

# **FISCAL ADJUSTMENT AND FISCAL RESPONSIBILITY LEGISLATION: THE CASE OF BRAZIL**

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Overview of fiscal adjustment  
in Brazil

## The need to contain public indebtedness

- Improved track record over the years at all levels of government
- Debt has been a source of vulnerability
  - Sustainable debt levels are lower in emerging markets in general
    - Lower revenue ratios, more volatile tax bases, higher spending on debt service, supply-side constraints and “debt intolerance”
    - Empirical evidence suggests that debt levels above 30-50 per cent may not be sustainable on average in emerging markets
  - Composition of debt also matters
    - Relatively short maturities and a high share of securities paying floating interest rates or indexed to the exchange rate.

## Public sector borrowing requirements

(In per cent of GDP)

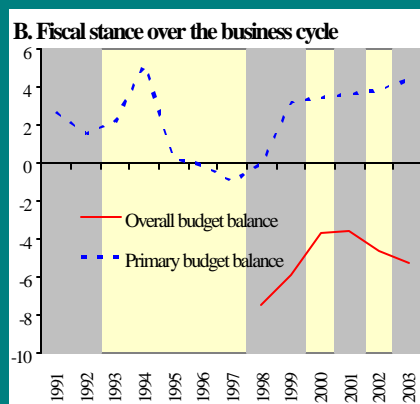
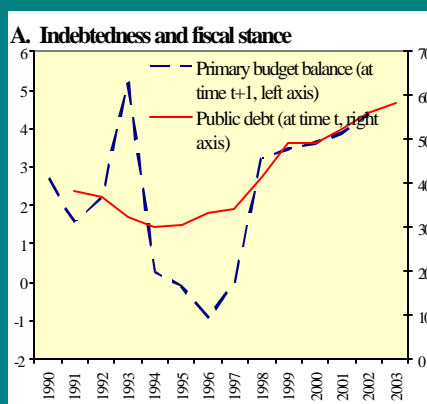
	1995	1998	2003	2004-May
Overall balance	-7.3	-7.5	-5.2	-4.1
Central government	-2.4	-4.9	-4.1	-3.3
Regional governments	-3.6	-2.0	-1.8	-1.5
States	...	-1.8	-1.5	-1.3
Municipalities	...	-0.2	-0.3	-0.2
Public enterprises	-1.3	-0.5	0.7	0.7
Primary balance	0.3	0.0	4.4	4.3
Central government	0.5	0.6	2.6	2.6
Regional governments	-0.2	-0.2	0.9	0.9
States	...	-0.4	0.8	0.8
Municipalities	...	0.2	0.1	0.1
Public enterprises	-0.1	-0.4	0.9	0.8

## A fiscal reaction function?

- Primary surpluses have been raised to keep the debt-to-GDP ratio on a sustainable path
  - Even in periods of economic slowdown
    - => pro-cyclicality in fiscal policy, not uncommon in Lat Am
  - Fiscal consolidation vs. short-term demand management as the overriding objective of fiscal policy
- OECD experience: pro-cyclicality is not uncommon
  - => particularly when retrenchment is needed to restore fiscal sustainability

## Reacting to rising indebtedness

(In per cent of GDP)



## Achieving fiscal adjustment

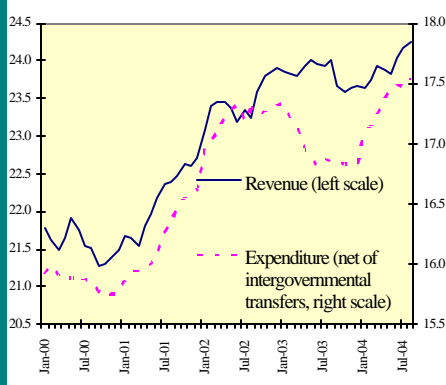
- Fiscal consolidation has been achieved predominantly through revenue hikes
- Intergovernmental dimension:
  - Federal tax revenue has been broadly stable, but revenue from federal “contributions” has risen
  - The sub-national tax take has also increased
- Background:
  - Empirical evidence for OECD countries
    - Fiscal adjustments are more successful when based on the retrenchment of current expenditure, rather than on hiking revenue and/or cutting back public investment
  - Evidence for Latin America is limited
    - => Rocha and Picchetti (2003) show that the fiscal consolidation in 1994 in Brazil was likely to be unsuccessful as it was achieved on the back of public investment retrenchment, while wages and transfers remained unchanged

- Downward rigidity in current spending has resulted in a compression of capital outlays
- Revenue earmarking is widespread
  - About 80 per cent of federal tax revenues are earmarked, against less than 60 per cent in 1988
  - An arrangement is currently in place for withholding part of federal earmarked revenues
  - Discussions are under way to implement a comparable arrangement at the state level
- Mandated minimum spending levels for several social programmes is an additional source of budget inflexibility
- At the same time, social security pressures have mounted
  - New expenditure commitments, particularly in old age-related assistance, have been created

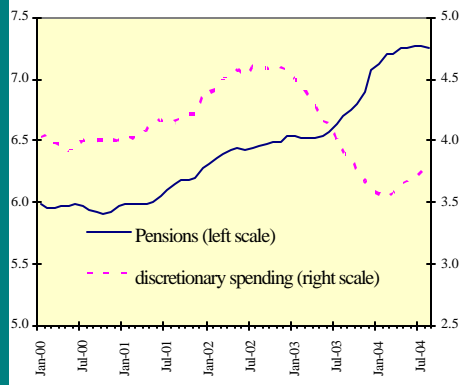
# The adjustment mix

(In per cent of GDP)

**C. Central government revenue and expenditure**



**D. Central government outlays on pensions and discretionary programmes**



## Bottom-line: moving forward

- Brazil will need to continue to post sizeable primary budget surpluses to allay concern about the dynamics of the country's public debt
- Efforts are needed to improve the quality and longer-term sustainability of fiscal consolidation
- Public policies will need to become more pro-growth
  - ⇒ increasing emphasis on rebalancing tax and spending programmes towards boosting private sector development
- A sustained retrenchment in current expenditure would pave the way for:
  - Reducing the tax burden over the longer-term, once macro-fiscal conditions have improved and fiscal consolidation has delivered an appreciable fall in indebtedness
  - Reallocating budgetary resources towards cost-effective public investment, particularly in infrastructure

## The role of Fiscal Responsibility legislation in fiscal adjustment

### International experience

- Administrative controls: more prevalent in developing countries and emerging market economies.
- In some OECD countries, sub-national borrowing is subject to central government approval
  - Ireland, Japan, Korea, and the United Kingdom
- But a number of OECD countries are beginning to remove restrictions on sub-national borrowing
  - Czech Republic, Hungary, Finland, New Zealand, Norway, and Mexico more recently

- More comprehensive fiscal rules include ceilings on public debt or budget balances
  - These rules may be expressed in actual or cyclically-adjusted terms
  - The overall budget balance can be capped
    - Austria, Belgium, Finland, Sweden, and Spain
  - The operational, rather than overall, budget balance can be capped allowing borrowing for investment purposes.
    - France, New Zealand, and Norway
- Golden rules: budgeted deficits must not exceed investment spending
  - United Kingdom: two fiscal rules were set out in 1997: the “golden rule” and a debt rule, or “sustainable investment rule”,
  - Switzerland: an expenditure rule was introduced at the federal government level in 2003. It aims at keeping the cyclically-adjusted balance close to zero and sets a ceiling for expenditure, which cannot exceed cyclically-adjusted revenue.
- Ceilings on the public debt and/or debt service outlays
  - Hungary, Poland, and Portugal

- Markets appear to be a poor substitute for fiscal rules, particularly at the sub-national level of government
  - The conditions for effective market-based discipline are rarely fulfilled in practice
  - Prudential regulations on investors’ exposure to sub-national government debt are often weak
  - Information disclosure requirements tend to be more lenient on sub-national governments than on the central government and corporations
- To embed some flexibility in fiscal rules, escape clauses are in place in many countries
  - Austria, Italy, Poland, some Canadian provinces, and the European Union’s Stability and Growth Pact).

- A word of caution:
- It is sometimes easy to bypass ceilings on budget aggregates through creative accounting
  - United States' Budget Enforcement Act, BEA (in place up to 2002) could sometimes be circumvented by designating funds as emergency spending or by using advanced appropriations to spread budget authority over more than one year
  - Narrowing the coverage of legislation also creates problems
  - Expenditure can be channelled through the tax system, off-budgetary funds, public-private partnerships, and loan guarantees to implement policies which would otherwise be explicit in the fiscal accounts
- The future costs of current policies can be underestimated when the policy framework is not transparent
  - This is the case when policy decisions granting tax expenditures, creating off-budgetary funds, or committing public resources to public-private partnerships and loan guarantees are not subject to standard budgetary oversight and may be difficult to reserve.
    - A wider use of accrual accounting, as a complement to current cash accounting, would also help to make the true cost of government activities more transparent.

## The experience of Brazil: Background

- Sub-national debt restructuring programmes of 1997-98:
  - No bail-out of the regional governments
  - Programmes strengthened federal control over sub-national finances through the introduction of explicit sanctions for non-compliance and the use of shared revenue as collateral for the servicing of the restructured debt
  - Continued enforcement and restricted access to financing have required a considerable fiscal adjustment at the state and municipal levels of government to generate the primary surpluses needed to service their outstanding debt obligations
- Introduction of caps on personnel outlays
  - First step towards the rules-based rationalisation of sub-national spending
  - It was recognised that failure to retrench current expenditure would undermine any sustained effort towards fiscal consolidation, subsequently putting compliance with debt restructuring at risk

## The experience of Brazil: the Fiscal Responsibility Law

- On **revenue**, the LRF mandates:
  - the withholding of discretionary federal transfers to the states and municipalities that do not collect effectively their own taxes
  - the publication of the impact of tax exemptions on the budget, when the exemptions take effect and in two subsequent budgets
- On **expenditure**, the LRF bans:
  - the creation of permanent spending mandates without a corresponding increase in permanent revenue or a reduction in other permanent spending commitments
  - new spending commitments that cannot be executed before the end of the incumbent's term in office, as well as the recording of these as unspent commitments in the two quarters prior to the end of the incumbent's term in office, unless there are sufficient cash balances to cover them at the end of the fiscal year.
- The LRF contains a **golden-rule provision** for capital spending

- Separate ceilings for **personnel spending** at each level of government (including pensions and payments to sub-contractors)
  - and sub-ceilings for the executive, legislative and judiciary branches of each level of government
- Provisions on **indebtedness** and the issuance of public debt by the central bank.
  - the central bank is prohibited from issuing debt in the domestic market
  - the LRF prohibits credit or debt restructuring operations among the various levels of government
  - ceilings on the consolidated debt of the public sector have been set by the Senate at, respectively, 350, 200, and 120 per cent of net current revenue of the federal, state, and municipal governments.
- The LRF also contains **escape clauses**
  - the time frame for reducing personnel spending or indebtedness in excess of the mandated ceilings can be lengthened if the economy contracts by 1 per cent or more during the previous 4 quarters, or a national catastrophe is declared by the legislature, as well as in the case of a state of siege
  - These escape clauses can only be exercised with congressional approval

- More transparent fiscal reporting
- The LRF strengthens the legal framework for medium-term budgeting
  - Fiscal Targets and Fiscal Risks Annexes to budget documentation
- Fiscal Crimes Law (FCL)
  - applies to public officials of the executive, legislative and judiciary branches of the federal, state and municipal governments, as well as their decentralized agencies and public enterprises
- Prudential regulations limiting the exposure of financial institutions to government debt
  - financial institutions' exposure to the government is limited to 45 per cent of their net wealth, including all credit operations and loan guarantees
  - aggregate caps have been introduced on credit operations with the municipalities to finance investment in water and sanitation, subject to the observance of the debt service ceilings set under the FRL
    - The option of introducing similar aggregate caps for investment in transport infrastructure is under discussion, pending an assessment of the measures introduced for water and sanitation against the expected increase in government spending on these programmes

## Municipal finances: an overview

## A word of caution

- An increase in local government spending, particularly on infrastructure, need not enhance economic performance for the economy as a whole
  - Empirical evidence on the link between fiscal decentralisation and economic growth is mixed: Davoodi and Zou (1998), Zhang and Zou (1998), Glaeser *et al.* (1995), de Mello (2002)
- The scope for enhancing economic performance by boosting local government spending on infrastructure depends on how these outlays are financed
  - Deficit bias: overlapping responsibilities across the different levels of government, reliance on open-ended grants, weak accountability, offloading of expenditure mandates.
- The association between fiscal decentralisation and performance indicators in the infrastructure sector is not clear-cut
  - Evidence: Estache and Sinha (1995), Humplick and Estache (1995)

- Fiscal rules do not necessarily reduce the ability of local governments to invest
  - United States: rules-induced pro-cyclicality cannot be ruled out
  - but it can be mitigated by accumulating rainy day funds in good times to avoid disruption in the financing of public investment in bad times.
- Not all public investment is productive
  - Particularly where local government spending is financed in a fiscally unsustainable manner
  - Evidence: Devarajan *et al.* (1996): investment component of public expenditure may turn out to be unproductive when financed by instruments that misallocate government spending at the expense of current expenditures

## Brazil: constraints on local government investment

### Four problems and a complication

- 1. Institutional constraints
  - Constitution empowers local governments to delegate to the private sector (often through concessions) the provision of local services such as urban transportation and water/sanitation
  - Other services requiring considerable infrastructure investment
    - inter-municipal transport and gas distribution are under the purview of the states
    - energy, telecommunications and inter-state transportation, among others, are assigned to the federal government

- 2. The municipalities are becoming more active in the provision of social services, rather than infrastructure
  - This is essentially the case of health care, with the decentralization of the national health system (SUS) in the early 1990s, and education, particularly after the implementation of FUNDEF in 1997
  - Expenditure on these two functions account for almost one-half of municipal spending, but are financed predominantly through revenue sharing and the earmarking of revenue
  - In some cases, municipal governments are also involved in the provision of conditional income transfers to poor households, a social expenditure more often financed by the central government

## Composition of public social spending, 2002

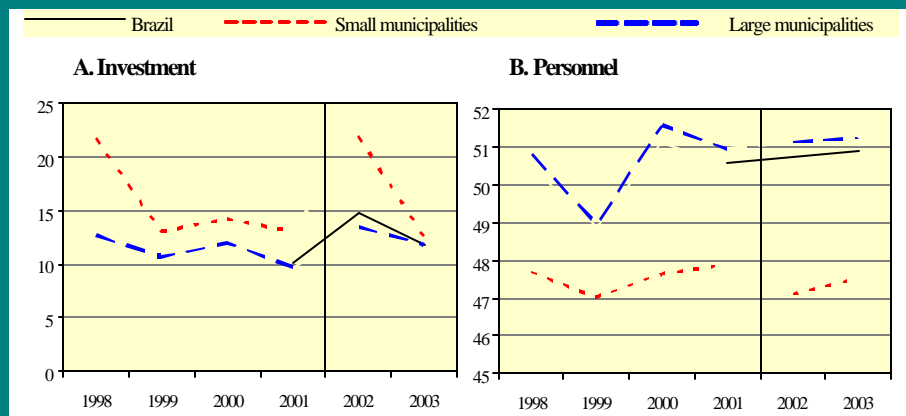
(In per cent of GDP)

	Total	Levels of government		
		Central government	States	Municipalities
<b>Total public social spending</b>	<b>24.4</b>	<b>13.3</b>	<b>5.8</b>	<b>5.2</b>
Social assistance	0.9	0.5	0.1	0.2
Social security	10.7	9.2	1.2	0.3
Health care	4.7	1.9	1.3	1.5
Sanitation	0.4	0.0	0.2	0.2
Labour	0.7	0.6	0.0	0.0
Education	5.4	1.0	2.6	1.8
Culture	0.2	0.0	0.1	0.1
Civil rights	0.2	0.0	0.1	0.0
Housing	0.1	0.0	0.1	0.1
Urbanisation	1.0	0.0	0.1	0.9
Land reform	0.1	0.1	0.0	0.0

- 3. Limited budget flexibility: expenditure rigidity
  - Minimum spending levels for education and health care and some revenue earmarking
  - Spending on personnel, including pensions to retired civil servants, places a heavy burden on municipal budgets
  - Outlays on debt service are relatively low but reduce the room for manoeuvre in indebted jurisdictions
    - The municipalities of São Paulo, Rio de Janeiro, and Salvador accounting for about 75 per cent of outstanding municipal debt

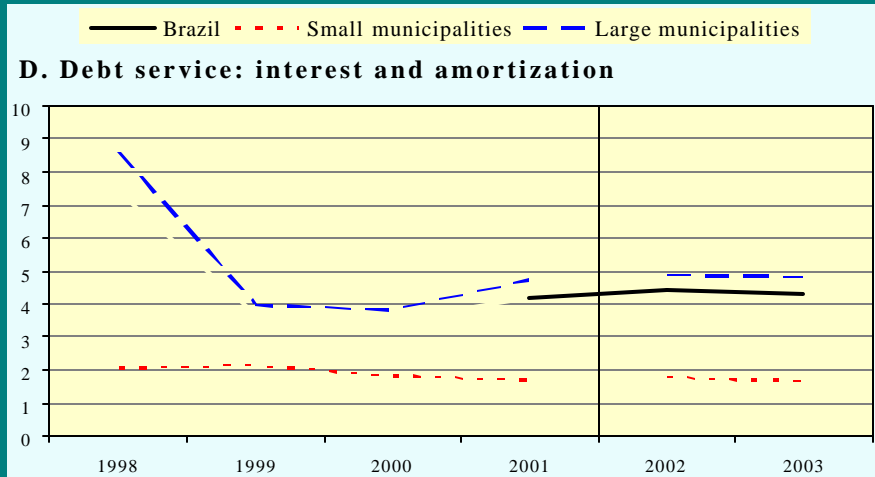
## Capital vs current spending

(In per cent of current spending)



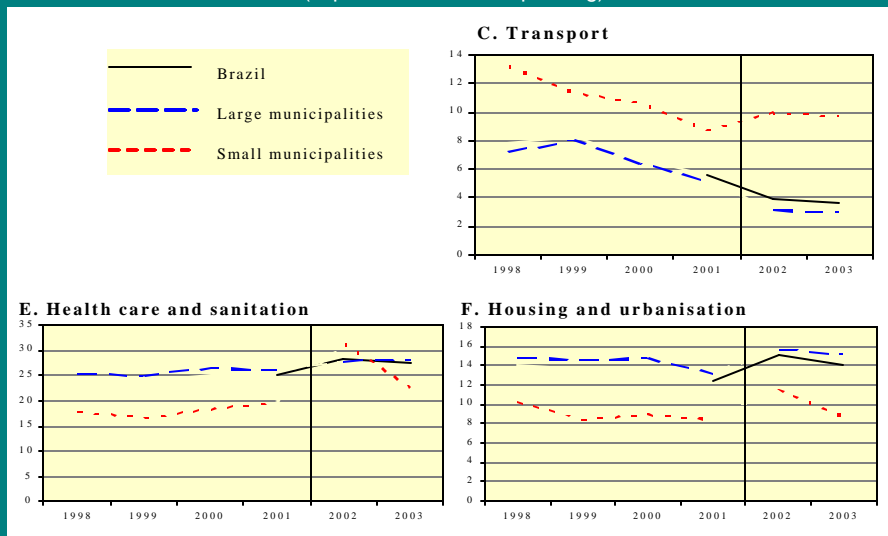
# Fiscal probity is paying off

(In per cent of current spending)



# Trends in municipal spending

(In per cent of current spending)



- 4. Limited budget flexibility: revenue raising capacity
  - The municipalities tax services, property and, to a lesser extent, raise revenue through user fees and charges
  - Revenue sharing is another important source of revenue at the municipal level, particularly for the smaller municipalities

## Municipal revenue, 2002

(In per cent of GDP)

	All municipalities	Metropolitan areas	Non-metropolitan areas
<b>Total revenue*</b>	<b>7.9</b>	<b>4.0</b>	<b>4.0</b>
<b>Own sources</b>	<b>1.5</b>	<b>1.2</b>	<b>0.4</b>
Local property tax (IPTU)	0.5	0.4	0.1
Services tax (ISS)	0.6	0.5	0.1
Transfer tax (ITBI)	0.1	0.1	0.0
Other taxes	0.1	0.1	...
User charges and fees	0.2	0.1	0.1
<b>Shared revenue</b>	<b>3.2</b>	<b>1.3</b>	<b>1.9</b>
Municipal Participation Fund (FPM)	1.2	0.2	1.0
ICMS	1.5	0.7	0.8
Motor vehicle registration tax	0.2	0.1	0.1
Federal income tax (IRRF)	0.2	0.1	0.0
Other	0.1	0.0	0.1
<b>Specific grants and compensatory transfers</b>	<b>2.2</b>	<b>0.9</b>	<b>1.2</b>
Health care	0.5	0.2	0.2
FUNDEF	0.7	0.2	0.5
Other current transfers	0.7	0.4	0.3
Capital grants	0.3	0.1	0.2
Other Revenues	1.0	0.6	0.4

## Regulatory uncertainty

- Regulatory uncertainty in some sectors has also discouraged private investment
- Regulatory uncertainty and constraints on pricing that simultaneously meets the requirements of private investors and the purchasing power of the population has deterred greater private sector involvement in some areas (e.g., transport)
- In the case of water/sanitation, public investment has been cut back over the years without an offsetting increase in private investment
  - predominantly due to a lack of clarity about which level of government is responsible for service delivery and regulation in the sector
  - particularly acute in the metropolitan regions, which straddle municipal borders
  - despite progress in increasing access by the population to drinking water, connectivity rates to sanitation, and in particular to wastewater treatment, remains low

## Options?

- Dealing with economies of scale, externalities and sunk costs
  - Cross-border joint ventures
    - The OECD experience is illustrative: water disposal in France, water supply and waste disposal in Norway
    - Brazil: hospital management consortia and inter-municipal water companies
- Public-private partnerships (PPPs)
  - Need for fiscal rectitude, adequate risk-sharing, accountability, and transparency in reporting