

# **The Political Economy of Fiscal Reform in Brazil**

## **The Rationale for the Suboptimal Equilibrium**

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## Abstract\*

This project examines fiscal reforms in Brazil since the 1990s, particularly in taxation, budgeting, and fiscal federalism. While recentralizing fiscal authority and massively expanding the extractive capacity of the state, policymakers chose not to revamp an inefficient tax system that has nonetheless proven capable of generating high levels of revenue. In budgeting, the economic crises of the mid-1990s prompted the government to rein in subnational fiscal imbalances but discouraged policymakers from introducing major changes in the tax system. As the executive derives utility from fiscal stability and inflation control because of electoral incentives and credibility gains in international markets, reform initiatives can generate political benefits for incumbent politicians. The paper finally argues that the Achilles' heel of the sustainability of the Fiscal Responsibility Law is its enforcement technology: the *Tribunais de Contas*.

**JEL Classifications:** H3, H77, H83, H71

**Keywords:** Fiscal responsibility laws, Fiscal federalism, Brazil, Political institutions

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## 1. Introduction

This report examines fiscal reforms in Brazil since the 1990s, focusing on the varying reform outcomes in the areas of taxation, budgeting, and fiscal federalism. Although the extension of reforms varies greatly across issue areas, Brazil has made great improvements in fiscal governance in the last decade and a half. The paper discusses these outcomes as endogenous choices of policymakers and as representing a general political equilibrium. This approach departs from existing analytical strategies in the fiscal policy literature because it explicitly incorporates the political and institutional determinants of policy choices into the analysis. A basic lesson from this literature is that fiscal choices are feasible and sustainable only where there is consistency between the content of reforms and the preferences of policymakers and key political actors. This elementary intuition is usually forgotten in current contributions. The content of reforms itself is largely context-specific and varies across issue areas, but there is also a common pattern deriving from the general policymaking process. If fiscal policy is endogenous, the crucial question arises of what determines reforms.

Why, when and how do fiscal reforms take place? In order to answer these questions one has to establish how the changes in the incentive structure and payoffs of an institutional arrangement affect the interaction among the actors. Changing economic and political conditions, particularly crisis episodes, are the usual suspects as the root cause of institutional change in the last two decades. But change also occurs because of a dynamic disequilibrium resulting from internal mechanisms and processes, some of which may be path dependent. Reform initiation is conceptually and empirically distinct from reform implementation and sustainability. Governments may respond to a crisis with a reform proposal that may bog down during its negotiation or be unsuccessfully implemented due to resistance from the actors involved. Governments may also refrain from responding to crises if they prefer the status quo to changes. The institutional requirements for reform approval and implementation include a governance structure which is consistent with the actors' preferences.

Fiscal policy outcomes have indeed improved in Brazil since the mid-1990s. This poses the question about the possible determinants of the changes. Most of the institutional changes took place during Cardoso's two terms of office (1995-2002), although some initiatives preceded his administrations. No significant departure from the mechanisms of fiscal governance introduced by Cardoso has occurred since President Lula's inauguration in 2003. Table 1 depicts

the four alternative scenarios arising from the combination of crises and reforms. The three major institutional innovations in fiscal governance are associated with crisis episodes, and therefore are located on the left-hand side of the table. They include the following: a budget reform associated with a major scandal (known as *escândalo dos anões do orçamento*); the privatization of banks and utilities and new fiscal federalism measures in the wake of the states' debt crisis; and the Fiscal Responsibility Law (FRL) following the Asian and Russian crises. The crises provided the window of opportunity for reforms in the three cases mentioned. In the case of tax reform, however, the impact of the crisis was radically different: it inhibited reforms.

**Table 1. Role of Crisis in Fiscal Reforms**

	Reforms		
	Yes		No
Crises	Episodes	Responses	Non-reforms
Yes	1993-1994: Budget committee scandal	Reorganization of budget institutions	Constitutional amendment for tax reform was presented and was withdrawn
	1994-1997: Budget deficits, Hyperinflation, Subnational debt crisis	Privatization of state banks and Renegotiation of subnational debt	
	1997-1999 Asian, Russian crises, Default of MG	Fiscal Responsibility Law (LRF)	
			Several tax reform proposals were discontinued
No			Incremental increase in tax revenue by higher taxes or new social contributions

Source: Authors' compilation.

The international crisis led risk-averse policymakers to prefer an inefficient system that was capable of generating high levels of revenue to a streamlined and more efficient system. Efficiency considerations lost importance in the context of crisis. Another example of non-

reform with great impact in the fiscal performance of the country was the massive expansion of tax revenue associated with hikes in existing social contributions and also the introduction of new contributions and to a lesser extent of new taxes. These changes do not qualify as reforms, although they are a crucial part of the fiscal game. For the analysis of tax reforms, it is necessary therefore to distinguish the cases of relatively established systems—those capable of generating a great amount of revenue and where efficiency and redistributive gains are the primary goal of reform—from cases where increasing revenue is the fundamental objective. A less strict definition would include these changes in the response to crisis category, although its incremental nature contrasts with reform initiatives that take the form of major legal change through fiscal reform packages. We retain the distinction to highlight the differences.

While providing the window of opportunity for reforms in the case of changes affecting fiscal federalism, the crises cannot explain the approval and sustainability of reforms. Thus, the key question is: what factors explain the success attained by the governments in the fiscal area? This paper explores the role of the political incentives faced by the political actors involved in the fiscal governance game. This process has been associated with the reassertion of federal fiscal authority in the country and in the strengthening of the Ministry of Finance in the process. More hierarchical fiscal and budgetary institutions are argued to be associated with fiscal discipline. The effectiveness of delegation of authority to the Ministry and the president in the fiscal area, however, is contingent on the broader political structure of governments (Hallerberg, 2004: 31). Countries like Brazil, with multiparty presidential regimes where coalition governments are formed in post-election bargaining and adopt a federal structure, face a potentially serious coordination problem in overcoming common pool problems in the fiscal arena. There are two classes of common pool problems of a fiscal nature that need to be addressed in a country like Brazil: first, those associated with the fiscal behavior of the states, and second, those associated with coalition management. Both types of problems have been overcome in Brazil with varying degrees of success.

In the paper we develop the argument that there are gains from trade that allow the party controlling the presidency to buy support from the legislature at a relatively low cost. In its relations with the state governments, a powerful president and finance minister have managed to recentralize fiscal authority in the country, curbing state fiscal autonomy. 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 a self-enforcement case. The executive had the enforcement technology, and the law has been an effective commitment device. The executive was able to implement its preferences because of its institutional prerogatives and because there were gains from trade in federal government-state relations. Governors developed an interest in reforms in the wake of the approval of the reelection amendment and in view of the compensation mechanisms involved in the reform process. We argue that the executive derives utility from fiscal stability and inflation control because of electoral incentives and of credibility gains in international markets. Political competition is a precondition for the existence of these incentives. In the Brazilian case we find evidence of intense competition between the two parties that have alternated in power, the PT and the PSDB. At the subnational level, political competition is intense overall despite the varying patterns found across the country. This endogenous perspective allows us to understand fiscal reform initiatives as generating political benefits for incumbent politicians. It should be stressed that fiscal stability has been attained at the cost of systemic inefficiency as a result of highly regressive and distortionary taxes. Thus, the fiscal governance game in Brazil leads to a suboptimal equilibrium.

The paper is organized in two parts. Part one contains background information, an overview of Brazil's recent fiscal performance, and an inventory of changes in fiscal institutions since the 1990s as well as a stylized model of the country's overall policymaking process. In the next section, we provide selected evidence about the current fiscal situation of the country. We briefly describe the improvements in fiscal indicators and provide background information on taxation and the evolution of fiscal federalism. This discussion sets the stage for section three, where we provide an inventory of reforms. We take stock of the tax reform initiatives in the country since the early 1990s as well as the changes in budgetary institutions and fiscal federalism. In the fourth section, we discuss the country's political institutions and provide an account of the policymaking process as a general political equilibrium. Part two contains two case studies of fiscal reforms: first, a case study of the renegotiation of state debts and privatization of state banks; second, a detailed analysis of the enactment of the Fiscal Responsibility Law and its sustainability.



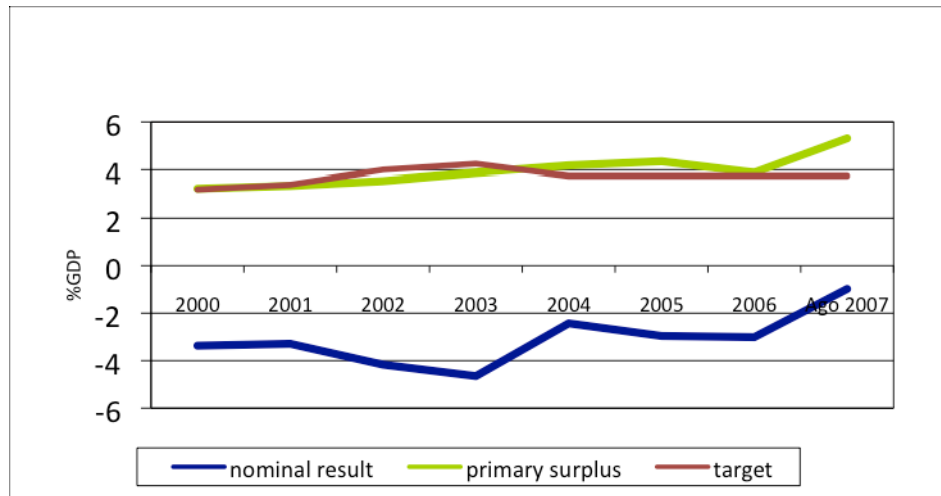
## **2. Recent Fiscal Outcomes in Brazil**

In this section we present evidence of the improvements in Brazil's fiscal situation over the last decade and a half. The evidence suggest that a) there have been improvements in fiscal sustainability at all levels of government; b) although the tax system has remained grossly inefficient, there have been massive increases in tax revenue, particularly from social contributions; c) there has been a recentralization of resources in the hands of the federal government as a result of the concentration of tax and spending authority in the central government.

### ***2.1 Fiscal Results***

In the last decade, the fiscal situation in Brazil has shown great improvement. The primary budget surplus targets have been raised over time since 1999 and have often been exceeded to ensure the sustainability of public debt dynamics. Indeed, Brazil's fiscal adjustment since the floating of the *real* in 1999 has been impressive: the consolidated budget shifted from a primary deficit of almost 0.2 percent of GDP per year in 1995-98 to a surplus of almost 4 percent of GDP on average during 1999-2005, a period when average real GDP growth fell to just over 2 percent per year and was more volatile. In 2007, the surplus reached 3.98 percent, exceeding the target of 3.75 percent (See Figure 1), and the surplus for 2008 is expected to improve further, reaching 4.27 percent, despite worsening of economic conditions. Fiscal outcomes that exceed fiscal targets have been, in fact, the prevailing pattern since 2002. 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 but also able to go through with the unpleasant politics of achieving these surpluses. Even more puzzling is the fact that Brazil has achieved this performance without a major comprehensive tax reform. Indeed countries that succeed in generating fiscal surpluses usually adopt a combination of major expenditures cuts and a major revamping of the tax system. Brazil has not adopted either of these policy options.

**Figure 1. Consolidated Public Sector Fiscal Accounts 2000-2007**



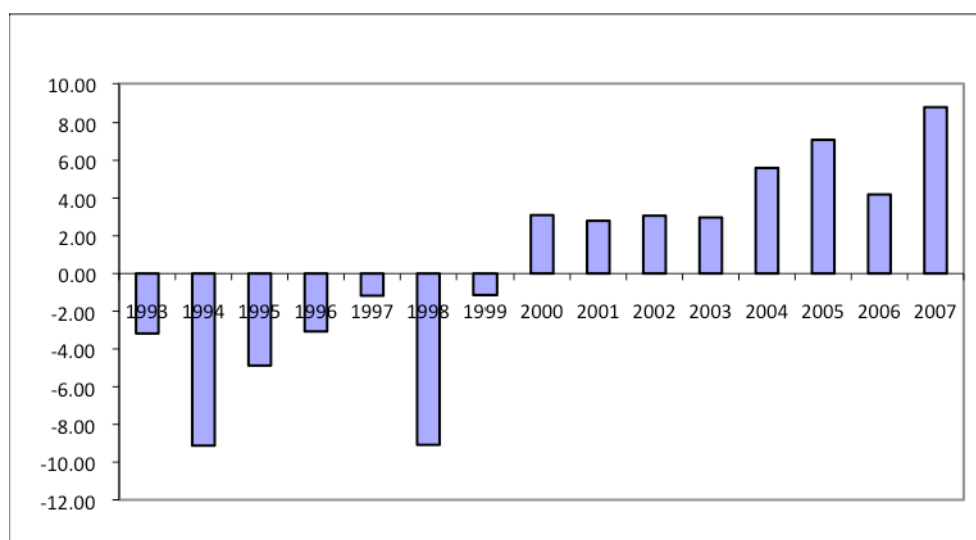
Source: National Treasury.

Recent evaluations of Brazilian fiscal management in the last decade have been exceedingly exhortatory. The IMF and World Bank, as well as risk rating agencies, have concurred in their assessment of Brazil's fiscal situation. An OECD study describes Brazil's fiscal adjustment since the floating of the real in 1999 as "impressive, even in periods of lackluster growth" (de Mello and Moccerro, 2006). Indeed, according to this source, Brazil's fiscal performance points to "a remarkable fiscal effort to ensure public debt sustainability" (de Mello, 2005). Disaggregating the factors that explain fiscal stance—those that are due to policy action from those that are related to the automatic stabilizers built into the tax code, the social security system, and unemployment insurance—the study concludes that discretionary action tends to be essentially pro-cyclical in downturns, underscoring the presence of a "strong sustainability motive" in recent Brazilian fiscal policy (de Mello and Moccerro, 2006).

The improvements in fiscal outcomes occurred both in the federal government and in the states. The states' fiscal situation improved considerably since the enactment of the Fiscal Responsibility Law in 2000, which imposed numerical rules for fiscal outcomes. Whereas all states faced a deficit prior to the enactment of the law, the consolidated state accounts have systematically presented a surplus roughly equivalent to 4 percent of GDP (see Figure 2). Figure 2 also shows that the increase in states' fiscal deficits in 1994 and 1998 reached almost 10 percent of GDP. Between 1993 and 1999, the fiscal deficit averaged 4.5 percent of GDP. Much of that may be ascribed to escalating public spending. The 1988 Constitution expanded states' spending commitments, which resulted in 28 percent expenditure growth at the subnational level

in actual terms between 1989 and 1996, whereas GDP increased only 14 percent. The states' payroll expenditures alone increased by 34 percent as a share of net revenues in that period. At the same time, states' revenues remained nearly unchanged because the boost in federal transfers and the widening of the VAT base following the Constitution were in part counterbalanced by the imperative of the states to elevate their own transfers to local governments. As a consequence of those elements, most state governments began to have financial difficulties and became highly dependent on short-term revenue anticipation operations (AROs) to secure payments to suppliers and public servants. In addition, states issued bonds through their state-owned banks and borrowed from private financial institutions. Another significant part of the deterioration in the states' fiscal accounts thus came from interest payments, since the net debt of subnational governments increased from 9.3 to 20.4 percent in GDP terms over the same time span.

**Figure 2. States' Fiscal Accounts 1998-2007**



Source: National Treasury.

A similar success story can be told regarding public debt. A succession of primary surpluses enabled the government to effectively reduce the GDP/debt ratio. Since 2002, when the GDP/debt ratio peaked at 55 percent, there has been a reduction in net debt as measured by percent of GDP, which was estimated to be below 36 percent in 2008 (see Figure 3). The initial deterioration of the fiscal situation of the federal government and the states was caused by the effects of the end of inflationary financing in the wake of the Real Plan. After this transition period the fiscal situation improved considerably. The magnitude of the changes is all the more

remarkable if we compare the fiscal situation of the last decade with the late 1980s and early 1990s. This pattern can be identified not only for the federal governments but also for the states. The decline in interest payments on the government debt has also contributed to reduce the overall value of debt obligations for the federal government. Interest payments account for 6 percent of GDP in the period from 2004 to 2007—a sharp reduction vis-à-vis the mid 1990s, when it reached double digits.

In fact, three serious fiscal crises stemmed from the over-indebted position of the states. First, in the wake of the worldwide debt crisis of the 1980s, Brazil was faced with major currency devaluations, and state governments stopped paying off their foreign arrears. The second state debt crisis took place between 1991 and 1993 and was largely a result of domestic debt operations contracted by the states with federal financial institutions coupled with the escalation of their bonded debt. At the time, the net debt of the states jumped from 7.5 percent to over 9 percent of GDP and continued to increase (see Figure 3). The third big crisis was brought about in the aftermath of the 1994 federal economic and fiscal stabilization package, namely the Real Plan. The package undermined the states' strategy of consistently bringing down public employees' real salaries and pensions by means of the inflation. Soon, state governments' payrolls easily surpassed 80 percent of their current revenues, while the states' bonded debt in that period grew at an average rate of almost 40 percent yearly.

**Figure 3. Net Public Sector Debt**



Source: National Treasury.

In reaction to those fiscal crises, the federal government decided to bail the states out. In general, the bailouts comprised a broad restructuring of state debts, with immediate debt forgiveness or the adoption of subsidized interest rates for the remaining debt. In 1989 it was established through Law 7976 that the federal treasury would assume the existing stock of external debts of the states contracted prior to December 1988 with federal guarantee.<sup>1</sup> To solve the second debt crisis the federal government approved Law 8727 in November 1993.<sup>2</sup> The new rescheduling agreement meant that the federal treasury should assume approximately \$28 billion of domestic state debts, with 20 years of refinancing and interest rates based on the weighted average of the original contracts. The 1997 comprehensive bailout was carried out but with a totally different approach based on hardening the budget constraint. A series of fiscal adjustment measures were eventually brought together by Law 9496.<sup>3</sup> Following the example of the state of Sao Paulo, the majority of the states agreed to take fiscal adjustment steps to be eligible to refinance their debts for up to 30 years with a 6 percent annual interest rate. Additionally, state governments' VAT revenues and constitutional transfers were pledged as a guarantee to the federal treasury of the debt repayment.

The combination of these factors along with the recent trade surpluses explain the sustained reduction in the nominal deficit<sup>4</sup> in the last decade equivalent to more than 1.3 percent of GDP. Also key to explaining these fiscal outcomes was the privatization program implemented by the federal government and that also involved virtually all states in Brazil to different degrees. Federal state-owned enterprises brought to naught their debts by 2000 and have generated significant surpluses since then, thereby contributing to the primary surpluses by more 2 percent of GDP (See Figure 3). Massive privatization of utilities and state banks occurred between 1997 and 2000. At the subnational level, federal refinancing of state debts—discussed at length in other parts of this paper—and a policy of carrot and stick made the privatization reform viable.

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<sup>1</sup> In 1989, 23 states had their debts bailed out by the federal government. Only four states, AP, DF, RR, and TO were left out.

<sup>2</sup> In the new bailout wave that took place in 1993, 25 states were included with the exception of AP and DF.

<sup>3</sup> In 1997, whereas 22 states were bailed out, AC, AL, AP, DF, and TO did not participate.

<sup>4</sup> The calculations of the primary deficit exclude debt repayments, while the nominal deficit includes them, and therefore it is a more robust measure of the country's fiscal situation. Sustained trade surpluses have been used for debt repayments, affecting the government's demand for credit and therefore playing an important role in reducing the nominal deficit.

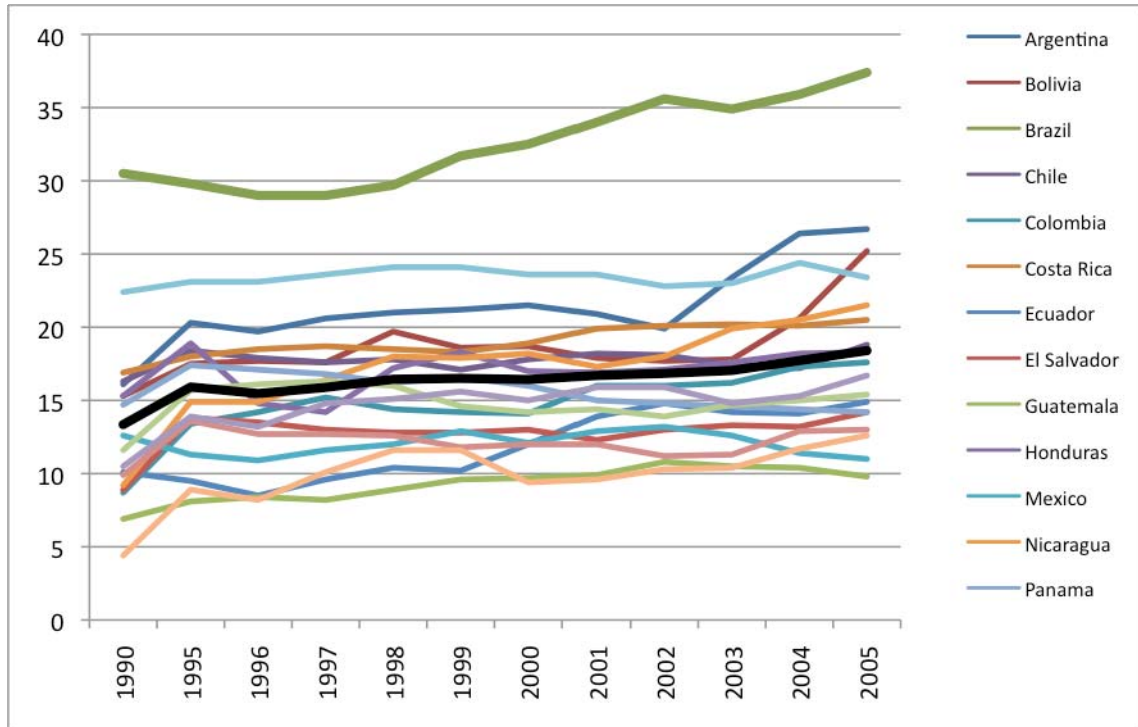
## ***2.2 Taxation Outcomes***

Part of the fiscal adjustment was made possible by a massive increase in tax revenues since the mid-1980s. This took place in the context of an already comparatively high tax burden. The tax take as a percent of GDP rose 12 percentage points (from 25 percent to 37 percent) between 1993 and 2005. This makes Brazil an outlier among developing countries in terms of ability to extract resources from society (Lora, 2007). In Latin America, Brazil's tax take has been twice the Latin American average (Figure 4). The increase in taxation was due to the introduction of new taxes and increases in existing tax rates, particularly federal taxes and the so-called social contributions.<sup>5</sup> Indeed, the fiscal budget, which comprises income tax, the federal VAT, and other less significant sources, accounted for an average of 8 percent in the period 1995 to 2005. By contrast, the extended social security budget, made up of contributions earmarked for social assistance, health care, and pensions, rose 84 percent between 1991 and 2005, reaching 14.5 percent of GDP at the end of this period. As Figure 5 shows, the share of the states increased in tandem with the expansion of federal taxes and contributions. In 2007 it reached 26 percent of GDP—9 percentage points above its 1992 level.

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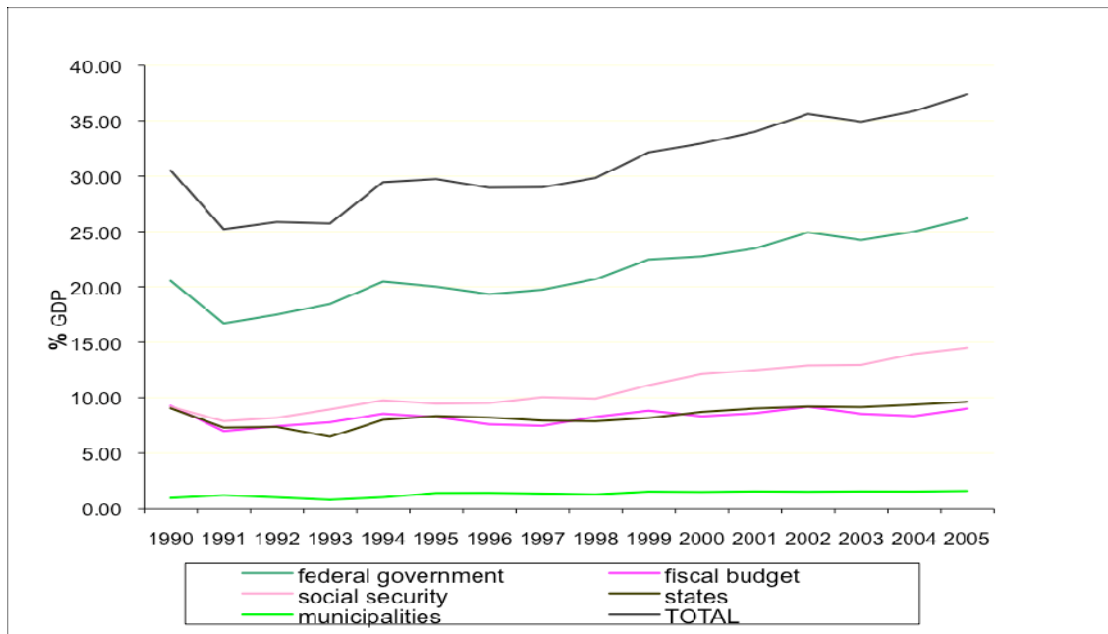
<sup>5</sup> Social contributions are a special category in the Brazilian tax system. Unlike other taxes, they are created with a special purpose, and in theory the revenue is earmarked for this purpose.

**Figure 4. Tax Burden in Latin America (1990-2005)**



Source: CEPAL.

**Figure 5. Tax Burden as a Percentage of GDP by Level of Government**

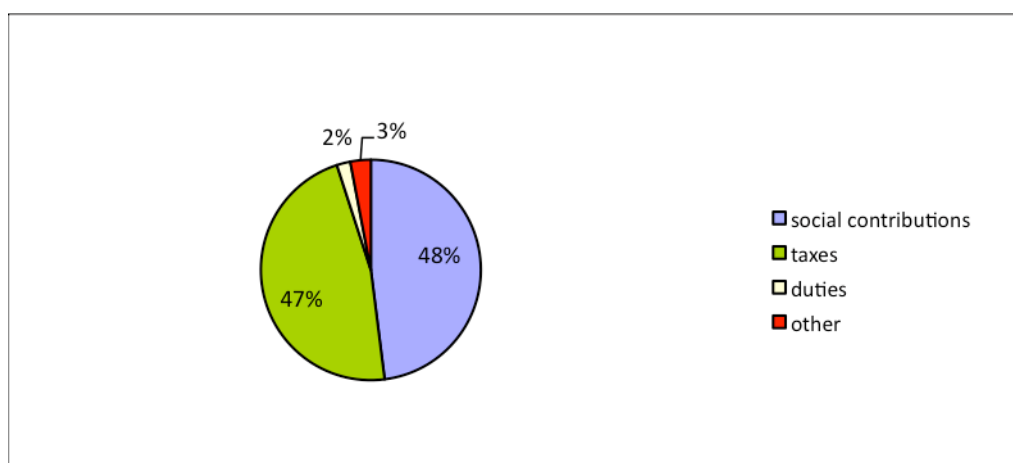


Source: CEPAL.

The lion's share of the new revenue has been generated by social contributions, which, unlike normal taxes, are not shared with the states and municipalities. The political economy of state versus central government fiscal relations is fully explored throughout this paper. Suffice it to say that the government's choice of relying on contributions had a fundamental impact in Brazil's fiscal federalism. Annex 1 and Figure 6 present data on the current composition of total revenue by type of tax. Social contributions have risen to represent approximately half of central government revenue and 9 percent of GDP (see Figure 6 and 7). The contributions were instrumental to the government because of an additional feature: unlike normal taxes, collection of contributions could start in the same fiscal year as their introduction.

As detailed in Annex 1, tax assignment across the various tiers of government is unique in Brazil because of the vast tax powers enjoyed by the states, which collect the one tax that yields the most revenue (8 percent of GDP), the ICMS,<sup>6</sup> an arrangement not found in any other country. Despite the great vertical fiscal imbalance in a number of provinces, which are highly dependent on federal transfers, the large states possess great fiscal autonomy (see Figure 8).

**Figure 6. Total Revenue by Type of Tax, 2006**

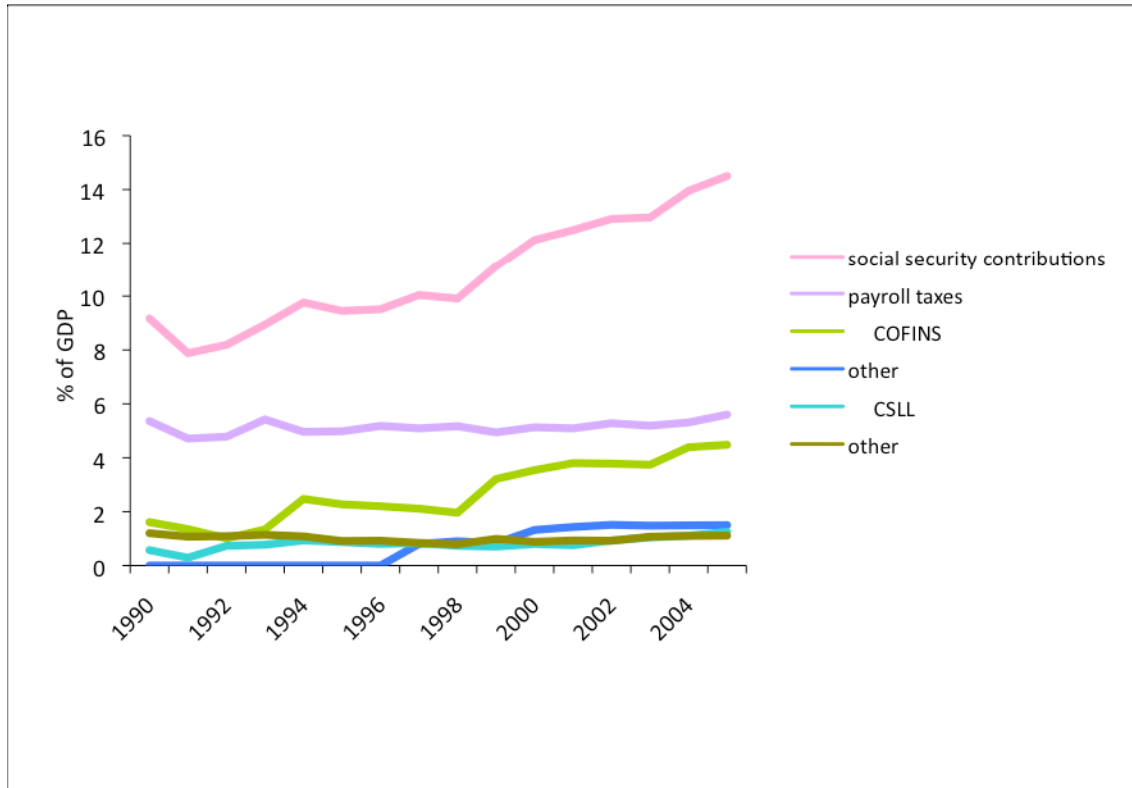


Source: National Treasury.

<sup>6</sup> ICMS stands for *Imposto sobre Circulação de Mercadorias e Serviços*. It is a value added tax on goods and services collected by the states. It is roughly similar to the IPI (*Imposto sobre Produtos Industrializados*), which is collected by the federal government.

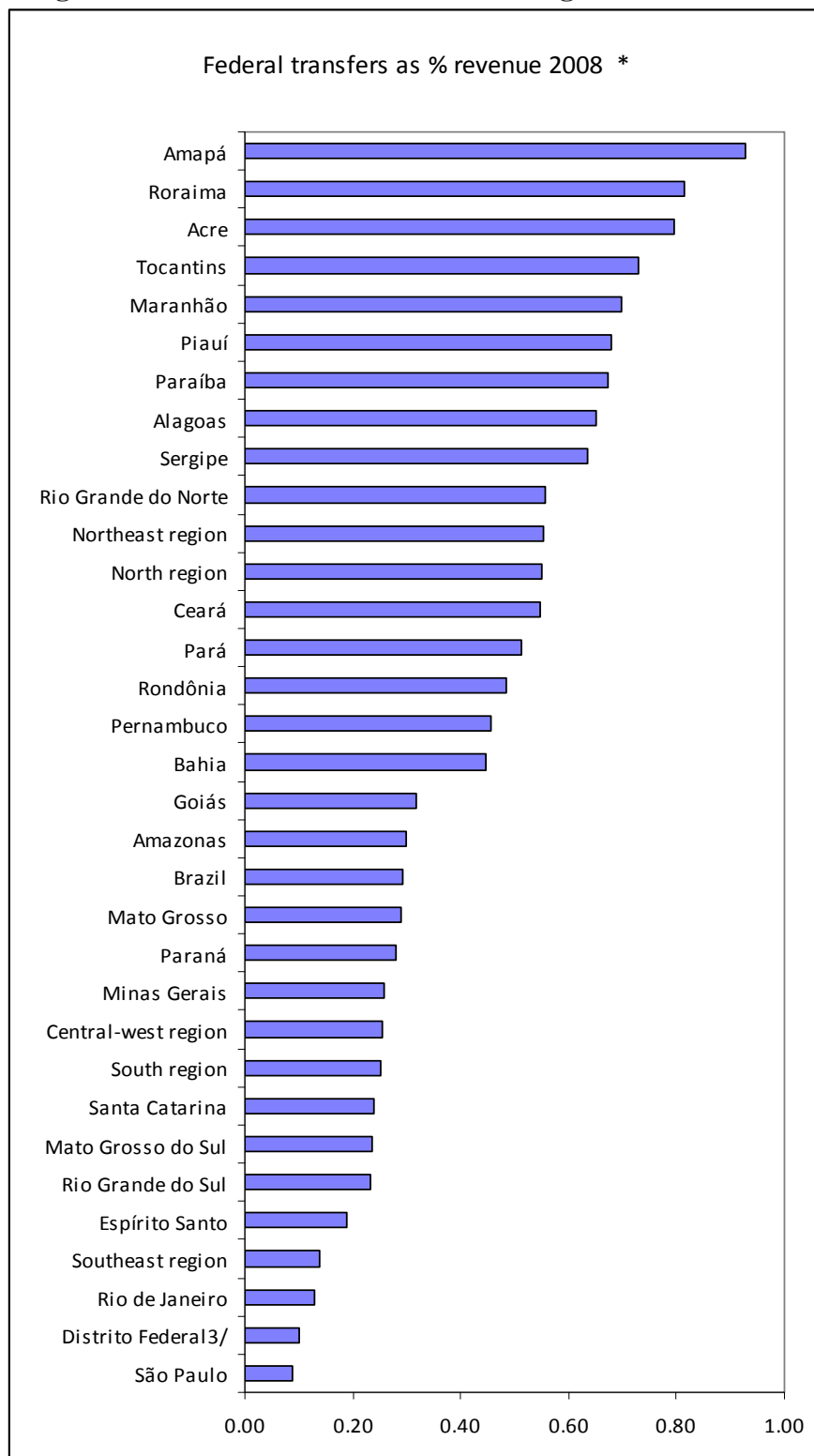


**Figure 7. The Expansion of Social Contributions**



Source: National Treasury.

**Figure 8. Federal Transfers as a Percentage of Revenue 2008**

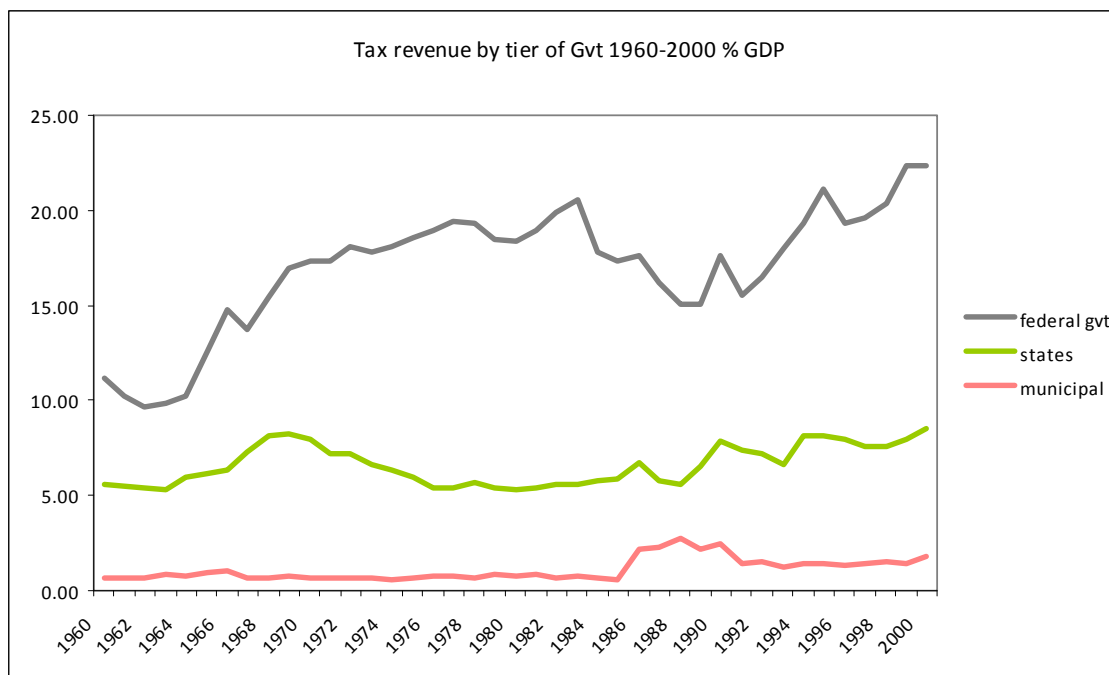


Source: IPEADATA.

### 2.3 Fiscal Federalism

As Figure 9 shows, the history of fiscal federalism since the 1960s has been marked by the expansion of federal fiscal space, which faced an interregnum in the late 1980s and early 1990s, to fully recover its historical path in the 1990s (see Figure 8). In the 2000s the expansion of federal and state taxation was commensurate. However, in the mid-1990s the federal government started de-earmarking revenue that was part of the pool of taxes forming the basis of constitutionally mandated transfers to the states and municipalities (the IPI and income taxes; Alston et al., 2006. See Annex 2). This in practice was tantamount to a recentralization of resources in the hands of the federal government. As discussed at length in other parts of this paper, this and related measures were taken as a reaction to the fiscal decentralization of revenue called forth by the Constitution in 1988, which had started earlier in 1985 through a constitutional amendment.

**Figure 9. Tax Revenue by Tier of Government, 1960-2000**



Source: IPEADATA.

The recentralization of resources in the hands of the federal government constitutes a process of concentration of tax and spending authority in the central government. However, it has taken place in a context of extensive decentralization of final appropriation of public expenditures. As detailed in Annexes 3 and 4, Brazil has a complex constitutional arrangement for revenue sharing among levels of government, including a unique scheme of transfers from the states to the municipalities. This arrangement creates a complex incentive structure, which is also the object of analysis in other sections of this paper. In addition to the constitutionally mandated transfer of fiscal resources to subnational governments, the central government operates a number of sectoral transfers in the areas of education, health care, and social assistance, among others, involving strict conditionalities. The net result of these transfers is that administrative decentralization has deepened further in the last decade or so. As shown in Table 2, the municipalities are the main beneficiaries. They collected an estimated 6.4 percent of total revenue in 2004, while executing 17.3 percent of total expenditures. The corresponding figures for the states and the central government show that tax collection and expenditures execution are roughly balanced.

**Table 2. Revenue Collected versus Disposable Income by Level of Government**

	Central	States	Local	Total	Central	States	Local	Total
Revenue collected								
1960	11.14	5.45	0.82	17.41	64.0	31.3	4.7	100
1980	18.31	5.31	0.90	24.52	74.7	21.6	3.7	100
1988	16.08	5.74	0.61	22.43	71.7	25.6	2.7	100
2004	25.10	9.82	2.21	37.14	67.6	26.4	6.0	100
Disposable revenue after transfers								
1960	10.37	5.94	1.11	17.41	59.5	34.1	6.4	100
1980	16.71	5.70	2.10	24.52	68.2	23.3	8.6	100
1988	13.48	5.97	2.98	22.43	60.1	26.6	13.3	100
2004	21.32	9.38	6.43	37.14	57.4	25.3	17.3	100

*Source:* Afonso (2006).

The current fiscal status quo is favorable showing a positive trend towards sustainability. Indeed, there have been improvements in the country's fiscal position for over a decade. This was attained by a rising tax burden and an active federal policy towards assuring fiscal surpluses and strengthening budget control over budgetary and fiscal issues. In the next section we take stock of the institutional changes that have occurred or have only been attempted.

### **3. Inventory of Reforms**

This section provides background information on key changes introduced in the area of fiscal federalism and budgetary institutions as well as a brief overview of the tax reform initiatives of the Cardoso and Lula governments (1995-2008). We show that the federal government has successfully implemented an agenda of reforms for fiscal federalism while also promoting extensive fiscal reforms in the states. By contrast, the reform agenda in the area of taxation has never been implemented, and only marginal incremental changes have occurred. As indicated before, non-reform does not imply that the status quo was maintained. Rather, it simply means that important changes occurred via incremental expansion of rates of existing taxes and contributions (and introduction of some new social contributions as well). As for the budgetary institutions, we show that the changes enhance the preponderance of the executive in the budget process.

After the transition to democracy in 1985, Brazil experienced important institutional changes. These were encapsulated in the Constitution of 1988. The most important effect of the new charter was the dramatic expansion of entitlements in social security and social assistance. Both the types and value of social benefit and transfers were significantly extended. Non-contributory pensions were created, particularly for rural workers. It also established a floor value for social security benefits equivalent to the minimum salary. In addition, it granted civil servant status to about 250,000 federal employees, thereby creating a flow of future pension commitments at a much higher level than the prevailing level. Furthermore, the Constitution mandated the fiscal decentralization of the country by increasing the shares of municipalities and states in the total revenue. In addition to more resources, it allowed the states to set different

rates for the state's VAT. In a soft budget constraint, this produced a situation in which the states could engage in fiscal wars, thereby depressing total tax revenue.<sup>7</sup>

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. Moreover, subnational 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 subnational interests and of demands for redeeming the country's "social debt."

The fiscal game in the 1990s reflected, to a great extent, the reactions from the federal Government to this state of affairs. The federal government also reacted to the new fiscal federalism by resorting to a two-pronged strategy. The first one, which involved the path of least resistance, was to raise non-shared taxes (the so-called social contributions). This explains why these highly distortionary forms of taxation came to represent half of federal tax revenue. Social contributions are cascading taxes, which in many cases exploit similar tax bases. As discussed before, the rigidity imposed by the Constitution caused the federal government to resort to an increasingly inefficient tax system. The second strategy involved withholding funds mandated for distribution to subnational governments and required changes in the Constitution. 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. This did not involve major concessions on the part of the federal executive. 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. In light of our previous discussion, the economic crises of the early and late 1990s provided the window of opportunity for the reforms, but some of the measures taken had already been discussed shortly after the Constitution was promulgated.

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<sup>7</sup> For a discussion see Rodden, Eskeland and Litvack (2003). Where they prevail, subnational governments increase expenditures without incurring the full cost.

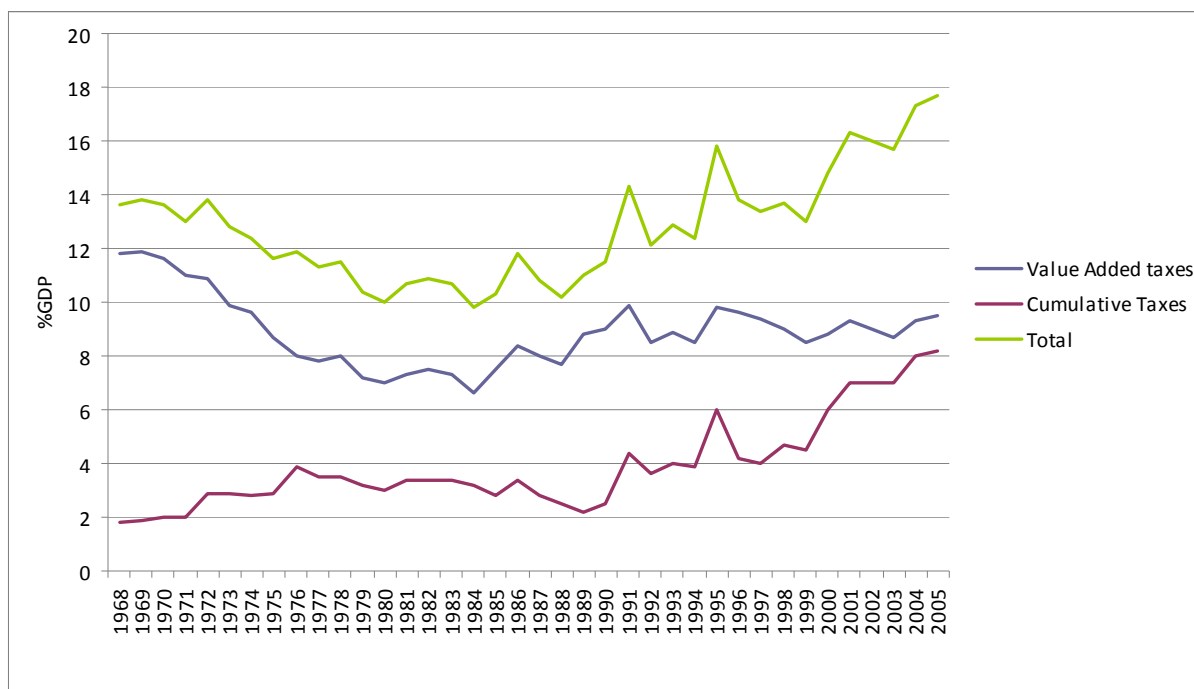
In some cases, such as the Fiscal Responsibility Law, there were provisions in the Constitution calling for the regulation of subnational spending.

In the remainder of this section, we provide selected evidence of the reforms in each issue area under analysis.

### ***3.1 Tax Reform Initiatives***

In this subsection we take stock of tax policy initiatives and adjustments over the last decade. We say initiatives rather than simply reforms because Brazil illustrates the case of a country where no comprehensive reforms have been implemented despite the massive increase in tax revenue in the period under scrutiny. To be sure, there have been some incremental changes in the taxation of both corporate and personal income, but little reform in the taxation of consumption and in the elimination of cascading taxes. As Figure 10 shows, while the share of value added taxes has not changed since 1992, cumulative taxes have doubled between 1992 and 2002, mostly as a consequence of social contributions. Fiscal reform initiatives have overshadowed the tax reform agenda, and the tax changes that effectively have been implemented have had the single objective of expanding revenue with no efficiency or redistributive considerations in mind. This does not mean that there has been a shortage of proposals. Many proposals, in fact, have been discontinued, only to be resurrected with strikingly similar content in different reform plans.

**Figure 10. Cumulative and Value Added Taxes as a Percentage of GDP, 1968-2005**



Source: Dain (2006).

Unlike other countries in the region—with the exception of Chile—Brazil already possessed a modern tax system as well as a professional tax administration in the late 1970s. The tax take in the 1970s, which averaged 25 percent of GDP, was already among the highest in developing countries. The country was also a pioneer in value added taxation, which was introduced in the late 1960s. However, in the last 15 years, the expansion of social contributions (that exploit in many cases the same tax bases) along with other measures elevated the share of cumulative taxes in the tax system. The current tax system (depicted in Annex 1) consists of a highly inefficient and regressive system, which nonetheless serves the government's purposes because of the massive revenue it generates.

By virtue of its level of detail and its comprehensive nature, the great majority of policy reforms in Brazil, particularly tax reforms, require changing the Constitution.<sup>8</sup> The chronology of

<sup>8</sup> The developments in terms of the provisions that did not require constitutional reforms focused on income taxation and marginally on VAT rates. In 1995 the government revamped the small business (by introducing the so-called SIMPLES scheme) and corporate taxation and implemented measures to close many loopholes in transfer pricing. In line with international trends, the government lowered (with oscillations) top personal marginal rates from 60 percent in 1985, to 50 percent in 1987, 25 percent in 1989, 35 percent in 1995, 25 percent in 1997, and 27.5 percent in 1999. These have become in force until late 2008 when a new rate scale was introduced consisting of 4 rates using the existing top and lower brackets. For business, the corresponding rates were reduced from 40 percent in



the main changes in the tax legislation since 1988 is presented in Annex 4. It depicts the main themes that have dominated the reform agenda since the early 1990s and which have remained in the agenda up to the current tax proposal put forth by Lula. First, the creation of a national VAT, by the fusion of the IPI (the federal VAT) and the state VAT (the ICMS). Second, converting the existing system into a destination VAT whereby tax is collected at the place of consumption rather than production of goods and services (thereby ensuring tax harmonization with other countries). Third, eliminating cumulative taxation, particularly those associated with social contributions. Fourth, eliminating taxation of exports. Fifth, streamlining the system by making it simpler, while maintaining the extant tax take.

Most legislative battles over the last decade and a half have involved the fate of tax and fiscal initiatives taken in the early 1990s (see Annex 4). Under the administrations of President Itamar Franco and President Fernando Henrique Cardoso, the mechanism for de-earmarking funds mandated for distribution to the states (*Fundo social de emergencia*—the Emergency Social Fund) was successively extended (renamed Fiscal Stabilization Fund in 1996, and de-earmarking of Federal Revenue, DRU, in 2000). By the same token, a tax on financial transactions (IPMF) was approved on a provisional basis (later renamed CPMF), and a comprehensive tax reform package was proposed in 1995.

The second attempt at a comprehensive tax reform by the federal government was the Constitutional Amendment presented by Cardoso's administration in 1995. Cardoso proposed PEC 175 in August 1995, in his second year in office. The PEC 175 was relatively timid even by Brazilian standards where reforms are incremental. The proposal's central idea was to eliminate the Tax on Manufactured Products (IPI), which is levied at the federal level, and change the structure of the current state ICMS so as to create a single tax levied both at the federal and state levels. A single value-added tax to be collected by central-level authorities was a long-term objective. In its first stage, a two-tier "ICMS" would be introduced with two distinct tax rates, to be collected by federal as well as state administrations.<sup>9</sup> Furthermore, the ICMS on interstate

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1985, to 30 percent in 1990, to 25 percent in 1995. In addition, changes were introduced to broaden the tax base. VAT rates, in turn, rose marginally in the period but because of good tax management VAT productivity was the highest in Latin America, and about almost three times that found in Argentina. The same applies to personal income productivity (see Lora, 2001).

<sup>9</sup> The new ICMS rules defining permanent tax rates was believed to stop what has been dubbed a "fiscal war" among the states, since any companies benefiting from tax waivers in a particular state would undergo an increase in the federal rate by the same proportion. States engaged in fiscal wars by reducing the rates of state taxes in order to attract investments.

trade would be collected at the destination of products, not at the origin, thus substantially benefiting the poorer consumer states. Various versions of the proposal were discussed after amendments were incorporated in the Committee.

Pedro Parente—then the executive secretary of the Ministry of Finance—proposed a new draft of the substitutive in 1998, which was viewed as an alternative counterproposal to that presented by the *rapporteur*, Mussa Demes. The proposal called for the replacement of the ISS, IPI, ICMS, CSLL and the main cascading taxes, i.e. PIS and COFINS, with a single federal VAT, a state retail sales tax, and a selective tax in place of the IPI. It was a more radical proposal than that of the *rapporteur*. However, the proposal was presented in draft form and the government never mobilized its party leaders to advance it in the Legislature.

In the new legislature (1999-2002), the taxation committee worked on the proposal and approved a draft solution that was not supported by the government. The committee presented the proposal to the tax reform agenda as an informal contribution. The president of the Chamber of Deputies then announced that the government was not going ahead with tax reform.

The early 2000s was marked by deadlock. Discussions were held around the same issues that dominated the tax agenda for a decade. None of the proposals garnered strong government interest. The only new development in 2001 was the creation of the CIDE contribution earmarked for the transport sector signaling that any attempt at comprehensive reform was out of the picture and that its main concern was raising revenue. In 2002 by Provisional Measure 66, the government assembled an array of marginal changes in a symbolic mini-reform that could be called a reform proposal. Very limited in scope, the reform was restricted to measures that could have been put in place by means of an ordinary law, hence avoiding the political stress involving the approval of a constitutional amendment. Basically, the COFINS was converted into a non-cumulative tax, an arrangement was created for the CIDE revenue sharing, and the DRU and CPMF were extended. Other minor measures involved the granting of tax relief for some economic activities, the simplification of procedures for small businesses taxation, and the partial replacement of some payroll taxes with turnover taxes.

The newly elected President Lula presented the third important reform proposal to Congress, in 2003. Essentially the same issues that dominated previous discussions were reconsidered, but within a more restricted scope. The proposal introduced broad changes in the

tax regime, broadening the tax base and increasing rates, but its net impact on the overall tax system was expected to be neutral (no revenue gains or losses to any tiers of government).<sup>10</sup> A modified version of the initial proposal was thus agreed in Congress and approved as Constitutional Amendment 44. The more controversial and radical changes would be considered separately in a new PEC.

The government discontinued proposals for a major revamping of the tax system. However, in 2007, during Lula's second term, they resurrected as an amendment Proposal 31-a, also known as PEC 255. The aspects covered in the proposal are similar to those of previous reform proposals: uniform state VAT legislation throughout country to be created; turnover and cascading taxes (PIS/PASEP, COFINS) to be converted into a single federal tax; and provisional contribution on financial transactions (CPMF) to be made permanent among others.<sup>11</sup>

A major governmental defeat involving the CPMF signals that the executive is constrained but not overly dominant. Popularly called *imposto do cheque*, the CPMF was created in 1996 as a federal contribution applied to all financial bank transactions. Originally designed to be a temporary taxation fundamentally allocated to the universal health care system (SUS), the CPMF lasted as a provisional contribution for about 12 years when it was finally abolished on December 13, 2007 in a historic roll call when the executive's bill requesting its extension until 2011 was defeated in the Senate. It was an upset result because the executive's majority coalition was not able to obtain the necessary majority of 49 votes in the Senate; it received only 45 votes. With this political defeat in Congress, the government lost about R\$ 40 billion in revenue with the aliquot of 0.38 percent of each financial transaction according to the 2008 government's budget proposal.

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<sup>10</sup> According to the proposal, the progressivity of the tax system would be improved because of changes in the state VAT (ICMS). The VAT collection would remain the responsibility of the states but the tax would have a nationally unified legislation for the 27 Brazilian states, implying a reduced number of tax rates (no more than five). Incentives conducive to the "fiscal war" among the states would be gradually terminated while new incentives would be banned. Exports would be exempted from the tax, which would be levied on an origin basis, with the door open for the adoption of the destination principle at a future time. A fusion was proposed of cascading contributions to form a new federal VAT. The COFINS would be transformed into a non-cumulative tax along with the PIS-PASEP. In contrast, the cumulativeness of the CPMF would be preserved, as that contribution would be converted to a permanent tax. Taxes on companies' payroll would be scaled down, while the social security system would be financed in part by an extra turnover tax. The proposal also extended the de-earmarking of federal taxes from 2003 to 2007 and raised the rate and extended the CPMF (tax on financial transactions). Accordingly, states and municipalities envisaged revenue gains from the CPMF becoming a tax rather than a contribution. Likewise, states were to receive 25 percent of CIDE's revenue; municipalities in a state get 25 percent of the state's share. The sharing of both CPMF and CIDE revenues with subnational units was figured out as a possible solution for the stalemate in the negotiations of the proposal.

<sup>11</sup> At the time of writing, this bill has not been put to a vote.

The negotiations of the government with legislators about the extension of the CPMF exposed several mistakes. First, the government took for grant its approval without any policy concession. Later, when the government realized that would not be easy to just approve the extension, it suggested a smaller aliquot of 0.36 percent in 2007 and greater reduction in the following years up to 0.3 percent. Without success, the government promised to allocate part of the CPMF to education. Anticipating that it would be defeated, the government, as a last resort, sent a letter signed by the finance minister agreeing that the CPMF would be entirely allocated to the SUS. However, it was too late!

This episode represents a signal and a remarkable mobilization of several different sectors in society (media, interest groups, business sectors, etc.) and opposition players that the federal government's ability to keep increasing the tax burden was running out. One of the most important criticisms the CPMF received from those sectors was the lack of transparency in its allocation. In fact, the CPMF was never fully allocated to the universal health care system as originally intended; rather, it was diverted to other purposes, such as the government's priority of its primary surplus. The social movements against the CPMF, supported by the Industrial Federation of the State of Sao Paulo (FIESP), composed of more than 200 unions and associations (<http://www.contraacss.com.br/>), was able to gather more than 1.5 million signatures all over the country against the CPMF while at the same time supporting the idea of a comprehensive fiscal reform. Actually, this movement continues to be active as a kind of "vigilante" against any further government's attempts to bring the CPMF back in and mobilizing the society in opposition to additional tax increase.

### ***3.2 Fiscal Reform of the States and Federalism***

It is necessary to distinguish two phases in the relationship between the national government and governors. The first phase (1985-1992) was transitional and marked by the rules of the political game not being fully institutionalized. In this period, governors derived their power by virtue of the role they played in the democratic transition. The second phase (1993-2002) corresponds to the Cardoso administration, when the new constitutional rules of the game were in place. The reform of fiscal federalism started with provisions to restrict subnational debt in 1993, followed by Constitutional Amendment 1 in 1994 (the Social Emergency Fund), which called for the retention of federal monies earmarked to the states. A second stage started in 1995 with the

beginning of the process of refinancing of state debts, which was followed by the massive privatization of state banks and state utilities in 1997-1999. Although they could not qualify as reforms of fiscal federalism per se, they affected federalism and intergovernmental relations in key ways. A third stage was reached with the promulgation of the Fiscal Responsibility Law in 2000, which dramatically changed the rules governing the fiscal and financial matters of the states.

In the first phase described above, governors were powerful. They derived their powers from two sources. They enjoyed great political power in the 1980s because of the role they played in the democratic transition. Governors tend to have some, yet declining, influence in the behavior of Federal Deputies and Senators in Congress (Cheibub, Figueiredo and Limongi, 2002). Governors could also influence the electoral career of legislators at the state level but, unlike its neighbor Argentina, they play no direct role in the election of senators or presidents. Second, governors were powerful because the Brazilian Constitution vests the states with substantial tax powers. Brazil's version of the VAT—the ICMS—is collected by the states and represents the single most important tax in the country. In addition, the institutional source of the state's power also has to do with the state's prerogative to own banks and public enterprises. The federal government, however, was able to impose the privatization of banks and public enterprises, thereby dramatically undercutting the power of governors, due to fiscal problems facing the states following monetary stabilization. The federal government also resorted to a strategy of carrot and stick, offering incentives (e.g., anticipation of revenue from future privatization of state utilities controlled by state governments). Indeed, between 1997 and 2000, 24 state utilities were privatized. In addition, following PROES (Program of Reduction of the State Participation in Banking Activity), 23 state banks were either privatized or closed (see Annex 5).<sup>12</sup>

The states were fiscally weak. With inflation under control, state banks lost their principal source of revenue (i.e., floating of financial assets). On the other hand, the surge in interest rates

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<sup>12</sup> The PROES was created in 1996 and was modeled at the arrangement established between the federal government and the state of Sao Paulo. After the Bank of Sao Paulo (BANESPA) received a federal government intervention for about one year, state and federal governments aimed to sign a deal that maintained BANESPA under the control of the state government. Half of the state's debt with BANESPA would be obtained with the privatization of state assets, and the national treasury was in charge of financing the other half. However, this negotiation was very tough and protracted, lasting more than five months. When the Senate finally approved the deal, the state debt with the BANESPA was about 20 billion. At the end of the negotiation, the Governor of Sao Paulo, Mario Covas, refused to sign the agreement (Leite, 2001).

caused a rapid deterioration of the fiscal situation of the states. The Real Plan implemented in 1994 brought inflation to zero and represented an exogenous shock that undermined the ability of the states to resist the preferences of the federal executive. This was because the states saw their debts rise due to the sharp increase in interest rates at the same time that the speculative operations that provided the state banks with extra revenue<sup>13</sup> ceased to be feasible when inflation fell dramatically. The federal government implemented a program aimed at renegotiating the states' debts. These included debt swaps under favorable conditions, which were linked to a number of conditionalities. Prior to 1994, there were several incentives, including massive bailouts and refinancing of debt, under Brazil's fiscal federalism that encouraged states to behave in a fiscally irresponsible manner. These can be seen in the history of opportunistic behavior by the states and associated to federal bailouts. In sum, while it is clear that federalism matters and governors play an important role, the national executive throughout most of the last decade has been able to have its agenda implemented by recentralizing the political game. This includes passing legislation that adversely affected state governors (including the Fiscal Responsibility Law of 2000) and initiating measures that led to the political recentralization of the country.

The debt accumulation process of the 1990s helps explain the circumstances under which the governors were willing to accept restrictive fiscal reforms that prevented them from overspending or incurring new debts other than borrowing for capital formation. The size of the subnational debt stock (13 percent of GDP in 1997, excluding subnational public enterprises) and the governors' difficulty balancing their budget both played a role in their decisions to renegotiate their debts and cooperate in the approval of the fiscal responsibility legislation. With the suppression of the high inflation regime, it was no longer possible to rely on the inflation rate to bring down the real value of current expenditures. The fiscal situation at the state level was so precarious in that period that the states found themselves with 70 percent on average of their budget devoted to personnel spending, leaving little room to implement their political platforms. Governors saw little alternative but to restrain expenditures overall, despite the high political costs attached to that decision.

In response to the states' fiscal crisis, the federal government passed Law 9496, in September 1997, to bail out the states based on a subsidized 6 percent interest rate (substantially lower than the market interest rates, which averaged 21.4 percent from 1997 to 1999, according

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<sup>13</sup> This involved investing cash deposits into short-term speculative operations.



to the Brazilian Central Bank). In exchange for the bailouts, the states made commitments to implement fiscal adjustment programs designed to reduce their debt and avoid deficit spending. However, while renegotiating the debt, the governors became aware of contract clauses establishing withholding of state funds in the event of default on federally owned debt. The purpose of these clauses was to guarantee that the contracts would be fulfilled and the states would be able to reduce their debt stock over time. Governors also agreed to privatize the state-owned banks because these banks were having serious financial difficulties after the launching of the Real Plan.

If a state refused to adopt fiscal adjustment measures, it would have to rely on an additional tax effort to simultaneously equate revenues with expenditure over the whole fiscal year and reduce the amount of outstanding debt. Although the states continued to control taxation policy without much interference from the federal government, they would pay a very high political cost for increasing tax collection. For one thing, increasing the sales tax (particularly the ICMS, which in 1997 accounted for about 91.5 percent of fiscal revenues for state governments) would have been a major challenge, as large campaign contributions would frequently come from business groups that had a financial interest in not increasing the sales tax rates. Moreover, the governors realized that they would have a hard time securing a budget that was sufficient for the purpose of fulfilling their election promises. Those promises typically involved higher infrastructure investments and spending more on social programs.

On the other hand, the states welcomed the fiscal adjustment legislation on the grounds that the rules could become a useful legal instrument in the hands of governors to reduce personnel expenses without the political costs that usually followed such measures. Moreover, the governors were more focused on the tax reform going on in Congress than on the discussions involving the approval of the Fiscal Responsibility Law (Complementary Law 101, of 2000).

As argued by Alston et al. (2004), the executive had the capacity to impose its fiscal preferences because it could exchange the federal government's advancements for fiscal reforms, including privatization of state banks and public utilities; it had agenda powers and other legislative prerogatives to implement its agenda; and because of the approval of the reelection amendment, which strengthened not only the president vis-à-vis governors but also helped extend governors' time horizons (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 majority of public opinion, which became strongly inflation averse. 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, the relative success of hierarchical control is due to a combination of both endogenous incentives from the governors and the preponderance of the executive in the policy-making process.

### ***3.3 Budgetary Institutions***

Since the Constitution, the budget has not faced a comprehensive reform. However, the budget scandal of 1993—the so called *escândalo dos anos do orçamento*—provided the window of opportunity and set the stage for a series of reforms to the budgetary process in subsequent years. Under military rule (1964-1988), the budget was entirely dominated by the executive branch and the role of congress in the process was just to rubber stamp it. Legislators were barred from presenting budget amendments. The new constitution of 1988 restored the right of Congress to change the budget. The model that prevailed between 1988 and 1993 was highly centralized by a small, secretive committee made up of individual legislators relatively free from the oversight of the executive branch and parties. Very high inflation contributed to budgets' lack of transparency. The scandal laid bare the inadequacy of the model and allowed a reform that strengthened the role of the executive and Congress as an institution in the process.

Although legislators have the right to amend bills that are exclusively introduced by the President, the rules regarding amendment of the budget proposal (PLO) have varied considerably in the past several 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-level blocs (*bancadas*



*estaduais*) to also amend the budget bill.<sup>14</sup> 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 nº 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 individual legislators to continue amending the budget bill. This resolution also established new rules for collective amendments, restricting them to five per standing committee; five 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.

Until 1993, there was no limit to the number of amendments that each legislator could make to PLO.<sup>15</sup> Resolution nº 1 of February 6, 1993 restricted the number of amendments for each legislator to 50. 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-CN further reduced the number of amendments to 20 and set a ceiling of R\$ 1.5 million as the total amount of amendments per

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<sup>14</sup> 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 million as the total amount of amendments per legislator. Recently, legislators decided to increase the value of this quota to R\$ 2.5 million and this year they decided to increase this ceiling to R\$ 3.5 million Reais for each legislator.

<sup>15</sup> 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).

legislator. Recently, legislators decided to increase the value of this quota to R\$ 2 million, and at the time of this writing, it is R\$ 3.5 million.

Resolution n° 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 the limited number and value of amendments, legislators have no guarantee that their amendments will be approved by the committee; thus, they still have to negotiate with *rapporteurs* 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 coveted. Frequently legislators can count on the support of their mayors and governors to lobby for their demands in 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. 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 to understanding the evolution of current budgetary rules.

#### **4. Formal Institutions and the Policymaking Process**

In this section we explore the institutional basis of fiscal governance in Brazil. We show how a powerful president has had the tools and the incentives to ensure good fiscal governance. The changes in fiscal and budgetary institutions as well as the reorganization of fiscal federalism that took place in the last decade and a half were feasible because of the institutional prerogatives of presidents and the fact that they internalize the costs of fiscal irresponsibility. The latter are essentially the political costs of inflation and international reputation. Rival explanations that

multiparty presidential regimes are doomed to failure are not consistent with the institutional performance of the country. The institutional prerogatives of presidents co-exist with relatively effective checks and balances. Therefore, presidential power is a constrained power.

There are two classes of common pool problems of a fiscal nature that need to be addressed in a country like Brazil: first, those associated with potential fiscal opportunistic behavior of state governors and second, those associated with coalition management in a very fragmented party system. Both types of problems have been largely mitigated by several institutional measures that recentralized the game in favor of the national executive since the 1988 Constitution. In addition, it seems to us that presidents have learned how to deal and manage their multiparty coalition in Congress. However, it is important to recognize that governors, at the subnational level, as well as party leaders, at the national level, will always try to find ways to overcome those constraints set by the national executive. A very good example, discussed in detail later in this report, is the opportunistic behavior by state governors to window dress their expenditures by postponing unpaid commitments to the next fiscal year in order to meet the requirements of the Fiscal Responsibility Law.

One might argue that a powerful executive would have the conditions to set fiscal policy at its ideal point. Why, then, do Brazilian presidents seem to be content with this apparently suboptimal outcome which increases taxation without making the system more efficient? To solve this puzzle, one has to take into account that the bliss point of the executive has been contingent on what Alston et al. (2009) call the fiscal imperative. Moreover, contextual factors such as the Russian and the Asian crises led the government to refrain from taking further initiatives that might represent a risk that could affect revenue generation. The same rationale could be applied to the current administration. The current system is highly complex, affecting a vast array of interests. Therefore, its reform has high political costs. Considering that the current system is inefficient but generates enough revenues, the net benefits of efficiency-oriented reforms would be small or at least unpredictable.

Within the class of multiparty presidential regimes, the case of Brazil is particularly interesting. Brazilian executives have achieved substantial success despite dealing with a situation of minority presidentialism, one of the most fragmented multiparty systems in the world, and frequent party-switching by legislators (Mainwaring, 1999; Melo, 2004; Desposato,

2006).<sup>16</sup> Since 1990, the party of the president has always held less than 25 percent of the seats in the lower house. Furthermore, while parties in the pro-presidential coalition almost always vote with the announced position of party leaders in the aggregate (Figueiredo and Limongi, 2000), coalition discipline is far from perfect (Ames, 2002; Amorim Neto, 2002). As Samuels (2000) notes, Brazilian executives must build legislative support almost from scratch with each new controversial proposal.

The success of Brazilian executives owes in large part to the various institutional instruments available to them (Figueiredo and Limongi, 1999; Amorim Neto et al., 2003). The Brazilian executive, especially vis-à-vis presidents in other regimes, has extensive legislative powers and resources (Figueiredo and Limongi, 1999; Alston and Mueller, 2006). Some of these powers permit the executive to establish and defend the bargaining status quo. The most striking power in the Brazilian Constitution is the ability of the president to legislate via executive decrees (*medidas provisórias*). Executive decrees not only give the president the power to legislate immediately and without congressional approval; they also give him influence over the ongoing legislative agenda (Pereira et al., 2005 and 2008). Additionally, the Constitution allows the president to defend the status quo by reacting to the legislature's attempt to change it, either through package or line item vetoes. The executive also has the prerogative to pry a bill from a committee by requesting urgency.

The Brazilian executive also possesses various resources that he can trade for legislative support. Perhaps most importantly, the executive controls the disbursement of pork to individual legislators through the execution of individual budgetary amendments and establishes the characteristics of its governing coalition. Other resources available to the executive include a spoils system (more than 40,000 jobs in the public bureaucracy are under the discretion of the president), intergovernmental transfers to states and municipalities, and discretionary financial resources in the National Development Bank (BNDES) that are not counted against the annual budget. In a recent study of presidential organization in Brazil, Inácio (2006) also noted that executives frequently redesign the internal structure of the presidency itself, using staffing and organizational reforms in ways that resemble the allocation of ministerial posts.

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<sup>16</sup> The average legislative support for Fernando Henrique Cardoso (monthly data from 1997-2002) is 70.0 percent, while the average legislative support for Luiz Inácio Lula da Silva (2003-2005) is 81.6 percent.

Besides centralizing the decision-making processes inside Congress and granting impressive legislative powers to the executive (Figueiredo and Limongi, 2000), the Brazilian political system also affords the president an extraordinary amount of control over the annual budget. The executive has the exclusive right of budgetary initiation. Although legislators may propose individual amendments to the annual budget, it is the executive who determines which amendments actually will be appropriated. Thus, in political terms it is the president—not Congress—who has the power of the purse. Several recent studies have demonstrated linkages between legislators voting in accordance with the executive's wishes and having their individual amendments to the annual budget (i.e., pork) approved and disbursed (Ames, 2001; Pereira and Mueller, 2004; Alston and Mueller, 2006). This control over the pork barrel is one of the president's most effective powers. Legislators who behave according to the preferences of the executive within Congress gain access to budgetary resources that empirically have been shown to increase their chances of political survival (Ames, 1987; Samuels, 2002a; Pereira and Renno, 2003). This inter-temporal exchange appears to work in two directions, as the executive both offers pork to induce support and supplies pork to reward voting behavior (Pereira and Mueller, 2004).

The ability to manage coalition characteristics is the other important executive power that the Brazilian political system affords. Among the political inducements available to presidents is recognized membership in the formal pro-government coalition, cabinet posts, patronage, and campaign assistance. To the extent that being associated with the government and with the potential passage of legislation is useful for a legislator or political party, recognition as a member of the governing coalition is a valuable commodity. This is especially the case if the party has access to the policymaking powers and resources associated with cabinet posts. Political patronage is valuable in that it bolsters support for the party and the re-election prospects of individual legislators. In the Brazilian multiparty case, on the other hand, an executive with minority support has numerous options for creating a coalition government.<sup>17</sup> These options generate a market for legislative support in which the executive and various parties may negotiate for inclusion in the governing coalition. Since re-democratization, and

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<sup>17</sup> Such coalition-building is necessary for majority support. Since 1990, the Brazilian executive's party has never held both a "shield" (permitting it to evade responsibility and shift the blame) and a "sword" (that can be used to bind the hands of the political competitors) of more than 25 percent of the seats in the lower house of the national legislature. A total of 21 parties won seats in the Chamber of Deputies in the most recent 2006 elections.

especially after the new Constitution of 1988 that set the rules of the current political game in Brazil, all elected presidents 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 in the governing coalition (Figueiredo and Limongi, 1999).<sup>18</sup> Although none of the elected presidents belonged to a party with a pre-electoral majority of seats, they have, nevertheless, been able to achieve congressional support by the use of their extensive legislative and non-legislative powers.

Despite the high level of presidential powers, they are not absolute. Presidents are able to get most of what they want, but not everything or all the time. Political institutions provide several checks, which limit the president's control. Although the Brazilian 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. Among these checks are the judiciary, the Constitution, public prosecutors, governors, and a free and active press. Checks on executive power, especially in a regime in which the executive has substantial legislative powers, are valuable for most legislators. Despite having little autonomy, coalition members may resort to blackmail and other stalling techniques to block particular policies. These constraints help to prevent opportunism, facilitate providing credible commitments, but sometimes prevent adaptation to shocks.

In addition, the electoral connection for the president works as a strong safeguard. Given this electoral constraint, the president has incentives to pursue sensible macroeconomic policies, as he is seen by the electorate as being responsible for outcomes related to basic issues such as 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. Thus, if an incompetent or ill-intentioned president were to come to power, strong presidentialism would not mean a blank check to pursue misguided policies. As discussed before, political competition is a precondition for the existence of these incentives. Indeed, there has been intense competition between the two parties that have alternated in power, the Workers' Party (PT) and the Brazilian Social Democratic Party (PSDB), since 1994. This is not to say that there are no inter-temporal incentives for deviating from prudent fiscal behavior and that there is

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<sup>18</sup> The only occasion without a stable majority coalition was the period from March 1990 to October 1992 under President Collor. Collor preferred to work through ad hoc minority coalitions and, perhaps as a consequence of this political choice, he was subsequently impeached.

no political business cycles. Rather, it is to stress that unless there is some external shock to the built-in incentives, the normal form of fiscal governance has been relatively effective. As already indicated, the outcome is suboptimal and this institutional arrangement leads to lost efficiency.

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.<sup>19</sup>

## 5. Case Studies

### 5.1 Tax Reform: *The Reform that Never Was*

Developments in the area of tax reform in Brazil since the early 1990s have a number of distinct features. First, there is a recurrent reform agenda that has never been implemented despite the executive's enormous preponderance in its relations with Congress, which is evident in other issue areas such as fiscal federalism and social security. In these areas, the government was successful in implementing reforms that negatively affected the interests of the states and municipalities. Second, reform initiatives have been discontinued because the federal government has opted for an inefficient system with high extractive capacity to an efficient system with uncertain future revenues.

As discussed before, there have been numerous proposals that were never seriously considered by the government. Paradoxically, these include proposals that were presented by the government itself. The fate of the most important proposal presented in the last 15 years—PEC 175—illustrates the logic underlying tax reforms. A substitutive proposal proposed by the committee came to light in September 1996 but was discontinued. The government refused to accept the rapporteur's substitute proposal and decided to stop negotiating the PEC 175. One possible but misleading interpretation is that the government was blocked in his proposals and therefore decided not to pursue the reform further. In fact, the payoffs of the reform game had changed as a result of the developments in the run against the *real* following the Russian and Asian crises. As per our discussion of the role of crisis in reform initiation, the crisis inhibited

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<sup>19</sup> Although these imputed motivations fit well with presidents' behavior since 1995 (FHC and Lula), the match with previous presidents is not so clear. We note however that even though they were not approved at the time, Collor proposed several constitutional reforms that would eventually be adopted in subsequent policy reforms.



reforms, particularly those geared towards efficiency gains as opposed to revenue boosting.<sup>20</sup> The second round of the proposal took place in 1997. The Pedro Parente proposal represented a new version of the substitutive, which was supposed to have the backing of the federal executive and expected to be an alternative counterproposal to the one presented by the rapporteur. The proposal was circulated informally and was supported by business groups and the media. It was understood that the proposal meant to gauge the level of support for it among social actors and experts. The proposal involved the replacement of the ISS, IPI, ICMS, CSLL and the main cascading taxes, i.e., PIS and COFINS, with a single federal VAT, a state retail sales tax, and a selective tax in place of the IPI. It was a more radical proposal than that of the rapporteur. However, the proposal was presented in draft form and the government never mobilized its party leaders to advance it in the legislature. In fact, it actively worked to undermine the workings of the committee. Party leaders, for example, backing the government, instructed party members not to be present so as that the committee would lack a working quorum (authors' interview with committee members).

The committee, which was controlled by independent congressmen and dissident members of the government coalition, continued working on its proposal and held a very large number of sessions with business representatives and experts, despite the government's lack of interest as a result of the financial crisis and the presidential race. Many of the committee members had political links to business organizations. It is interesting to note that the proposal enjoyed ample support in many sectors, particularly business. *Ação Empresarial*, for example, led by Jorge Gerdau— one of the most vocal representatives of business in Brazil and a global steel magnate—embarked on a public campaign for the reform. The proposal was never put to a vote in the legislature between 1995 and 1998, despite the fact that the rapporteur had prepared three reports.

In the new legislature (1999-2002), the taxation committee resumed work and held countless hearings. Finally, the amended substitutive proposal was approved at the end of 1999 by 34 “yes” and one “nay.” The government reacted against the proposal by criticizing it, as did the states. Later, in March 2000, the substitutive proposal for the PEC 175 was approved by vote in a special committee, but it was rejected once again by the federal government. The committee offered the draft as an “informal contribution” to the tax reform agenda of the new government.

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<sup>20</sup> Indeed, the country's tax burden was already much higher than would be expected considering its GDP per capita.



The president of the Chamber of Deputies, a prominent government leader, then announced that the tax reform was not to be part of the legislative agenda for the time being. It then became apparent to the key players that the federal government had in fact decided to abandon the reform due to the worsening economic conditions in the wake of the Asian and Russian crises and the subsequent run against the *real*. The government then pursued a strategy of passing ordinary legislation on specific aspects of taxation. It also submitted a constitutional amendment for the creation of a federal VAT (PEC 383, of 2001), which was never put to a vote.

In sum, the fate of Cardoso's tax reform is associated with risk aversion and the uncertainty about the short-term impact in terms of gains and losses. One of the authors of the reform proposal repeatedly reminded his audience that good taxes are old taxes (Melo, 2002). The international crisis and the run against the *real* made economic policymakers risk averse. They refrained from presenting a comprehensive reform of Brazil's tax system that might lead to less revenue. Passing such a reform would also have implied a nontrivial political cost due to the fact it affected many interests, including business, regions, and subnational governments. The government had the political clout to pass it, but the game around reform had changed.

Second, non-reform was also a product of the relative success in introducing incremental changes that did not require changing the Constitution.<sup>21</sup> These marginal changes were instrumental in generating more revenue and at the same time made the system marginally less inefficient. As indicated before, the government preferred the status quo of a highly extractive, inefficient tax system to an improved system with uncertain revenue outcomes.

Constitutional Amendment 44 approved by Lula as tax reform in fact looked much more like a symbolic move to indicate the government's activism in the area than a true reform proposal.

## ***5.2 Responding to Crisis (1997-1999): The States' Debt Renegotiation and the Privatization of State Banks***

This section analyzes the renegotiation of the states' debts with the federal government and the process that led to the privatization of state banks. As discussed at length in Alston et al. (2004), the view of the Brazilian political system as a federal structure in which governors wield vast

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<sup>21</sup> These included the extension of a temporary Tax on Financial Transactions (CPMF); the extension of the earmarking schemes; a simplified mechanism for taxing small businesses (SIMPLES); a specific proposal eliminating ICMS on exports (the so-called Lei Kandir; and raising the rates of a high-yield social contribution, the Cofins.

powers is inaccurate, as it depicts a state of affairs that prevailed between 1986 and 1992. In fact, the circumstances that characterized this period were unprecedented and extraordinary.<sup>22</sup> The president was able to impose his fiscal preferences because of various factors. In addition to enjoying agenda-setting powers and controlling resources, the federal executive was also helped by the approval of the reelection amendment. With the approval of Constitutional Amendment n. 16, of June 1997, which allowed the president and governors to run for re-election, the federal government made every effort to speed up the implementation of fiscal adjustment measures in the states. The reason was that the 1998 electoral race that would take place statewide and nationwide would bring about new incentives for the governors, who in order to get reelected were likely to face a dilemma between increasing vote-earning expenses and paying interest on debt. A massive increase in the states' fiscal deficits had occurred during the 1994 electoral year, justifying the federal government's concerns.

In fact, some state governments facing financial hardship decided not to pay their debts following election-year spending sprees, resulting in a political conflict between these states and the federal government. This reflected the influence of incentives resulting from power alternation upon the behavior of state governments, which, in order to fulfill their election promises, encouraged nonpayment of debt inherited from previous governors. Fearing a loss of popularity, the governors blamed their predecessors for passing budget imbalances along as well as the federal government for having included tough clauses in the debt renegotiation contracts, particularly clauses allowing the federal government to withhold constitutional transfers from the State Participation Fund, or even to withdraw the corresponding monies directly from the state bank accounts.

This was the case, for instance, of Minas Gerais in 1999 and Rio in 2003. In both cases, the newly sworn-in state governors declared a moratorium, only to prompt the federal government to withhold federal transfers. At the time, the governors sought political support in the Chamber of Deputies and Senate through their congressional representatives to suspend the imposition of fiscal sanctions. There was even an attempt by the state governments to turn public opinion against the federal government by arguing that the sanctions would only aggravate their

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<sup>22</sup> First, a Constituent Assembly in which the federal executive played a minor role. This was unprecedented in Brazil. Second, the political conjuncture of transition to democratic rule, in which fiscal decentralization and increased social spending were important banners. Third, the specific sequence through which the political transition (democratic elections) occurred—first at the state level (1982) and subsequently at the national level—made the governors key political figures in the transition.

financial situation. In order to avoid defaults by other states in the future, the federal government did not accept the default, and the transfers were eventually withheld by the Brazilian Treasury Department as established in the debt renegotiation contracts and, in the case of Rio de Janeiro, by the Fiscal Responsibility Law.

Yet it was not just the rules-based fiscal constraints culminating in the Fiscal Responsibility Law that had a strong effect on the states' fiscal behavior, but also the Reelection Amendment. The incentives to overspend and roll over debts were much higher in the state governments facing higher chances of leaving office, as the incoming governors would have to bear the costs of fiscal imbalances. In other words, the strategic use of deficits by incumbent governors to limit the budgetary scope of their successors occurred mostly when their reelection was not possible according to the new rule (the politician was finishing his/her second term in office), or when the polls clearly showed that reelection was unlikely. In either case, there was polarization between the alternating governments, a condition already established by the theory (Aizenman, 1998; Alt and Lassen, 2003). For instance, a huge fiscal deficit (11.3 percent of net revenue) arising from the PDT administration in Alagoas was conveyed to a PSDB rival group taking office after the 2006 elections, whereas the newly sworn-in PMDB governors in Rio de Janeiro and Mato Grosso do Sul blamed the PT for the fiscal imbalances eroding the states' accounts.

Conversely, when an incumbent governor was expecting to be reelected, he or she would choose a more disciplined fiscal policy because their electorate could interpret good fiscal results, for instance, as indicating a competent, fiscally responsible governor. On the other hand, spending hikes in the 2002 and 2006 elections were regarded especially suspiciously and subject to investigation by the *Tribunais de Contas* based on the fiscal responsibility legislation.

In summary, governors running for reelection refrained, as much as possible, from defaulting on their debt interests payments because: 1) they knew that the president was politically strong with high probability of applying the contractual guarantees and therefore they acted with caution to avert a potentially harmful confrontation; 2) particularly in the case of states that were highly dependent on federal transfers, they would be at risk of not implementing their second-term political platform; 3) higher deficits could affect voters negatively; and 4) owing to the fiscal responsibility legislation, governors could face financial as well as criminal sanctions.

We demonstrate that the financial vulnerability that state governors faced and electoral competition are the key aspects for understanding these events that had important consequences for fiscal federalism in Brazil. The Real Plan<sup>23</sup> represented a shock that reinforced the power of the president. Its effects included 1) the fact that it laid bare the states' fiscal imbalances; 2) it made it impossible for the states to resort to floating and other financial mechanisms to finance their fiscal deficits; and 3) it caused a further deterioration in the deficits because of the sharp increase in interest rates.

As distinct from other initiatives of financial assistance to state banks, the PROES was voluntary. In addition, the local political elites had to share responsibilities via the approval of new legislation in the state assembly. The offer made by the federal government was to refinance 100 percent of the state debt conditioned on the privatization or elimination of the state bank. This agreement was an excellent deal for state governments because it created an opportunity to address a continuing drain on their budgets.

In fact, the renegotiation of state debts and the PROES occurred simultaneously. However, the timing of those negotiations took place according to the preferences of the national government. That is, the national government would be better off closing the spigot of state banks first because it would reduce one of the key sources of financial imbalance and, at the same time, would decrease the margin of negotiation of state governments. Governors, on the other hand, would prefer to lower their debts first and negotiate the issue of their state bank later. Governors' first-best solution would be to keep their banks—a source of resources and patronage—while being bailed out by the federal government. It is not hard to predict which branch of the government won this fight: the federal government. The state governments were too vulnerable and they faced high coordination problems in their attempts to negotiate a better deal. The electoral connection was important. Several governors would be running for reelection, and money upfront as a function of the bank privatization worked as a strong incentive for incumbent governors to agree with the federal government's agenda. As can be seen in Annex 5, the great majority of PROES agreements were celebrated during the first half of

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<sup>23</sup> The real plan was implemented in 1993 when Cardoso was a finance Minister during the national salvation government of Itamar Franco (1993-1994). It consisted of a series of measures that brought inflation dramatically down, including the introduction of a new currency, interest rates increases, free floating exchange rates, and the introduction of a new currency.

1998, prior the electoral campaign. As a consequence, the majority of governors decided to get rid of their state banks through privatizing, extinguishing, or transforming them into an agency.

Annex 5 contains information on the percentage of debt refinanced—in most cases in excess of 90 percent—on the date of privatization, on the party of affiliation of the state governor, and on the electoral risk he or she faced. There is evidence that the electoral risk the incumbent governors faced also played an important role in the governors' decision to accept the national government's proposal. To evaluate this argument, we use data from election polls in the 1998 and 2002 gubernatorial elections in order to operationalize the variable *electoral risk*. The data are for a candidate's chances in the gubernatorial race in the 1998 election. The following criteria for constructing the additive index are used: a) if the opposition candidate has more than 20 percent points ahead of incumbent (or its candidates),<sup>24</sup> 5 points; b) if the opposition candidate has more than 10 percent and less than 20 percent, 4 points; c) if the incumbent is ahead or behind the opposition by less than 10 percent, the risk is 3; d) if the incumbent is ahead for more than 20 percent, 2 points; and e) if the incumbent is ahead of the opposition candidate more than 10 percent and less than 20 percent, the risk is 1.<sup>25</sup>

In order to analyze the relationship between electoral risk and the decision of a state governor to subscribe to the agreement proposed by the federal government, we applied a chi-square test between signature of the contract (0 = before the election and 1 = after the election) and the variable electoral risk, which was transformed into a binary variable (0 = high electoral risk of winning and 1 high electoral risk of losing). See Table 3.

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<sup>24</sup> Because 19 governors sought reelection in 1998, an incumbent's candidate appeared in a small number of cases.

<sup>25</sup> For all cases, the vote for the two candidates reached at least 80 percent of the total. In the rare cases in which the vote was split between three candidates (as occurred in Sao Paulo, Rio Grande do Sul, and Mato Grosso), we added the votes for the candidates according to ideological criteria (e.g., PSDB and PT against Paulo Maluf (PPB)). Thus, this variable risk, in fact, captures the ex ante electoral risks.

**Table 3. Chi-Square: Electoral Risk X Contract Signature**

	Value	DF	Asymp/Sig (2-sided)	Exact. Sig (2-sided)	Exact Sig. (1-sided)	a.
Pearson Chi-Square	8.746 (b)	1	0.003			
Continuity Correlation (a)	4.156	1	0.042			
Likelihood ratio	6.052	1	0.014			
Fisher's Exact test						
Linear-by-linear association	8.366	1	0.004	0.034	0.034	
Number of valid cases	23					

Computed only for 2x2 table

b. 3 cells (75 percent) have expected to count less than 5. The minimum expected count is 0.39.

Source: Authors' compilation.

As the sample violates the assumptions of the chi-square (b), we adopted the results of the Fisher's test to demonstrate that there is association between electoral risk and the moment that the contract was signed (p-value = 0.034). That is, a state governor under greater electoral risk to be reelected tended to sign the contract with the federal government and, as a consequence, to receive resources from the BNDES, which would help the incumbent's electoral chances. Therefore, a governor's decision to recuperate the state bank was also influenced by electoral and political circumstances.

In order to specifically test the determinants of a governor's choice related to the four options offered by the PROES (1 = elimination; 2 = privatization by the national government; 3 = privatization by the state; 4 = bailout) we ran a multinomial ordered probit from 1995 to 1998. These four options represent the progressive loss of control by the state governor over the state bank. The independent variables are the following dummy variables: 1) if the state had a special investment agency (*agencia de fomento*) to support the state bank; 2) if the state bank had received a Government Temporary Intervention or RAET (*Regime de Administração Especial Temporária*), which was a mechanism that tried to avoid the extrajudicial liquidation of the state banks; 3) if the state had more than one state bank; 4) ideology of the governor based on his/her party affiliation (left, center, right); if the governor belongs to the presidential coalition; and 5) if the incumbent governor belongs to the same elite group of his/her predecessor. In addition, we have the following continuous variables: 1) state tax revenue/current net revenue; 2) state net fiscal balance; 3) expenditure with civil servant; 4) number of voters; 5) political party

fragmentation; 6) number of effective parties; 7) size of the governor's coalition in the state assembly; and 8) percentage of seats occupied by left-wing parties (see Table 4).

The understanding of the multinomial ordered models is relatively simple.<sup>26</sup> We assume that governors would have as a top preference to keep the state banks—a source of political finance and patronage—under their control. However, the negotiation with the central government under severe financial difficulties and the upcoming election when several of incumbents decided to run for reelection may have altered the order of governors' choice. Thus, the positive sign of the coefficient indicates that the governor chooses to maximize his/her dominant preference: bailout. On the other hand, the negative sign of the coefficient suggests that the governor presents a higher probability of following the dominant preference of the federal government.

Table 4 shows that the main explanatory variables for the adoption of the PROES from state governors were the presence of a special investment agency, if the state bank had received a Government Temporary Intervention: RAET, civil servant expenditure, supporting the president, and if the governor belongs to a political party located at the center of the ideological spectrum. It is important to highlight that the coefficient of those variables was negative and statistically significant, suggesting that they influenced governors to follow the preference of the federal government. In sum, there was an equilibrium of states having their own banks in the early 1990s. However, this led to a situation where the state governments' debt came to represent a threat to federal fiscal sustainability. Recurrent bailouts undermined the federal stabilization plan. Presidents could not easily abolish the banks unilaterally. However, the debt crisis, together with the re-election clause, changed the nature of the game.

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<sup>26</sup> Pindyck and Rubinfeld (2004: 372-374).

**Table 4. Multinomial Ordered Probit of PROES**

	Model 1	Model 2	Model 3	Model 4
Investment Agency	-1.65*** (.190)	-1296*** (.197)	-1.506*** (.213)	-1.514*** (.217)
RAET	-1.939*** (.264)	-2.087*** (.279)	-2.739*** (.227)	-2.915*** (.281)
More Banks	.0663*** (.182)	.680*** (.185)	.749*** (.221)	.840*** (.214)
Tax Revenue		.003 (.004)	-.0009 (.005)	.001 (.005)
Fiscal balance		-.041 (.005)	.006 (.007)	-.058 (.007)
Civil servant expenditure		-.018*** (.006)	-.033*** (.007)	-.035*** (.006)
Voters			.055*** (.018)	.055*** (.018)
Support President			-1.366*** (.021)	-1.337*** (.224)
Fragmentation			4.429* (2.682)	1.260 (3.097)
ENP			-.143* (.081)	-.073 (.090)
Governor's Coalition size			.022* (.008)	.009 (.008)
Size Left-wing parties			.071*** (.119)	.078*** (.012)
Incumbent's Predecessor			.537** (.235)	.750*** (.261)
Left				Left out
Right				-.246 (.349)
Center				-.782** (.390)
Pseudo R <sup>2</sup>	.2256	.2502	.3792	.3863

Statistical significance: \*\*\* 1 percent; \*\* 5 percent; and \* 1 percent. Standard error in parenthesis  
Source: Authors' compilation.



### **5.3 Responding to Crisis (1999-2000): The Fiscal Responsibility Law**

In this section we explore the enactment and sustainability of the Fiscal Responsibility Law (FRL) to illustrate the main arguments advanced in the paper. These include the fact that the federal executive has the incentives and the institutional capabilities to rein in subnational fiscal behavior. The FRL also illustrates two additional aspects. First, there is an endogenous element not only in the incentives of the federal government but also in the response of state governments to the law, at least in the initial states of the process when the bill was presented. Second, the sustainability of the Law depends not only on the incentives of the federal government but also on the audit institutions, *Tribunais de Contas*, which were mandated to monitor the application of the law. This last point is essential because it addresses the argument that governors may resort to accounting tricks to escape the penalties for not complying with the FRL. We show that these accounting tricks are used although they are not extensive or great in magnitude and that the fact that the monitoring is somehow decentralized by the *Tribunais* opens up the possibility of creative accounting. The extent to which they are used depend on the quality of the institutional environment, which is ultimately determined by the level of political competition in the state.

The FRL is the main piece of legislation in the area of budget and fiscal control in the time period under consideration. The FRL was introduced as a response to the run against the *real* and the concomitant crisis of confidence that affected the Brazilian economy in the wake of the Asian and the Russian crises. The currency crisis was triggered by the default of the state of Minas Gerais in a much-publicized move that made headlines in the major economic newspapers worldwide. However, the FRL has to be situated within a process of reassertion of federal fiscal authority since 1995. Along with its companion law, the Fiscal Crimes Law, the FRL is the culmination of a relatively successful set of measures to constrain fiscal behavior and control the state governments' indebtedness. As examined in Section 2 of this report, the fiscal record of the three tiers of government has improved significantly, with increasing primary surpluses produced at the state and national levels. 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. However, there was a strong element of endogeneity in the reaction of governors to the proposal. Many countries adopted fiscal responsibility laws in the region, but in

most countries adherence to the law is voluntary.<sup>27</sup> The Brazilian LRF provides a contrasting case because the law is mandatory. Furthermore, the FRL sets parameters for all levels of government and thus represents a top-down approach to fiscal rules and budgetary control. Not only does the FRL provide *ex ante* and *ex post* controls on both borrowers and lenders, but it also specifies in great detail the budgetary and fiscal rules governing public sector indebtedness, credit operations, and public account's reporting (see the detailed FRL provisions in Annex 6).

The law applies to the federal government as well. More importantly, it stipulates that the federal government has the exclusive prerogative of setting debt parameters and expenditures ceilings. The FRL also bars the federal government from financing subnational governments. This is meant to eliminate 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 fiscal governance. Article 52 of the Constitution stipulates that it is up to the Senate to approve global debt ceilings for the three tiers of government. However, the FRL vests the federal government with the power to propose limits for these ceilings. The Senate has retained the power to set the ceilings and conditions pertaining to all issuances of securities by the federal and subnational governments as well as any federal government warranty for credit operations, both external and internal. These constitutional provisions were reinforced by the FRL, which imposes debt ceilings for each level of government.<sup>28</sup>

Despite the Worker's Party (PT)'s strong criticism of the law during its legislative discussion and its implementation, the Lula government has shown a strong commitment to the new fiscal rules. The FRL has 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 success of the FRL for the purpose of promoting fiscal equilibrium came about quickly at the subnational level. It has been applied in all 27 states' accounting and depicts the aggregate annual fiscal balance. The figures have been calculated as a proportion of the Net Current Revenue (RCL) of the states, that is, the total state revenues net of constitutional

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<sup>27</sup> This is not to argue that non-compliance in other contexts is necessarily a product of this top-down approach, although we think that it plays a role in the positive fiscal outcomes in Brazil.

<sup>28</sup> 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.

transfers to municipalities and public servants' contributions to social security. Figure 2 shows the average of the percentages for each state. The data show that there was a clear reversal in the time series in 2000. In the period 2000-2003, the fiscal balance averaged 3 percent, but by 2004 it had climbed to 8 percent.

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.<sup>29</sup> This underscores the fact that the law is primarily an instrument of the federal government to control subnational spending. This is consistent with the interpretation in this paper about the preponderance of the executive in the budgetary and fiscal game. However, this is also consistent with the view of the law as an endogenous development that reflects consensus on the fiscal imperative.

We argued before that the reforms that culminated in the promulgation of the law contain strong endogenous elements but also represented a process through which the executive managed to reassert its fiscal authority over subnational governments. While the endogenous component was crucial for reform initiation and approval, in a context in which states were fiscally vulnerable, the common pool problems facing the states had become systemically unsustainable. Although the Cardoso administration was strong (as a result of the reelection amendment), it is also true that over time many of the endogenous elements (for the states, not the federal government) faded away and the sustainability of the hard budget constraint has come to depend on the state level, particularly *Tribunais de Contas*. This section discusses the extent to which the latter constitute an effective enforcement technology.

Fiscal rules, to be enforced, require self-enforcement by the players (states) or an external enforcer with the power to ensure compliance. As stated before, the Brazilian case approximates the external enforcer case. The executive had the enforcement technology, and the law has been an effective commitment device. We argue that the sustainability of the current fiscal situation is therefore not dependent on the states' cooperation. Although the FRL could be reversed, we note that there is some rigidity in it, as an absolute majority in two rounds of voting in the two chambers is required for a change in the law. The FRL is a *Lei Complementar* (complimentary

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<sup>29</sup> This remains true in mid-2009 when the paper was revised.

law), indicating that its provisions were already contemplated in the Constitution. As such, it requires approval by an absolute majority in the two chambers.<sup>30</sup>

The legislative workings in Congress for the approval of the law illustrated the preponderance of the executive in the policy-making process. The law was introduced as a response to the run against the *real* and was announced in these terms by the government. The legislative process was characteristic of many bills in Brazil that are proposed by the executive branch: the bill was approved very quickly, attracting a large number of amendments and suggestions, a tiny number of which got the sympathy of the government and were incorporated into the text. There were many demonstrations and much resistance on the part of municipalities, governors, and the largest opposition party under Cardoso, the PT.<sup>31</sup> Finally, however, the FRL bill was approved by a massive majority of 385 votes for the government and 86 against it. In the Senate, the committee rapporteur also rejected 13 amendments from the floor. 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.<sup>32</sup>

Although we argue that the executive has the upper hand in the executive-legislative relations, particularly in fiscal and budgetary matters, the interests of subnational executives are relevant to explain the highly successful implementation of the law. 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 it may help them achieve this goal. However, in the context of highly indebted and fiscally vulnerable states, governors also have an interest in shifting the blame of austerity measures onto other actors. This calculation is,

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<sup>30</sup> Governors could eventually influence the delegation process in some aspects of interest to the states, but although popular in the discussions in the early 1990s, the argument that this can be exerted to national issues is completely discredited in academic circles. See Alston et al. (2006).

<sup>31</sup> The bill was presented in Congress in April 1999 and was approved in May 2000. The executive proposed the FRL Bill first (in May), and the *Leis de Crimes Fiscais* in October, because of its more controversial nature as it imposed individual penalties, including imprisonment, on mayors and the upper echelons of the executive at the three levels of government. The *rapporteur* of the bill in the Chamber of Deputies 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. 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*).

<sup>32</sup> 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 two to a maximum of four, to a minimum of six months to a maximum of 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.

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 tying the hands of the future governor and curbing his “fiscal powers” (Melo, 2002; Gama Neto, 2007).

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, particularly for pay hikes. Governors and mayors used the FRL and its companion as an excuse to say no to demands for special interest expenditures and transfers that would violate the FRL.<sup>33</sup> The law was a “shield” (allowing governors to evade responsibility and shift the blame) and a “sword” (that could be used to bind the hands of political competitors). Gama Neto (2007) and Carvalho (2006) provide extensive evidence that 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 the next election in 2002. (In 1998, 19 governors had been reelected and would not be allowed to run for a third term in 2002.) This explains the high level of support by governors for the law. This support was not sufficient or even necessary, as suggested by the approval of many initiatives that directly impinged on subnational interests. Nonetheless it helps explain the smooth and successful implementation of the FRL. Observers who ignore the executive’s ability to overcome party fragmentation cannot explain these outcomes without resorting to implausible arguments.

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 to 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 cancels out their intended effects. Ultimately, the extensive controls and limits contained in the law can be understood as a second-best solution to fiscal and budgetary pathologies.

#### ***5.4 The Sustainability of the FRL and the *Tribunais de Contas****

What explains the current sustainability of the Law? An answer to this question requires a discussion of the role played by the *Tribunais de Contas* (TCs) in fiscal governance. Along with

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<sup>33</sup> Webb (2004, p. 8) reports that in many cases state governments have put up posters describing the penalties as a reminder of why they are turning down special requests.

the Treasury, the TCs are the key players in assuring transparency and compliance with the law. However, while the Treasury is a federal institution, the TCs are state-level institutions. Despite the general trend towards greater professionalism and independence from the state executive in most states after the 1988 Constitution, there is some space for political influence, particularly in the least politically competitive states. In other words, while fiscal rule-making is centralized, the oversight of compliance has an element of decentralization that might affect the sustainability of the law.

The *Tribunais de Contas* are state-level institutions constitutionally defined as ancillary bodies of the legislative branch, with the purpose of examining the accounts of the three branches of government in terms of their compliance with the principles of public administration (public morality, impartiality, transparency, and efficiency) as well as the specific legal requirements for the hiring of personnel, granting of pensions, procurement, intergovernmental transfers, competitive public bidding, and fiscal responsibility. They enjoy a great level of functional, administrative, and political independence. These institutions were significantly strengthened by a number of changes introduced in the Constitution of 1988, which could be interpreted as the turning point in the history of audit institutions.<sup>34</sup>

In terms of political autonomy vis-à-vis governors, new provisions restricted the appointment powers of governors over the institution's board (the *Pleno*), which is made up of seven members. The latter were granted virtual life tenure and cannot be dismissed *ad nutum* by the governors or the legislatures. Governors appoint one member freely (subject to requirements of expertise among other requirements) and they nominate two members from the pool of the auditors and prosecutors of the institution, enhancing the institutions' technical profile. These two members are tenured civil servants without any particular loyalty to the governor. The legislature would appoint the other four members. Prior to the enactment of the Constitution, the executive had the prerogative of appointing all of the TCs' board members. The senior auditors and prosecutors are recruited through a very competitive system and enjoy civil service status (tenure) and high salaries (their salaries are set as a percentage of the judges of the Federal High Court). In some states, the TCs are a formidable administrative machine employing over a thousand professionals, including economists, engineers, accountants, and lawyers. These

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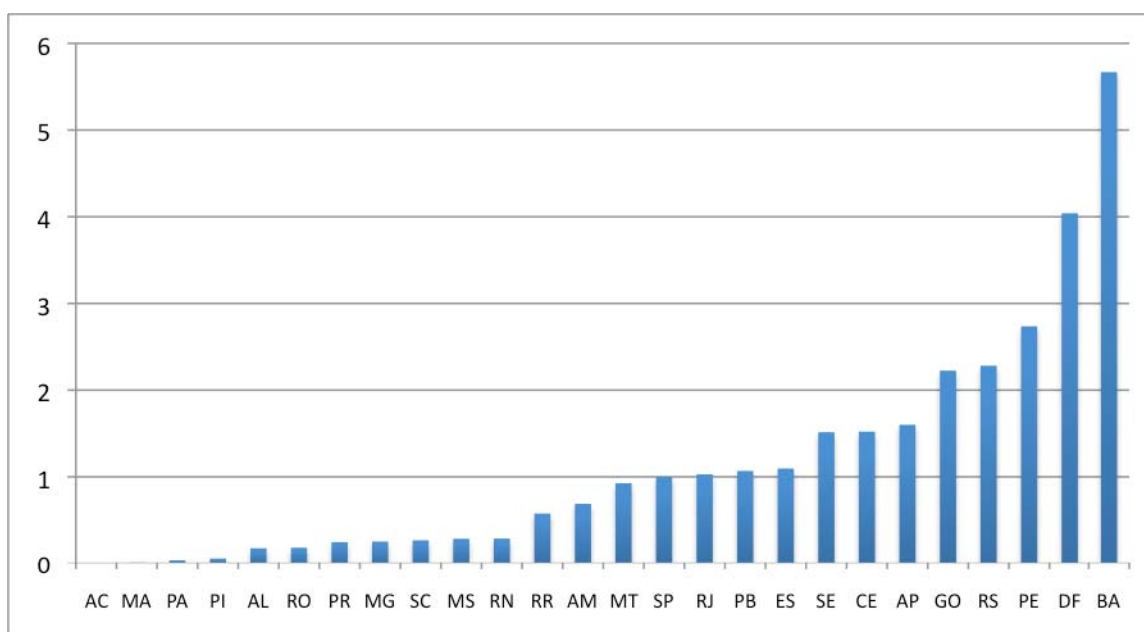
<sup>34</sup> Other checks and balance institutions have also been strengthened in the new Constitution, such as public prosecutors (*Ministerio Público*), *Advocacia Geral da União*, *Procuradoria Geral da República*, etc.

officials therefore have incentives to be strict in the application of sanctions. Auditors are very critical of the subordination of the courts to the whims of the political marketplace. These features provide important incentives for them to be impartial. However, this impartiality is vulnerable to the great influence exercised by governors in states where they enjoy a hegemonic position.

The Constitution vested the *Tribunais* with the role of external control of public administration. They exercise oversight over the execution of budgets. Although they can impose fines on members of the executive and legislative should the law be breached, it is up to the public prosecutors to press charges against the perpetrators of crimes. (In about half of the states, public prosecutors sit on the board of these institutions). As discussed before, the Fiscal Responsibility Law mandated that the *Tribunais* must audit the enforcement of the law by imposing procedural rules (reporting transparency, etc.) that the Tribunal checks.

An active Tribunal is one that does much more than the minimum required of one report per administrative unit, especially reports resulting from auditors' decisions or denunciations. As we can see from Figure 11, there is a huge variation in the degree of activities among audit institutions in Brazil. This activity is measured in terms of a ratio of the number of audit cases performed by each Tribunal and the number of administrative units under its jurisdiction.

**Figure 11. Activism of Audit Institutions (2000)**



Source: Melo et al. (2009).



In order to check the extent to which there is creative accounting and the role of the *Tribunais*, we focus on the states' fiscal figures in the period comprising two gubernatorial elections following the introduction of the numerical rules. We check for creative accounting in the states' fiscal indicators and discuss the extent to which it may be affecting the sustainability of the FRL. Creative accounting has been documented in OECD countries (Milesi-Ferreti and Moryama, 2003; Von Hagen and Wolff, 2006), and in this subsection we investigate the extent of its use in Brazil. We present qualitative (see Table 5) as well as quantitative evidence about creative accounting.

**Table 5. Creative Accounting at a Glance: Brazilian States**

1)	<u><i>Ambiguous or inaccurate reporting of end-of-term cash balances</i></u> Alagoas; Goiás; Mato Grosso do Sul; Minas Gerais; Paraíba; Pernambuco; Rio de Janeiro; Rio Grande do Sul
2)	<u><i>Negative balances recorded as unpaid commitments</i></u> Alagoas; Goiás; Mato Grosso do Sul; Minas Gerais; Paraíba; Pernambuco; Rio de Janeiro; Rio Grande do Sul
3)	<u><i>Peak expenditures in pre-election years</i></u> Alagoas; Goiás; Mato Grosso do Sul; Minas Gerais; Paraíba; Pernambuco; Rio de Janeiro; Rio Grande do Sul
4)	<u><i>Personnel expenses not properly recorded</i></u> Alagoas; Goiás; Minas Gerais; Paraíba; Rio de Janeiro; Rio Grande do Sul
5)	<u><i>Improper application, recording of earmarked funds</i></u> Goiás; Minas Gerais; Paraíba
6)	<u><i>Spending spree in months prior to election</i></u> Rio de Janeiro; São Paulo
7)	<u><i>Expenditure cuts right after elections</i></u> Rio de Janeiro; São Paulo
8)	<u><i>Improper recording of privatization proceeds as net revenues</i></u> Paraíba; Pernambuco

*Note:* Selected sample.

*Source:* TCs and State Ministries of Finance.

As proxy of creative accounting we follow Afonso (2006) and use the *restos a pagar* in each fiscal balance. These are unpaid commitments that obscure the real fiscal position of a state in a fiscal year. We provide qualitative evidence for the selected group of states that have recorded unpaid commitments (*restos a pagar*): Rio Grande do Sul, Goiás, Mato Grosso do Sul, Alagoas, Minas Gerais, Rio de Janeiro, and Paraíba (the data refer to the financial deficits after



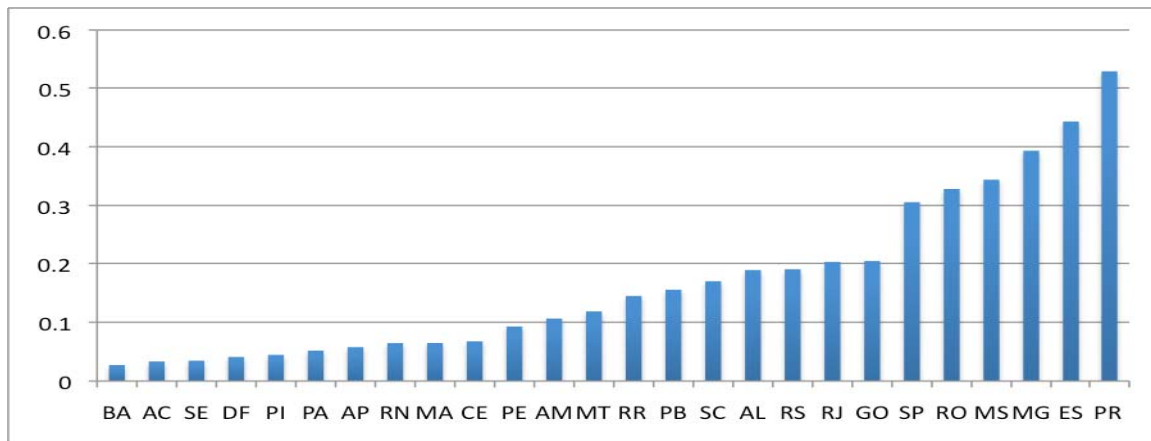
the 2006 elections). We gathered information for two additional units, in spite of being states that notified financial surpluses in their 2006 balance sheet data: the state of Sao Paulo, given its political importance and strong impact in the Brazilian GDP, and Pernambuco, for having reported the country's highest primary surplus as a proportion of net current revenue (Portuguese abbreviation: RCL) in 2006. Such characteristics make these states very useful for comparison.

The great majority of states in our sample have recorded yearly financial deficits as unpaid commitments (*restos a pagar*). These are the kinds of expenses the payment of which are delayed to the subsequent fiscal year, thereby postponing their impact on the primary balance. If inadequately documented over the years, financial deficits, also known as end-of-year negative cash balances, can obscure the evolution of a state's underlying fiscal position. For the most part, unpaid commitments have not been net of the "creative" part of the outlays, and as a consequence, official information concerning the states' readily observable end-of-term cash balances has been disputed. Annex 7 shows the unpaid commitments of the selected group of states as a proportion of their net current revenues. Notice that as a rule the indicator reaches its peak in the pre-electoral years of 2001 and 2005.

To a large extent, the state governments resorted to many accounting tricks in their attempt to record expenditures within the FRL spending limits, attention being given to the limit for personnel spending set at 60 percent of RCL. For example, some types of personnel expenses have been wrongly classified as income tax deductions or pension payments and have not been reported under the line of personnel spending. In these cases, governors have benefited from lenient interpretations of the state *Tribunal de Contas* regarding the expenses they should classify as personnel expenses. Similar inconsistencies of interpretations can be found in the calculations of the net current revenue (RCL), leading states such as Pernambuco and Paraiba to exaggerate the indicator as a means to accommodate spending increases, by adding privatization proceeds to budget revenues.

Figure 12 shows that, during the period analyzed, there is a huge variation of unpaid commitments from one state to the next, where the state of Bahia delayed the smallest amount to be spent in the subsequent fiscal year and the state of Parana was the champion of unpaid commitments. What can explain this variation?

**Figure 12. Descriptive Distribution of the Average of Unpaid Commitments by State, 2000-2002**



Source: National Treasury.

One may argue that an active audit institution does not mean necessarily independence from politicians' influence. Melo et al. (2009) have demonstrated that the key variable explaining the degree of activism of an audit institution in Brazil is the presence or lack of a senior auditor and/or a public prosecutor on the Audit Board. That is, tribunals with auditors on their boards are more prone to action. Therefore, we included in the model a dummy variable with the value of 1 if the audit institution has a senior auditor on the board and zero otherwise.<sup>35</sup> Consistent with our previous work, we expect that the presence of auditor restrains a governor from making use of unpaid commitments.

In order to deal with the effect of political competition on the probability of state governors making use of unpaid commitments, we included in the model the variable *government turnover* and *legislative party fragmentation* in the State Assembly. The former variable consists of an index of elite instability, which was built by taking as a reference the last three consecutive elections for state governors in Brazil: 1994, 1998, and 2002.<sup>36</sup> In line with the expectation found in the literature, we predict a positive coefficient for *government turnover* and

<sup>35</sup> We also tested for the presence of a public prosecutor on the audit board as well. However, as a matter of colinearity with auditor, the variable public prosecutor dropped in our econometric exercises.

<sup>36</sup> This index varies from zero (when the same coalition was the winner in all three consecutive electoral episodes) to 4 (when no one single coalition was able to win two elections). The intermediate values of the vulnerability index refer to situations when an electoral coalition won two consecutive elections but lost the third one (index equal to 1); or when the first elite coalition in power is defeated and a new elected elite wins the following two elections (index equal to 2); and finally a situation in which an elite group has its electoral dominance interrupted by a second electoral elite which gains power for just a single electoral period, after which the original elite returns to power (index equal to 3).

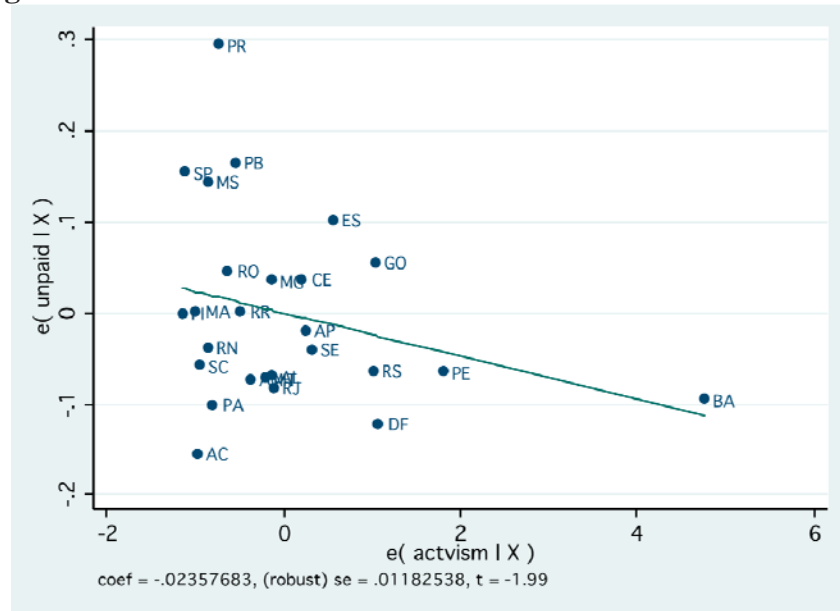
unpaid commitments. That is, the greater the electoral risk, the greater the incentives governors will have to carry deficits over to their rival successors via unpaid commitments. As for legislative fragmentation in the state assembly, it requires an index of the number of political parties per seats in the 1999-2002 period.<sup>37</sup> We assume that the greater the fragmentation, more difficulties the governor will face in coordinating his/her legislative coalition, thus generating incentives to rely on the unpaid commitments mode often. We also control for the state per capita GDP because richer states tend to have worse fiscal situations for a variety of reasons, including the ability to contract loans and issue debt.

Although the results generated by our empirical exercises should be interpreted with caution given the small number of cases (see Table 5), we find empirical evidence of the correlation between *restos a pagar* (unpaid commitments) and the activism of *Tribunais de Contas* (see Figure 13). As we expected, the more independent a *Tribunal de Contas* (measured by the presence of a senior auditor on its board), the smaller the incentives governors will have to rely on window-dressing mechanisms (measured by unpaid commitments). Political competition, both at the executive branch (see Figure 14) as well as in the legislative sphere, also matter for creative accounting. That is, the higher the government turnover and legislative fragmentation within state assemblies, the greater the incentives governors will have to make use of unpaid commitments.

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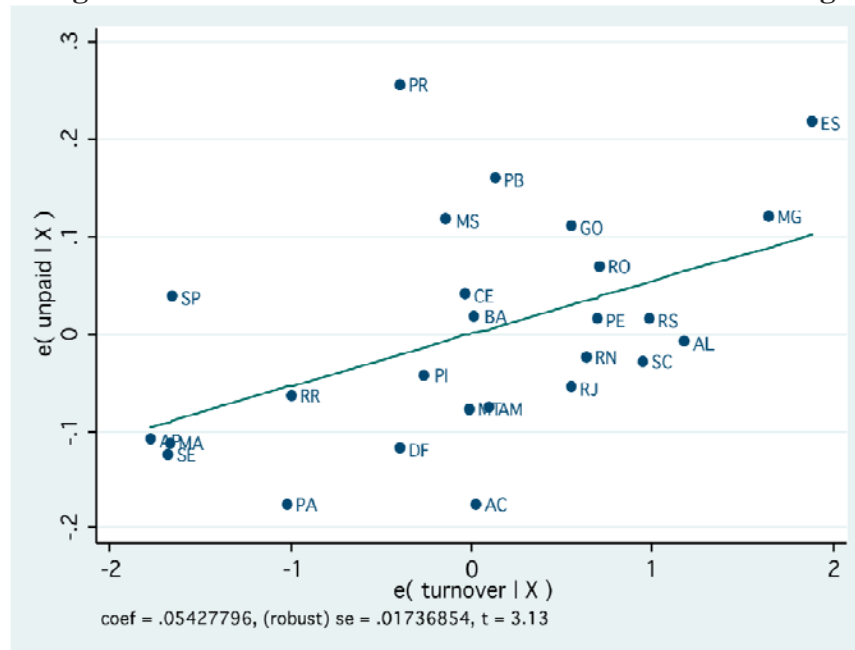
<sup>37</sup> For more information, please see the *Almanaque de Dados Eleitorais* (Laboratório de Estudos Experimentais), <http://www.ucam.edu.br/leex/>

**Figure 13. Activism of Courts of Account and Creative Accounting**



Source: Authors' compilation.

**Figure 14. Governor's Turnover and Creative Accounting**



Source: Authors' compilation.

On the basis of these preliminary empirical exercises we reach two major conclusions. First, there is ample evidence of creative accounting in the states, which in itself represents an indication that the influence of the *Tribunais de Contas* is binding and that there are costs for breaching the law. Second, because the *Tribunais de Contas* are not immune to the influence of legislators and state governors, there is evidence that the institutional quality of the *Tribunais de Contas* is associated with more creative accounting. More independent and active institutions constrain the use of creative accounting at the state level. The Achilles' heel of the law is therefore the quality of subnational institutions and the degree of political competition.

**Table 6. Determinants of Unpaid Commitments**

	Models				
	(1)	(2)	(3)	(4)	(5)
Activism	-.0309** (.0128)	-.0263*** (.0143)	-.0229** (.0114)	-.0205** (.0103)	-.0235** (.0118)
Turnover		.0568*** (.0174)	.0699*** (.0145)	.0571*** (.0146)	.0542*** (.0173)
Auditor			-.0818** (.0439)	-.0666* (.0383)	-.0623* (.0384)
Fragmentation				1.2362* (.7361)	1.1210* (.7450)
GDP p/capita					5.87e-06 (.00001)
Constant	.0128*** (.0388)	.1208*** (.0458)	.1428** (.0512)	-.9701 (.6463)	-.8841 (.6542)
N	26	26	26	26	26
R <sup>2</sup>	0.0886	0.3242	0.3993	0.4839	0.4900

Statistical significance: \*\*\* 1 percent; \*\* 5 percent; and \* 1 percent. Robust standard error in parenthesis.  
Source: Authors' compilation.

More specifically, we demonstrated that the magnitude of financial liabilities registered as unpaid commitments was positively correlated with the number of relevant political parties in the legislature. These results are in line with the literature, in the sense that the logic of the common-pool resource problem clearly applies here. That is, opportunistic politicians in a party will seek to maximize the electoral benefits from overspending and externalize the overall cost to all other parties. Therefore, everything else being equal, there is evidence that highly fragmented state assemblies are associated with greater unpaid commitments than less fragmented ones.

Another hypothesis tested in our models was that the prospect of not being re-elected, i.e. the turnover variable, provides state governors with an incentive to overspend and then register the deficit as unpaid commitments. According to the literature reviewed (Aizenman, 1998; Alt and Lassen, 2003), this would create a situation of soft budget constraints. The variable turned out strongly significant and correlated positively with the size of unpaid commitments, which means that if there is a rise in the turnover rate, this can result in higher expenditures and the use of window-dressing expedients by state governors. The prediction is, therefore, that in the presence of electoral uncertainty, the incumbent would show above-average spending for electoral purposes and thus need to recur to creative accounting.

The quality of an audit institution and its independence from politicians influence are also important factors in governors' decisions to rely on window-dressing mechanisms. Audit activism and political independence seem to restrain opportunistic fiscal behavior at the subnational level in Brazil.

Additionally, as a result of the FRL restraining overall spending in election years, states have resorted to expenditure hikes in pre-election years. Likewise, spending sprees at the beginning of election years have been a common strategy employed by incumbents to circumvent the spending limitation applicable to the last eight months of their term. In some cases, state governments struggled to curb basic expenses after elections in order to officially meet fiscal targets and thus avoid financial or even criminal sanctions, as seen in Rio de Janeiro and Sao Paulo. Other forms of covering vote-earning expenses included improperly using earmarked funds, e.g., public health funds shifted to finance infrastructure projects, educational funds diverted to cover campaign expenses, and so forth.

Annex 8 illustrates how accounting devices in Brazilian states have come in many different guises. The table has been constructed based on information extracted from states'

fiscal management reports as well as from auditing documents released by the *Tribunais de Contas*. The information has been checked against the states' budgetary execution data published by the Brazilian National Treasury.

Despite the hard budget constraints imposed in the context of the fiscal responsibility legislation, Brazilian states retain some ability to resort to some fiscal window dressing as a response to fiscal stress. It should be noted that a number of Brazilian states, despite having been regarded close to balance or in surplus under the FRL, have also shown signs of opportunistic fiscal behavior. For instance, in Ceara and Para, where full compliance with headline measures of primary surplus was reported over several years, the fiscal balance suffered a sharp decline in the electoral year of 2006, and the governors-elect in both states claimed to spot financial deficits when they took office in 2007. The northern states of Amapa, Rondonia, and Roraima have minimized reported deficits through fiscal gimmickry as well. Incorrect imputation of privatization proceeds, for example, has helped them cover current expenditures, while increases in public works spending have been underestimated in the approved budget, causing a rise in expenses recorded at a later time as unpaid commitments. Additionally, the expenditure limits of the legislative branch have been consistently circumvented over the years while not recorded accordingly so that budget deficits were understated. In turn, governors in Sergipe and Parana have released multiple versions of their fiscal reports or have failed to publish their balance sheet data in due time as required in the fiscal legislation.

In sum, some of the fiscal tricks have been less mischievous than others. In any event, however, these examples bring to the surface a propensity of incumbents to distort the fiscal position as a means to hide episodes of fiscal profligacy, which augments the probability that indebted governments will default.

Therefore, before jumping to the conclusion that the fiscal responsibility legislation has turned the Brazilian subnational politicians into highly disciplined public managers who neither overspend nor treat public finances irresponsibly in election years, we investigated not only the states' headline primary balances, but also how politicians in office managed to minimize the impact on the expenditure level of the numerical budget rules. We uncovered the existence of a margin for questionable accounting practices in conjunction with lax legislative interpretations to embellish their reported fiscal position.

## 6. Conclusions

In this paper, we have examined fiscal reforms in Brazil since the mid-1990s. The most obvious finding is that the status quo has changed radically over the last decade or so. Brazil was a reform laggard and had one of the poorest fiscal performances in the region. A scenario of budget deficits, high inflation, and a severe subnational debt crisis (which triggered a run against the *real*) gave way to a very favorable macroeconomic environment characterized by successive fiscal surpluses, a declining debt-to-GDP ratio, and low inflation. As discussed, the outcomes across the issues areas have varied significantly. In terms of fiscal federalism, the states moved from a deficit position to positive fiscal balances, and there is significant transparency in fiscal accounts. Although there has not been any significant episode of tax reform, there have been massive increases in tax revenue over the last decade and a half. And tax revenue has been used to ensure macroeconomic stability. While this stability is crucial for development outcomes, the inefficiencies and inequities of the tax system remain a serious obstacle to sustainable development. On net, however, the balance seems to be positive.

The paper discusses these outcomes as endogenous choices of policymakers and as representing a general political equilibrium. Reforms succeed when there is an alignment of interests among the actors involved rather than when the content of reforms is technically optimal or the sequencing of a set of reforms is appropriate. In the case of Brazil, there is evidence that the favorable fiscal outcomes are a product of the reforms. This seems to be the case of the reforms in fiscal federalism and budgetary institutions. But because there is a strong element of endogeneity in the reforms it is difficult to differentiate the outcomes from the general conditions that favored the reforms.

The reforms we discuss were not imported as models to be emulated but reflected the incentives that the actors faced. Not only the incentives were appropriate but also the main actors—particularly those in the executive branch, the president and the finance and planning ministers—had the institutional capacity to negotiate from a position of power. The Fiscal Responsibility Law was approved relatively easily, without major resistance, and the governors actually cooperated with the reform. Similarly, the renegotiation of the debt of the state treasuries had the cooperation of state governments, including some that were controlled by the opposition. The other actors involved benefitted because there were gains from trade from the reforms and the transaction costs involved were not very high. Another facilitating condition was the fact that



the time horizons of the key players were extended when the reelection amendment was approved for chief executives at both the state and federal level. Cardoso's coalition enjoyed a large majority in the Senate and a small majority in the Chamber of Deputies that could be mobilized to approve the reforms. The fact that the president's party held only a quarter of the seats in Congress was no obstacle for the reforms.

If we argue that fiscal policy is endogenous, the next step is to establish the determinants of reforms. In the Brazilian case, the fiscal crises of the states in 1993-1995 and the financial crisis opened up by the Russian and Asian crises (1998-99) clearly provided a window of opportunity for the reforms. Similarly the reform of the budget process was prompted by the budget scandal. A contrasting case was tax reform, which was actually watered down in a series of moves to be discontinued by the government. But the conditions leading a problem to be a key issue in the governmental and legislative agenda may be absent during reform implementation. Unless there is a high cost for reversal, reforms can be undone unless they are backed by a reform coalition involving the relevant actors. Reforms in Brazil have not been blocked nor were they unsuccessfully implemented due to resistance from key actors.

The failure of tax reform initiatives in Brazil could be misconstrued as representing a case of blocked reforms. Why did the government bother to present a constitutional amendment reform if it had no intention of reforming the system? Our account of the reform episodes shows that in successive initiatives the reform proposals were parametric (and usually did not require changes in the Constitution and that the government chose the status quo, which allowed it to extract massive revenue, to a reformed and presumably more efficient system with an uncertain level of revenue. During the Cardoso years, the reform took place in periods of crises—first first of the states and second an international crisis. The context of crises exacerbated the uncertainties involved both for the federal government and for the states. Resistance to reform from subnational governments did not preclude the government from imposing losses on the states as a number of consecutive mechanisms were introduced for the retention of federal funds mandated to be shared with the states.

The developments in the fiscal arena have been associated with the reassertion of federal fiscal authority in the country and the strengthening of the Ministry of Finance in the process. These were key to overcoming the common pool problems caused by the fiscal behavior of the states and those associated with coalition management by a minority government. Presidents

have had the capacity to craft coalitions because there are gains from trade that allow the party controlling the presidency to buy support from the legislature at a relatively low cost. In his relations with state governments, a president may have managed to recentralize fiscal authority in the country, curbing their fiscal autonomy. We argued that 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 the external enforcement case, although the executive was able to implement its preferences because of its institutional prerogatives and there were also gains from trade in federal government-state relations.

Intense political competition between the PT and PSDB was a precondition for the political equilibrium we identify in fiscal governance. This endogenous perspective allows us to understand fiscal reform initiatives as generating political benefits for incumbent politicians. As indicated throughout the paper, fiscal stability has been attained as a suboptimal equilibrium because the current system is systemically inefficient as a result of highly regressive and distortionary taxes.

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## **Annexes**

### ***Annex 1. Overview of Tax System***

The 1988 Federal Constitution set up the institutional framework for the current Brazilian tax system. It provides the general principles of taxation as well as major directives on tax rates and revenue sharing. The Constitution also allocates tax authority to the different tiers of government, allowing the imposition of taxes on a wide range of economic activities. The revenue-sharing schemes are defined through a system of transfers between levels of government. The criteria for the transfers are based on population size and per capita income thereby resulting in greater transfers to lower-income states and municipalities.

*Federal Government:* The principal federal taxes are the Income Tax (IR) and the Tax on Manufactured Products (IPI), adding up to more than 90 percent of federal tax revenues. The IRPF income tax is levied on the income and proceeds of any nature earned by Brazilian-based individuals at a progressive rate of 15 percent or 27.5 percent, contingent upon the taxpayer's ability to pay. Companies pay a 15 percent Corporate Income Tax (IRPJ), based on their actual or estimated earnings, or on earnings ascertained by tax authorities. The IPI is a value-added, single-stage tax on production collected based on the sales price when a product leaves the manufacturing stage or upon import at a rate that is variable per product classification. Additionally, the federal government collects a Tax on Financial Transactions (IOF), comprising credit, foreign exchange, insurance, and security operations. A since-abolished Provisional Contribution on Financial Transactions (CPMF) was also assessed at a 0.038 percent rate on transactions between individuals and financial institutions, particularly current account debits. The central government also collects taxes on foreign trade, in particular the Import Duty (II) levied on CIF products and the Export Duty (IE). The IE is collected when a product made in Brazil or with domestic component parts is exported. The IE rate is usually 30 percent, whereas the II rate ranges from 0 percent through 35 percent of the product value.

A number of contributions to finance the social security system (pension, social assistance, and health care) are also levied at the federal level on corporate net profits and employer's payroll. For example, the Social Security Financing Contribution (COFINS) and the Profit Participation Program Contribution (PIS) are based on gross revenues and are collected at different rates according to the firm's tax regime (cumulative or non-cumulative). In essence, the



Contribution on Net Profit (CSLL) is a surtax levied at a 9 percent rate on a company's adjusted net profits, ahead of the allowance for income tax. There are also contributions on specific economic activities, such as the CIDE-Fuels, levied on the commercializing and import of fuels, at a rate variable per type of fuel. As opposed to taxes, such contributions are not shared with the subnational tiers.

*States:* At the state level, the main tax is the Merchandise and Service Circulation Tax (ICMS), which is a value-added tax imposed on sales of goods and carrier/telecommunications services. The ICMS is assessed on the entire chain of trades from manufacturers to end consumers on a non-cumulative basis and the transaction value serves as the tax basis. The ICMS legislation differs across the 27 Brazilian states as each state can determine unique tax rates for intrastate trade (usually 17-18 percent), as well as use different criteria for tax breaks and incentives, usually to attract investments. The rates for interstate trade are fixed by the Federal Senate (12 percent on transactions directing products and services to Southern and Southeast states and 17 percent to states in the North, Northeast and Center-West).

While the ICMS represents more than 20 percent of all taxes collected in the country (an impressive 8 percent of GDP), Brazilian states also impose taxes on motor vehicle registration (IPVA), collected yearly based upon the market value of the vehicle, and on inheritance and gifts (ITCD). The ITCD is a non-progressive tax figured on the value of assets or rights transferred by donation or estate succession. The tax rate ranges from 2 percent to 6 percent according to state law.

*Municipalities:* Municipalities are entitled to impose a Tax on Service (ISS), urban property (IPTU), and the transfer of real estate ownership (ITBI). The ISS is a cumulative tax levied on services provided by a company or self-employed professionals doing business in the tertiary industry, in accordance with a list of services other than those subject to ICMS attached to a federal supplementary law. The taxable basis of ISS is the price of the service rendered and the rate varies across municipalities, 5 percent being the most usual applicable rate. Although the ISS is not a creditable (non-cumulative) tax, like the IPI and ICMS, it is charged to the customer as part of the contracted sale price.

The taxation of urban real estate (IPTU) is second only to the ISS in terms of local tax revenues. The IPTU is assessed on direct or beneficial ownership and possession of urban



properties, and is collected yearly based upon the market value of the property by the municipality where the property is located. The IPTU rate is progressive and varies depending upon the individual municipality or city, but it is calculated on an estimated market price, taking into account the use and location of said property. The Inter-Vivos Property Transfer Tax (ITBI) is another local tax levied on the transfer of title to real properties and related rights. The most common ITBI rate is 2 percent of the property price, but can be up to 8 percent according to municipal law.

***Annex 2. Chronology of the Main Federal Fiscal Policy Rules in Brazil***

Year	Legislation	Coverage	Strategy/constraints
1988	Brazilian Constitution	General government	Increased revenue sharing benefiting states and municipalities without a corresponding transfer of spending responsibilities
1989	Federal Law no. 7976/89 (Bailout)	State governments	States' external debts contracted prior to 1988 rescheduled with a five-year grace on the repayment of principal
1993	Federal Law n. 8727/93 (bailout)	State governments	Renegotiation of states' debts through federal financial intermediaries
1994	Constitutional Amendment n. 01/94 (Emergency Social Fund)	Subnational governments	Provisional fund created to withhold a percentage of the federal tax revenues shared with states and municipalities to be used in federally mandated specific programs
1995	Complementary Law n. 87/96 (Camata Law)	General government	Personnel spending capped at 50 percent of net current revenue at the federal level and 60 percent at the lower level governments
1996	Complementary Law n. 82/95 (Kandir Law)	State governments	States not allowed to levy their value-added tax on primary and semi-manufactured exports (state revenues reduced)
1996	Federal Law no. 14/96 (FUNDEF)	Subnational governments	State and municipalities required to contribute a share of their tax and transfer revenues to fund educational policies
1997	Federal Law no. 9496/97 (Fiscal Adjustment and Restructuring Program)	State governments	Refinancing of state debts conditioned to the privatization of state-owned banks in order to restrain states' indebtedness capacity
2000	Complimentary Law no. 101/00 (Fiscal Responsibility Law)	General government	The FRL set fiscal surplus targets, debt thresholds, and spending limits, particularly in election years. Moreover, transparency prerequisites were introduced as well as stringent norms for budget balance.
2000	Federal Law no. 10028/00 (Fiscal Crimes Law)	General government	As a complement of the financial sanctions laid down by FRL, the Fiscal Crimes Law set penalties ranging from fines, to impeachment, to ineligibility, and even imprisonment of public officials not complying with the deficit rules.

### ***Annex 3. Revenue Sharing in Brazil***

The follow items summarize the revenue-sharing schemes for Brazil's states and municipalities.

- States Participation Fund (FPE): 21.5 percent of the total IPI and IR levies are transferred to the states and the Federal District in direct proportion to population size and in inverse proportion to per capita income.
- Municipalities Participation Fund (FPM): 22.5 percent of total IPI and IR levies are transferred to municipalities proportionally to population size. However, 10 percent of the FPM is set aside for capital cities.
- Municipalities are entitled to 50 percent of the IPVA, 25 percent of the ICMS, and 50 percent of the ITR collected within their territory;
- States and Municipalities are transferred 30 percent and 70 percent respectively of the IOF levied on gold-based transactions collected within their territory, as well as the whole federal income tax (IR) withheld at source on personnel payroll.
- 3 percent of the total IPI and IR collection are set aside in regional funds to finance development programs in the North, Center-West, and Northeast regions.
- Voluntary transfers based on agreements between levels of government, as well as funds earmarked for special purposes, such as primary education (FUNDEB) and health care services (SUS), complement the revenue-sharing schemes.

### *Annex 4. Chronology of Tax Reform Legislation*

<i>Year</i>	<i>Legislation</i>	<i>Status</i>	<i>Scope</i>
1988	Brazilian Constitution	Implemented	<ul style="list-style-type: none"> <li>• States granted a broad-base, value-added sales tax (ICMS);</li> <li>• Revenue-sharing funds increased to benefit states and municipalities;</li> <li>• Base of social contributions widened to compensate for federal revenue losses;</li> <li>• Municipalities assigned a tax on services and property.</li> </ul>
1991	Constitutional Amendment proposal ( <i>Emenda</i> )	Not implemented Due to Collor's Impeachment	<ul style="list-style-type: none"> <li>- comprehensive</li> <li>- Creation of federal VAT</li> <li>- State VAT to be collected in the state of destination, not origin, as a means to end the "fiscal war"</li> <li>-elimination of ICMS on exports</li> <li>- Cumulative social contributions to be changed into non-cumulative and extended as a surcharge on imports;</li> </ul>
1993	Constitutional Amendment n. 3	Implemented	<ul style="list-style-type: none"> <li>• Federal taxes on financial transactions (IPMF-CPMF) created;</li> <li>• Collection of value-added taxes possible at the production stage ;</li> <li>• Municipal tax retail sales of fuels extinct.</li> </ul>
1995	Constitutional Amendment Proposal PEC n. 175	Not implemented (dropped after various amendments)	<ul style="list-style-type: none"> <li>• Level of overall tax revenues at all tiers not to be reduced;</li> <li>• Cumulative social contributions to be changed into non-cumulative and extended as a surcharge on imports;</li> <li>• State VAT to be collected in the state of destination, not origin, as a means to end the "fiscal war"</li> </ul>
1995	Substitute Proposal for the PEC n. 175	Not implemented (approved by a special committee, not voted on the floor)	<ul style="list-style-type: none"> <li>• Uniform state VAT legislation all over the country to be created;</li> <li>• Municipal contributions to be created that finance public security and local services;</li> <li>• Provisional Measures (MP) to be prohibited on most tax issues;</li> <li>• Federal and municipal value-added sales taxes to be created.</li> </ul>
1996	Law 9311	Bill approved in dec 1996	Created the CPMF – tax on financial transactions
1999			CPMF extended
2001	Constitutional Amendment Proposal PEC n. 383	Not implemented (special committee not formed)	<ul style="list-style-type: none"> <li>• Uniform state VAT legislation all over the country to be created;</li> <li>• Local for collection of state VAT, whether at the origin or destination of production, to be established by complimentary law.</li> </ul>
2001	Constitutional Amendment Proposal PEC n. 504	Implemented (converted into Constitutional Amendment n. 31)	Introduces a new federal contribution for intervention in the economic domain (CIDE)
2002	Constitutional Amendment Proposal PEC n. 504	Implemented	<ul style="list-style-type: none"> <li>• Municipalities assigned tax competence to levy special contributions to finance public illumination services.</li> </ul>
2002	"Mini-reform" Provisional measure N 66 (Law 10637)	(converted into Constitutional Amendment n. 39)	The PIS/PASEP contributions were non-cumulative, and the rate was increased from 0.65 percent to 1.65 percent. However, their cascading effects were reduced due to the utilization of tax credits on items at the production stage. The COFINS rate for financial institutions was increased from 3 percent to 4 percent and the tax base for the CSLL on the tertiary industries was amplified to 32 percent.
2003	Constitutional amendment Proposal PEC n.	Both Implemented (converted into Constitutional Amendment n. 42)	Introduces broad changes in tax regime, widening tax base and increasing rates; states are to receive 25 percent of CIDE's revenue; municipalities in a state get 25 percent of the state's share. Extend the de-earmarking of federal taxes from 2003 to 2007; raise the rate and extend the CPMF (tax on financial transactions).

<i>Year</i>	<i>Legislation</i>	<i>Status</i>	<i>Scope</i>
2004	Constitutional amendment Proposal PEC n.	Implemented (converted into Constitutional Amendment n. 44)	States are to receive 29 percent of CIDE's revenue; Municipalities in a state get 25 percent of the state's share.
2007	Constitutional amendment Proposal PEC n		Extends de-earmarking (FEF) of 20 percent of federal taxes to December 2011.
2007	Constitutional Amendment Proposal PEC n. 31-A (also known as PEC 255)	Special committee formed, awaits deliberation	<ul style="list-style-type: none"> <li>• Uniform state VAT legislation all over the country to be created;</li> <li>• Turnover and cascading taxes (PIS/PASEP, COFINS) to be converted into a single federal tax;</li> <li>• Provisional contribution on financial transactions (CPMF) to be made permanent;</li> <li>• Non-imposed wealth tax (IGF) to be converted into a social security contribution.</li> </ul>

### Annex 5. State Government and PROES

States	Gov. Party	Electoral Risk	Debt/Refinance ( percent)	Date PROES	Financial Institution	Option
AC	PPR	4	19,252/18,226 (94.67)	31/03/98	Banacre	Extinction
AP	PSB	3		26/05/98	Banap	Extinction
AM	PPR	0	120,000/120,000 (100)	13/11/98	Bea	Privatization
PA	PSDB	2	274,495/261,160 (95.14)	30/03/98	Banpara	Bailout
RO	PMDB	2	146,950/143,667 (97.76)	12/02/98	Beron	Extinction
RR	PTB	2	7,247/6,601 (91.10)	25/03/98	Baner	Extinction
TO	PPR	-	-	-	-	-
AL	PMDB	4	677,887/648,241 (95.62)	29/06/98	Produban	Extinction
BA	PFL	2	959,662/883,010 (92.01)	19/03/98	Baneb	Privatization
CE	PSDB	0	138,081/126,916 (91.91)	12/11/98	Desembanco	Agency
MA	PFL	0	244,312/236,502 (96.80)	30/06/98	Bec	Privatization
PB	PMDB	-	266,313/244,255 (97.44)	-	Bem	Privatization
PE	PSB	3	136,641/157,571 (96.29)	12/06/98	Bandepe	Privatization
PI	PMDB	3	250,265/240,522 (95.05)	26/02/99	Bep	Federalization
RN	PMDB	3	73,272/72,479 (98.91)	13/05/98	Bandern/Bdrn	Extinction
SE	PSDB	4	389,065/355,162 (91.28)	31/03/98	Banese	Bailout
ES	PT	4	429,887/387.308 (90.10)	31/03/98	Banestes	Bailout
MG	PSDB	3	11,827,540/10,185,063 (86.11)	08/05/98	Benge/Credireal	Privatization
RJ	PSDB	4	18,067,577/14,464,066 (80.05)	15/07/97	M. Caixa	Extinction
SP	PSDB	4	50,388,778/46,585,141 (88.92)	31/03/98	BDMG	Bailout
PR	PDT	1	519,944/462,339 (88.92)	31/03/98	Banerj	Privatization
SC	PMDB	4	1,552,400/1,390,768 (89.58)	31/03/98	Banespa	Privatization
RS	PMDB	2	9,427,324/7,782,423 (82.55)	31/03/98	Nossa Caixa	Bailout
GO	PMDB	2	1,340,356/1,163,057 (94.08)	13/12/98	Banestado	Privatization
MT	PDT	2	894,957/858,637 (95.94)	16/12/97	Besc	Federalized
MS	PMDB	-	1,532,394/1,402,794 (91.54)	-	Badesc	Agency
					Banrisul	Bailout
					CEE	Agency
					Beg	Privatization
					Bemat	Extinction
					-	-

Source: Authors' compilation.

## ***Annex 6. The Fiscal Responsibility Law***

*Main provisions.* The FRL granted constitutional status to a number of existing rules and introduced new ones. These include the following: a) a golden rule provision for capital spending (i.e., annual credit disbursement cannot exceed capital spending); b) personnel expenditures (including pensions) capped at 50 percent of net revenues for the federal government and at 60 percent for sub-national governments; c) new, recurrent expenditure commitments require specification of their full funding for the year in which they become effective and for the two consecutive years; d) prohibition of spending commitments that exceed one budgetary period during the last year of tenure of the executives at any level of government; e) 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 f) public financial institutions at all levels of government are not allowed to lend to their main shareholders. In addition, the Central Bank prohibits bank lending to any state that is in violation of the debt and deficit ceilings of the Senate Resolutions or in default to the federal government or to any other bank. There are penalties for any bank that violates the rules. 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.

*Contingency provisions.* The Law has a number of provisions focusing on contingencies that might alter the macro environment in which the economy operates. For example, 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; and 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.

*Procedural requirements.* A key element of the FRL is that it stipulates a set of procedural rules that are to be strictly followed by the various institutional actors involved in fiscal governance. These rules are meant to ensure transparency in fiscal affairs. A list of the subnational governments that exceed the limit has to be published by the Treasury Secretariat

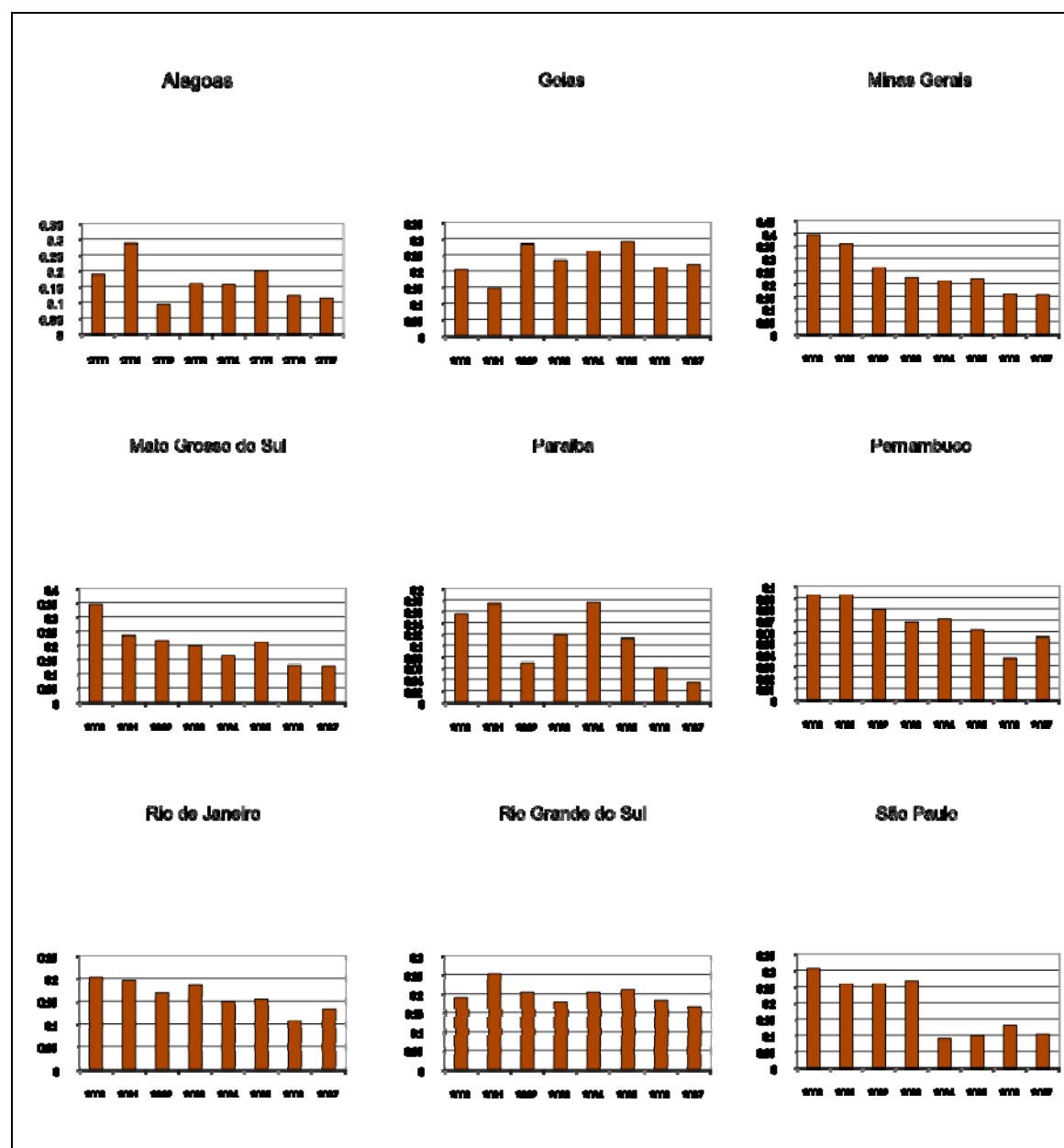
(STN) on a monthly basis. In addition to the institutional penalties called for in the LRF, the new Law 10028, known as the *Lei de Crimes Contras as Finanças Públicas* - Public Finance Crimes Law, of October 2000, which was presented to supplement the LRF, stipulates a number of legal sanctions applicable to individuals.

*Penalties from LFR and Lei de Crimes.* These include fines, loss of public employment, prohibition from holding public office for a maximum of five years, and imprisonment. The FRL provides for detention of up to four years for public officials who a) engage in credit 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; and 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.



## Annex 7. Fiscal Behavior in Selected States

Source: Authors' compilation.



**Annex 8. Creative Accounting: Wiggle Room for Non-Compliance with the FRL**

	<i>Operations in violation of the FRL</i>	Accounting Tricks	Status of Public Accounting
Alagoas	<ul style="list-style-type: none"> <li>• Personnel spending of legislative branch above the 3 percent ceiling</li> <li>• Overall personnel spending above the 60 percent ceiling</li> <li>• Excessive spending in duodecimal funds to judiciary and legislative branches</li> <li>• Expenditure increases overstepping the limits for election years</li> <li>• Underlying financial deficits conveyed to next administration</li> </ul>	<ul style="list-style-type: none"> <li>• Peak expenditures in pre-election years</li> <li>• Personnel expenses not properly recorded</li> <li>• Ambiguous or inaccurate reporting of end-of-term cash balances</li> <li>• Negative balances recorded as unpaid commitments</li> </ul>	<ul style="list-style-type: none"> <li>• Primary surplus targets met</li> <li>• All fiscal years approved by court of accounts</li> </ul>
Goiás	<ul style="list-style-type: none"> <li>• Personnel spending of legislative branch above the 3 percent ceiling</li> <li>• Contracting of new personnel in election years</li> <li>• Overall personnel spending above the 60 percent ceiling</li> <li>• Underlying financial deficits conveyed to next administration</li> </ul>	<ul style="list-style-type: none"> <li>• Peak expenditures in pre-election years</li> <li>• Personnel expenses not properly recorded</li> <li>• Improper application, recording of earmarked funds</li> <li>• Ambiguous or inaccurate reporting of end-of-term cash balances</li> <li>• Negative balances recorded as unpaid commitments</li> </ul>	<ul style="list-style-type: none"> <li>• Primary surplus targets met</li> <li>• All fiscal years approved, notwithstanding some negative remarks</li> </ul>
Mato Grosso do Sul	<ul style="list-style-type: none"> <li>• Failure to pay down debt refinancing contracts in due time</li> <li>• Underlying financial deficits conveyed to next administration</li> </ul>	<ul style="list-style-type: none"> <li>• Peak expenditures in pre-election years</li> <li>• Ambiguous or inaccurate reporting of end-of-term cash balances</li> <li>• Negative balances recorded as unpaid commitments</li> </ul>	<ul style="list-style-type: none"> <li>• Primary surplus targets met</li> <li>• All fiscal years approved, notwithstanding some negative remarks</li> </ul>
Minas Gerais	<ul style="list-style-type: none"> <li>• Expenditure increases overstepping the limits for election years (personnel spending, public works and media spending)</li> <li>• Underlying financial deficits conveyed to next administration</li> </ul>	<ul style="list-style-type: none"> <li>• Peak expenditures in pre-election years</li> <li>• Improper application, recording of earmarked funds</li> <li>• Personnel expenses not properly recorded</li> <li>• Inaccurate reporting of end-of-term cash balances</li> <li>• Negative balances recorded as unpaid commitments</li> </ul>	<ul style="list-style-type: none"> <li>• Primary deficits in 2001 and 2002</li> <li>• All fiscal years approved by court of accounts</li> </ul>

	<i>Operations in violation of the FRL</i>	Accounting Tricks	Status of Public Accounting
Paraiba	<ul style="list-style-type: none"> <li>• Contracting of new personnel in election years</li> <li>• Expenditure increases overstepping the limits for election years (personnel spending, public works and media spending)</li> <li>• Underlying financial deficits conveyed to next administration</li> </ul>	<ul style="list-style-type: none"> <li>• Peak expenditures in pre-election years</li> <li>• Improper application, recording of earmarked funds</li> <li>• Personnel expenses not properly recorded</li> <li>• Recording of privatization proceeds as net revenues</li> <li>• Ambiguous reporting of end-of-term cash balances</li> <li>• Negative balances recorded as unpaid commitments</li> </ul>	<ul style="list-style-type: none"> <li>• Primary deficits in 2001 and 2002</li> <li>• Fiscal year 2002 partially approved by court of accounts, entirely approved by deputies in Legislative Assembly</li> </ul>
Pernambuco	<ul style="list-style-type: none"> <li>• Expenditure increases overstepping the limits for election years (public works and media spending)</li> <li>• Underlying financial deficits conveyed to next administration</li> </ul>	<ul style="list-style-type: none"> <li>• Peak expenditures in pre-election years</li> <li>• Improper recording of privatization proceeds as net revenues</li> <li>• Ambiguous or inaccurate reporting of end-of-term cash balances</li> <li>• Negative balances recorded as unpaid commitments</li> </ul>	<ul style="list-style-type: none"> <li>• Primary deficits in 2000, 2001, and 2002</li> <li>• All fiscal years approved by court of accounts</li> </ul>
Rio de Janeiro	<ul style="list-style-type: none"> <li>• Expenditure increases overstepping the limits for election years</li> <li>• Overall personnel spending above the 60 percent ceiling</li> <li>• Failure to pay down debt refinancing contracts in due time</li> <li>• State debts above legal thresholds</li> <li>• Underlying financial deficits conveyed to next administration</li> </ul>	<ul style="list-style-type: none"> <li>• Peak expenditures in pre-election years</li> <li>• Spending spree in months prior to election</li> <li>• Personnel expenses not properly recorded</li> <li>• Expenditure cuts right after elections (especially in public security)</li> <li>• Ambiguous or inaccurate reporting of end-of-term cash balances</li> <li>• Negative balances recorded as unpaid commitments</li> </ul>	<ul style="list-style-type: none"> <li>• Primary surplus targets met</li> <li>• Fiscal year 2002 rejected by court of accounts, approved by deputies in Legislative Assembly</li> </ul>
Rio Grande do Sul	<ul style="list-style-type: none"> <li>• Personnel spending of legislative branch above the 3 percent ceiling</li> <li>• State debts above legal thresholds</li> <li>• Failure to pay down debt refinancing contracts in due time</li> <li>• Underlying financial deficits conveyed to next administration</li> </ul>	<ul style="list-style-type: none"> <li>• Peak expenditures in pre-election years</li> <li>• Personnel expenses not properly recorded</li> <li>• Ambiguous or inaccurate reporting of end-of-term cash balances</li> <li>• Negative balances recorded as unpaid commitments</li> </ul>	<ul style="list-style-type: none"> <li>• Primary surplus targets met</li> <li>• All fiscal years approved by court of accounts</li> </ul>

	<i>Operations in violation of the FRL</i>	Accounting Tricks	Status of Public Accounting
Sao Paulo	<ul style="list-style-type: none"> <li>• Expenditure increases overstepping the limits for election years (social spending, media spending, public security)</li> </ul>	<ul style="list-style-type: none"> <li>• Tax rebates to encourage voluntary tax levies in electoral years</li> <li>• Spending spree in months prior to election</li> <li>• Expenditure cuts right after elections (especially in infrastructure projects)</li> </ul>	<ul style="list-style-type: none"> <li>• Primary surplus targets met</li> <li>• All fiscal years approved by court of accounts</li> </ul>

Source: Authors' compilation.