0.8	0.8	0.9	0.9	1.0	1.1	1.2	1.2	1.4
Unemployment insurance	0.4	0.4	0.5	0.5	0.5	0.5	0.6	0.7	0.7	0.9
Civil servants’ and military pensions	2.1	2.3	2.2	2.1	2.0	2.0	1.9	1.9	1.9	2.0
Bolsa família and others	0.0	0.1	0.2	0.2	0.3	0.3	0.3	0.3	0.4	0.4
Transfers to companies	**0.2**	**0.3**	**0.2**	**0.2**	**0.2**	**0.3**	**0.3**	**0.3**	**0.3**	**0.2**
Consumption	**4.3**	**4.3**	**4.2**	**3.7**	**3.6**	**3.5**	**3.6**	**3.7**	**3.6**	**4.1**
Payroll	2.4	2.4	2.5	2.2	2.2	2.1	2.2	2.1	2.2	2.4
Others by Executive	1.8	1.8	1.6	1.3	1.3	1.3	1.2	1.4	1.2	1.5
Others by other branches	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2
Other current expenditures	**0.2**	**0.2**	**0.3**	**0.2**	**0.2**	**0.3**	**0.3**	**0.2**	**0.2**	**0.3**
Total current expenditures	**18.2**	**18.9**	**19.6**	**19.2**	**19.3**	**20.5**	**20.9**	**20.9**	**20.9**	**22.3**

Source: Ministry of Planning.

Table 4

Impact of Growth and Policy Measures on Central Government Fiscal Accounts
(revenues and expenditures increase, percent of GDP)

Contents				2009/2008	2010/2009
I	**Revenues**			**–0.41**	**0.60**
	I.1	Taxes		–1.06	0.65
	I.2	Social security contribution		0.33	0.26
	I.3	Others		0.32	–0.31
	I.4	Incentives (–)		0.00	0.00
II	**Expenditures**			**1.15**	**0.43**
	II.1	Wages and civil servants' benefits		0.45	–0.12
	II.2	Social security benefits		0.48	0.12
	II.3	Other mandatory expenditures		0.28	–0.01
		II.3.1	*Unemployment insurance*	*0.17*	*–0.01*
		II.3.2	*Social assistance benefits*	*0.07*	*0.03*
		II.3.3	*Subsidies to banking loans*	*–0.05*	*0.05*
		II.3.4	*Others*	*0.09*	*–0.08*
	II.4	Discretionary expenditures		–0.06	0.44
III	**Net proceeds from oil field sale to Petrobras**				**0.97**

Source: Budget Office, Ministry of Planning.

85 per cent of Bolsa Familia allowances are allocated. There is also an improvement in child labor in the northeast region – concentrated within households with per capita income up to around US$ 175 a month – which has dropped deeper than in the rest of the Country.[8]

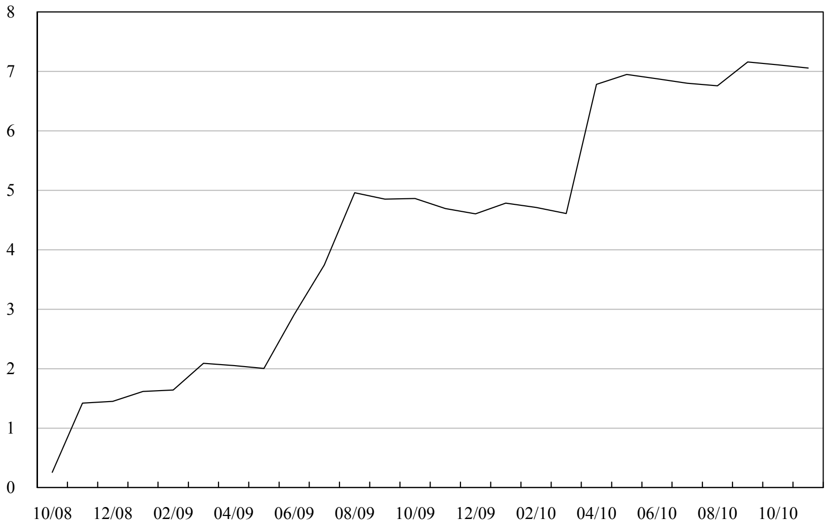
The restrictive monetary policy in place a few months before the eruption of the financial crisis of September 2008 allowed the monetary policy to be more effective at lowering interest rates and easing in reserve requirements to stimulate the acquisition of assets by big banks from small ones. Also, the public sector net debt had fallen to 38.4 per cent of GDP in 2008, opening fiscal space to ease fiscal policy.

The effect of automatic stabilizers in the 2009 budget is estimated in 0.27 percentage points of GDP in tax loss from the manufacturing production and 0.17 percentage points of GDP in unemployment insurance payments. Moreover, the central government undertook fiscal stimulus of 0.8 percentage points of GDP in tax deductions on production of cars, appliances and building materials. However, wages, social security benefits and other permanent mandatory expenditures were also raised by 1.21 percentage points of GDP in 2009, intensifying the procyclical nature of the 2010 budget. In 2010, the revenues were not able to fund all the expenditures growth, since they didn't follow the economic rebound at its same pace due to tax compensations from companies' losses in 2008 and to the one-year lag collection of corporate income tax. The

[8] 2009 National Household Sample Survey – PNAD/IBGE.

Figure 10

National Treasury-subsidized Long-term Loans to State Banks
(percent of GDP)



extraordinary net revenue raised by the sale of the amount equivalent to 5 billion barrels from sub-sal oil fields to Petrobras helped the central government achieve a primary surplus of 2.16 per cent of GDP in 2010.[9]

In order to offset the shortage of short term credit to medium and small companies, the government decided to shift the amount of long term subsidized loans to the National Development Bank (BNDES) to expand its lending capacity to the industry (Figure 10). The National Treasury loans to the financial institutions reached 7.1 per cent of GDP in 2010, from 0.3 per cent of GDP in October 2008, leading the budget subsidies to an increase of 0.1 percentage points of GDP.

During the crisis, the federal banks took part of the private banks' share of total loans. Although the policy was efficient in terms of providing liquidity to the productive sector, its continuity in 2010 has caused a distortion in the financial markets, as banks could borrow from BNDES at a much lower long term interest rate, favouring specific sectors against the rest of the economy. The government has recently launched some measures aimed to stimulate the creation of long term financial assets by the private banks and the development of a secondary market of long term private securities, with the intention of gradually reducing the state bank share of total long term domestic loans.

4 Near-term challenges

Considering an economic growth at its potential of 4.5 per cent and a primary surplus target of 3.1 per cent of GDP over the next four years, the baseline scenario to the public sector net debt is a fall from 40.4 per cent of GDP in 2010 to 30.1 per cent of GDP in 2015, over 10 percentage points in 5 years.[10] Figure 11 shows the public sector net debt to GDP projections.

A great part of this tendency is explained by the fall of the Selic target interest rate over the years, along with a declining share of the Treasury bonds indexed by this floating rate. In 1999,

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[9] In 2010, although the central government's primary balance was in line with its target, the public sector achieved 2.79 per cent of GDP, below its target of 3.1 per cent of GDP.

[10] In 2009, Petrobras, an oil company, was excluded from the fiscal statistics, raising the net debt by 2 per cent of GDP and reducing the primary surplus target by its contribution of 0.5 per cent of GDP. In 2010, Eletrobras, an electricity company, was also excluded from the target, which represented an additional exclusion of 0.2 per cent of GDP from the primary surplus. Therefore, from 2011 onwards, the estimated primary surplus was reviewed from 3.8 to 3.1 per cent of GDP.

70.8 per cent of the domestic public debt was indexed by the Selic rate; in 2010, it fell to 33 per cent. It is expected that the Selic rate will continue to decrease in the medium term, although at a slower pace.

Even though the fiscal stance shows a favorable scenario in terms of net debt growth pace, issues related to expenditures allocation have also to be taken into account, mainly by allowing a larger share of investment on total expenditure. In this sense, the government launched a large-scale investment program (Growth Acceleration Program – PAC) aimed to foster public investment in logistics (central government's budget and SOEs' budget), energy (SOEs' budget), housing (through CEF savings bank and government subsidies to low and medium income families), and sewerage (budget subsidies and subsidized financing to SOEs). The PAC Program also includes private investments raised through concessions to the private sector: from 2007 to 2010, the government has auctioned two large hydroelectric power plans, several electric transmissions, highways and one Public-Private partnership in the irrigation sector. Although the

Figure 11

Public Sector Primary Surplus and Net Debt
(percent of GDP)

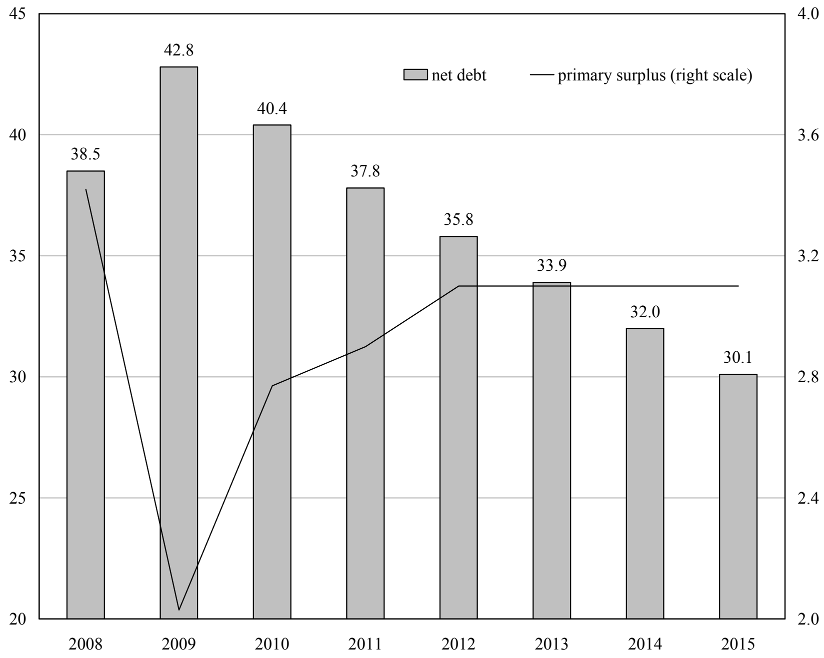


Figure 12

Selic Target Interest Rate
(percent per year)

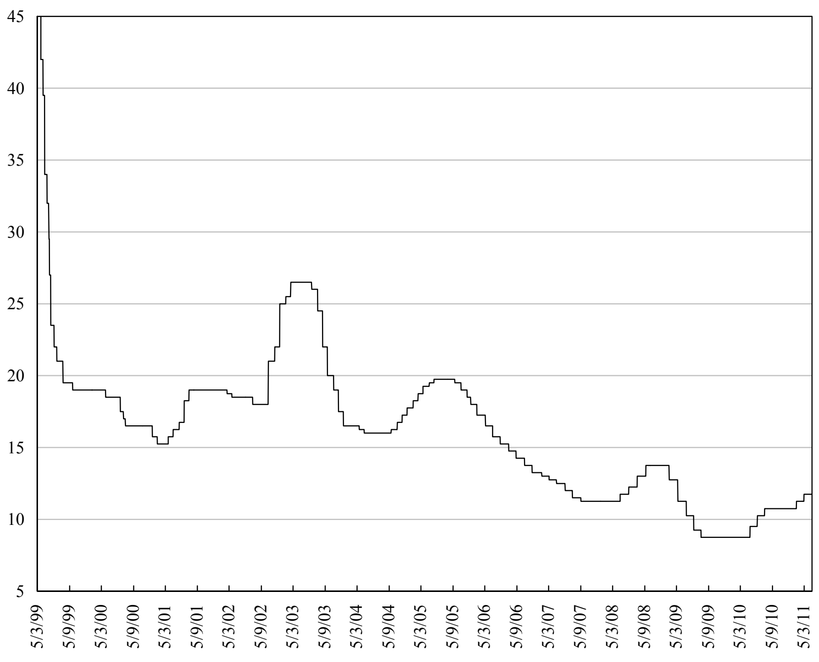
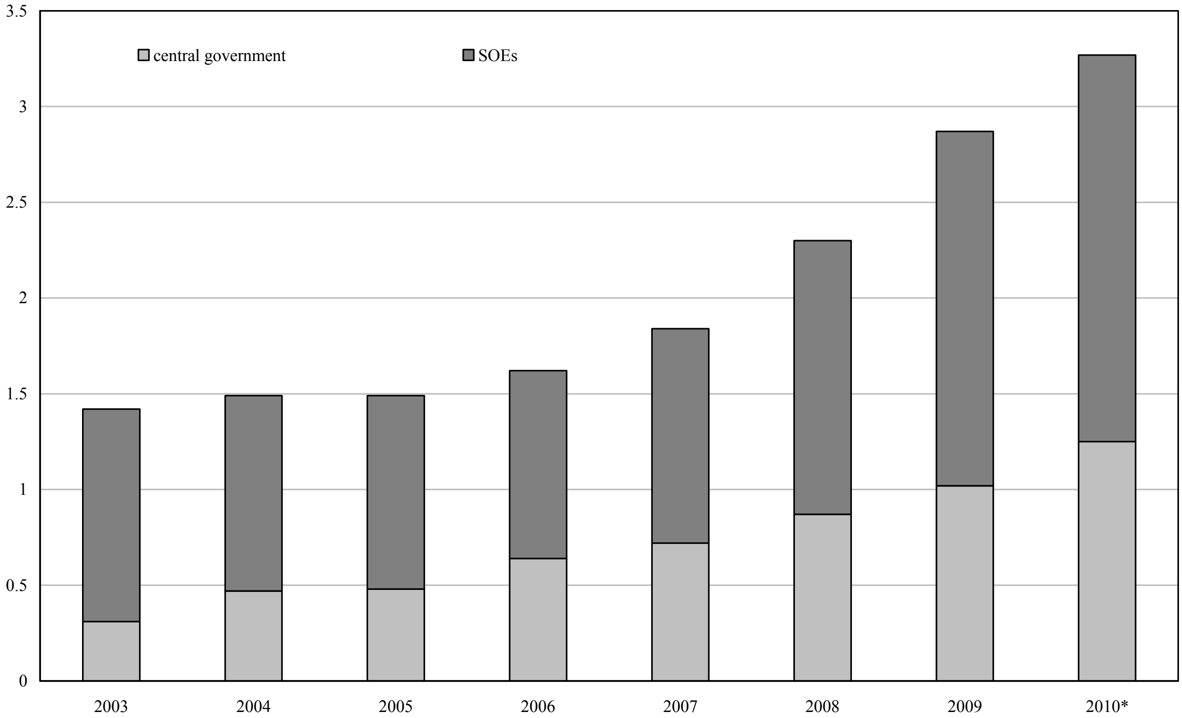


Figure 13

Federal Government Investment
(percent of GDP)



* 2010: 12 months accumulated until August.
Source: PAC Report 2010.

program represented an important effort in terms of increasing the share of public investment on total expenditure, it also exposed the existing red tape to run investments in Brazil by the public sector, related to restrict procurement laws and budget execution bureaucracy (Figure 13).

In 2010, the Brazilian economy faced a great rebound, reaching a real growth of 7.5 per cent, driven by household consumption and by the investment recovery in the first semester. However, the increase of domestic consumption in contrast with the slower growth in the developed economies led to a current account deterioration. The current account deficit, along with a high amount of inflows to the country – due to growth expectations and to interest rates differentials –, is putting up pressure on the Real currency to a huge appreciation, compromising a few manufacturing sectors, while it is also allowing the acquisition of capital goods by the industries. In 2010, the current account deficit reached 2.3 per cent of GDP, from 1.52 per cent of GDP in 2009, and may shoot up to 2.8 per cent of GDP in 2011. Moreover, the investment agenda already set – oil exploration in the sub-salt fields, public investment in logistics, World Cup, Olympics – will demand additional foreign savings and investments, considering that the low domestic savings will not be sufficient to fund the agenda. Since the private sector can do little in a period when it is increasing its own investment, the task of providing domestic savings falls to the public sector, through larger primary surplus, along with a greater share of investment on total expenditure.

Therefore, in the near-term, the fiscal policy is to be calibrated in order to enhance public savings, by conciliating primary surplus targets – which will allow interest rates to fall in the long term, providing room to foster private investment – with a larger share of investment on total expenditure in the following years. In order to provide fiscal space to increase the share of investment on total expenditures, the central government will have to make an effort towards the control of the growth pace of current expenditures, mainly those related to civil servants' wages, private sector social security and public sector pensions.

Finally, there is also a fiscal reform agenda left to be tackled in the near-term. In relation to the private sector social security system, although the recent increase in the formal labor sector has brought new revenues to the system, the gap between pension obligations and contributions tends to grow in the long run, from 1.18 per cent of GDP in 2010 to 1.67 per cent of GDP in 2030, due to fast demographic changes. People over 60 are projected to increase from 10 per cent of the population in 2010 to 18.7 per cent by 2030, as birth rates are lowering and life expectancy increasing.[11] Besides, the tax burden on formal labor – contributions to the pension system and to the unemployment insurance fund – amounts to over 40 per cent of the salaries, compromising employment and industrial competitiveness.[12] In regard to the civil servants' pension system, the shift from the actual system to the one similar to the private sector's – a basic defined-benefit system and a complementary defined-contribution funded system - is still to be implemented by the central government. Other challenges are related to the inflexibility of the central government budget: because a large amount of revenues is earmarked to specific programs and some mandatory expenditures are automatically adjusted, as in the case of health care and the benefits linked to the minimum wage, less than 15 per cent of the budget apply to spending cuts. Finally, the biggest fiscal challenges are how to aleviate the economy from the tax burden of 35 per cent of GDP and how to simplify the tax system. Over the past eight years, the government has pursued a consensus over a proposal that unifies municipalities', states' and several central government's taxes into a single value-added one. Recently, it took a new approach towards a more simplified version of that.

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[11] IBGE estimates.

[12] The total burden is 70 per cent of the salary, if considered 13rd salary and vacation pay.

ANNEX
FISCAL RESPONSIBILITY LAW

The Law can be decomposed in three main dimensions: general fiscal framework, ceilings on personnel and debt; and governance and transparency.

1 General fiscal framework

According to the Brazilian Constitution, the budgetary system is comprised by three important laws proposed by the executive branch to legislative approval: the Multi-Year Budget Framework Law (PPA), which encompasses the main strategies and all the programs related to them, to be tackled over the next four years; the annual Budget Guidelines Law (BGL), which selects the programs out of PPA to be considered as priorities for the fiscal year, and the annual Budget law.

Most part of the LRF general framework was defined through the inclusion of fiscal rules to be complied by those budgetary laws. The main changes are:

a) the inclusion of a Fiscal Policy Annex to the PPA with multi-year fiscal targets, along with the inclusion of Fiscal Targets Annex to the BGL. The fiscal Target Annex reports the fiscal compliance in the previous year and sets the fiscal target for the following 3 years, to be complied with during the budget execution. The governments are to indicate targets for the primary balance, the PSBR and the net debt;
b) the inclusion of a Fiscal Risks Annex in BGL describing the fiscal risks with an assessment of contingent fiscal liabilities, including the likelihood of adverse outcomes in legal dispute and the impact on fiscal aggregates of changes in macroeconomic indicators under which the annual budget is formulated.

During the fiscal year, the law defines that the revenues have to be reestimated every 2 months and, if they are not sufficient to comply with the fiscal targets, the government is to reduce its annual expenditures. Also, the executive is due to attend hearings at Congress on fiscal compliance every 4 months.

Moreover, the law requires that permanent spending mandates not be created without corresponding increases in permanent revenues or cuts in other permanent spending and contains a golden rule provision for capital spending (*i.e.*, annual credit disbursements cannot exceed capital spending).

2 Ceilings on fiscal aggregates

The Law considers that the concept of government comprises not only the executive, but also the legislative and judiciary branches, along with state-owned enterprises which depend on taxes to run their business. This very comprehensive concept creates a coo-responsibility among those entities over the compliance with fiscal targets and the aggregate ceilings.

A concept of Net Current Revenues (NCR) was created, which represents a proxy to the disposable revenue belonging to each level of government. Based on that, the law sets the following limits:

1) as demanded by the FRL, the Senate approved a resolution setting ceilings for sub-national government's debt to their NCR ratio, being 200 per cent for the states and 120 per cent for the

municipalities. In fact, since all the states also have debt targets under their debt restructuring agreements with the National Treasury, both debt targets have to be met;

2) on personnel management, the FRL establishes separate ceilings at each level of government, equivalent to 50 per cent of NCR for the central government and 60 per cent of NCR for the states and municipalities, as well as subceilings for the executive, legislative and judiciary branches.

If those limits are not met, the gaps are to be eliminated within the following eight months. Meanwhile, the state governments are not allowed to engage in new borrowings and sub-national governments are not allowed to receive discretionary transfers or credit guarantees from the central government.

The LRF limits are additional to those defined by the Senate Resolutions related to new domestic and external borrowings at the sub-national government levels and their SOEs, to be approved based on their creditworthiness evaluation.

3 Governance and transparency

In relation to governance, one of the most important rules is the prohibition of intra-govermental financing, which hinders the pressure for recurrent bail-outs by the states.

Parallel to the FRL, penalties for public officials that failed to obey fiscal responsibility by a Fiscal Crimes Law were stablished. Those penalties included administrative, financial, and political penalties and even prison time for violators of fiscal responsibility. Although it seems that the criminal component of the law may hit only municipal or minor officials, it sends a clear message of the seriousness of fiscal control.

Finally, in terms of transparency, the law defines that the each level of government is to release two reports: i) a bi-monthly budget execution; and ii) a comprehensive four-month report on compliance with the various LRF parameters, and on corrective measures if the ceilings are exceeded. Moreover, municipalities are to report to the National Treasury their fiscal balances of the previous year by end-April and the states, by end-May. The National Treasury is to publish a consolidation of the public finances of the previous year by end-June. Also, the Law requires that financial and actuarial assessment reports on the social security regimes of the public and private sectors, managed by the government be sent to congress along with the annual BGL.

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