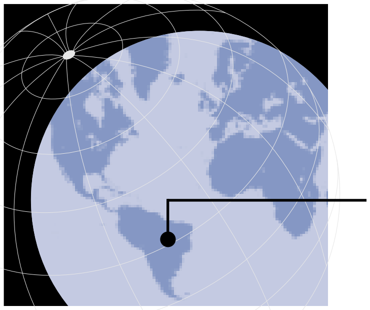

Brazil's federal government imposes fiscal rules on the states

BY *MATIAS VERNENGO*

President Fernando Henrique Cardoso declared recently that the Brazilian federal government is trying to create a "federalist mentality" in the country. The two examples of the new federalist mentality the president cited were the federal law that allows states to set regional floors for the minimum wage and the federal fiscal responsibility law that imposes limits on state governments' ability to spend.

The fiscal responsibility law is crucially important in an electoral year, since it is supposed to reduce the risks of populist measures by candidates seeking re-election (or by politicians supporting candidates, as in the case of President Cardoso himself and his preferred candidate, Health Minister José Serra.)

Ideally, the new law would avoid the all too costly effects of excessive spending in an electoral year. One just has to look south to Argentina where the De La Rua government inherited such damaging fiscal deficits from the Menem administration.

Cutting the public sector

The Brazilian fiscal responsibility law builds upon previous legislation according to which the federal administration refinanced states' debts in exchange for an agreement on sustainable budgetary equilibrium at the state level. In order to avoid price inflation the Brazilian federal government believes both levels of government have to pursue prudent fiscal policies.

The emphasis on fiscal equilibrium is in line with the views of the World Bank and the International Monetary Fund, and with the principles upheld by structural adjustment programs, according to which inflation results from excessive fiscal deficits.

The Brazilians have put special emphasis on cutting the cost of public sector workers. Between 1995 and 1999 Brazilian states spent on average 70 per cent of their disposable revenues on wages and salaries. But what many fear is that while it may be necessary to limit the salary burden, workers could end up bearing the brunt of the adjustment.

In fact, lower wages in the public sector added to the relatively poor performance of labor markets in the second half of the 1990s. In particular, after the 1997 Asian crisis, the average real income of workers fell to levels that are roughly equivalent to the level of the beginning of the decade, which are in turn forty per cent lower than the levels of the mid-1980s. And unemployment has been higher, reaching levels eighty per cent above those of the early 1990s.

In addition to the fiscal responsibility act the federal government has imposed limits on the debt that states can carry. The federal government can suspend its transfers to the states if the states do not respect the debt limits. This last measure has a severe impact on the ability of states to spend, and can be seen as an act of fiscal re-centralization. Some see this as being paradoxical, since it implies that in Brazil fiscal responsibility is not part of a movement towards fiscal decentralization, and of increasing participation by all levels of administration in the budgetary process.

In other words, the Brazilian fiscal responsibility law goes beyond the mere regulation of the relation between the different tiers of government, and increases the discretionary power of the federal authorities. In a way it imposes fiscal centralism in the name of economic stability.

Higher deficits and debt

In the first half of the 1990s there were *primary* fiscal surpluses (revenue minus spending excluding interest payments) and the *primary* deficit only increased after 1994. After 1998 the primary deficit becomes a surplus once again. In contrast the *operational* deficit (including interest payments) has been high all through the 1990s, with the exception of 1993 and 1994. In fact, the operational deficit exploded after the Mexican 'Tequila' crisis of December 1994. The operational deficit remains high today, even after the adjustment efforts that followed the 1999 crisis – of which the fiscal responsibility law is an important element.

The fiscal situation was not dramatic in the early 1990s. Then from the mid-1990s onwards — despite the fact that prices had been stabilized — the fiscal situation became more difficult to manage. Not only did the operational deficits increase steeply, but also the debt-to-GDP ratio grew from 29.2 per cent in 1994 to more than 50 per cent in 2001.

The increase in the federal government net debt has been impressive. Ironically, the fiscal responsibility initiative demands limits on local government debts, but not on the federal government. Of course, debt-burden in Brazil is relatively low compared to OECD countries such as Belgium or Italy that have debt-to-GDP ratios higher than 100 per cent.

The federal government was able to keep the primary deficit under control by increasing revenues to more than 30 per cent of GDP, and by cutting several expenses. Spending on wages fell from around 32 per cent to around 22 per cent. Transfers to states and local governments fell from 25 per cent to a little more than 15 per cent. In fact one of the main effects of the new law is that it forced all levels of the public administration to cut wages and limited debt in the lower tiers of government.

Cuts in social rather than "financial" spending

Despite concerns about the impact of the fiscal responsibility law on social conditions it has been negligible so far. In fact, the degree of income inequality has been fairly constant. At the end of the 1990s it is about the same as in the late 1970s. The recent fiscal initiative cannot be held responsible for the socioeconomic inequalities that plague the Brazilian society.

Still, the constraints the new law imposes on social spending, even if they do no harm, do not help to pay the accumulated social debt. For example, this year the federal government will cut R$ 2 billion (around US$ 800 million at market prices) from the health budget. These cuts will not in the short run affect Brazil's comprehensive anti-HIV/AIDS strategy, considered by many as a model program among developing countries, but they may affect the ability to run the program as effectively in the future.

And if social spending has been relatively constrained, the same cannot be said about the financial expenses of the federal government. The cost of interest on the accumulated debt, although fluctuating, has been kept at high levels. There are two explanations for this:

- Since the depreciation of the currency in January 1999, the fear of rekindling inflationary pressures has led to a reinvigoration of anti-inflationary policies. Brazilian authorities see high interest rates as an instrument to control inflation.
- The persistence of current account deficits since 1994 implies that high interest rates are needed in order to attract the capital flows to close the balance of payments. In both cases high interest rates are needed to solve problems generated by the external accounts.

And so, while the fiscal responsibility law effectively constrains *social* spending it is unable to control *financial* spending.

And budgetary cuts have not been limited to social expenses. They have extended to public investments as well.

For example, investment in energy production and distribution has been below the level needed to maintain potential growth. Between 1995 and 1999 investments have been on average US$ 3.7 billion, below the US$ 6.5 deemed necessary by specialists. As a result the federal government is imposing severe restrictions on energy consumption. On average, industrial users reduced their energy consumption by 20 per cent in 2001. In some sectors (e.g. aluminum, cement) the reduction was 25 per cent.

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More importantly, the cuts in energy production in the 1990s meant that government spending on hydroelectric plants fell and the slack was taken up by smaller private investment on thermoelectric plants. This means that the spending cuts have had a negative impact on the environment.

The "participative" model

Most Brazilians would agree that the pursuit of fiscal responsibility is in itself a noble task. Transparency in administration of the public affairs and accountability are laudable objectives. And there is widespread support for a decentralized form of fiscal federalism– as long as that does not jeopardize social welfare.

In this connection many Brazilians look to some of the policies discussed recently at the World Social Forum in Porto Alegre, capital of the Brazilian southern State of Rio Grande do Sul. The Social Forum, which serves as a counterpart to the Davos (now New York) World Economic Forum, promotes transparency and democratic participation in the budgetary process. These ideas build on the "participative" budget developed by the Worker's Party, that has run the city of Porto Alegre for the last twelve years, and the state for the last four.

The way the "participative" budget works is that decision making on taxes and spending is not limited to technicians and government representatives. It is the population, through a process of debates and consults, that defines and decides on amounts of expenses, as well as where and when the investments will be done. The "participative" budget has proven that the democratic and transparent administration of resources is an efficient way to avoid corruption and mishandling of public funds.

Unlike the fiscal responsibility law that tries to reduce corruption by limiting the spending abilities of the authorities, the "participative" budget tries to achieve the same result by stimulating the democratic participation of the citizenry. Ask many Brazilians what they think of this question and they're likely to respond that while fiscal responsibility is a good thing – it is even better when accompanied by democratic participation.