How to manage the public budget better

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MANAGING A COMPANY WELL IS closely related to managing its cash flow and requires knowledge not only of the actual position of its accounts but also of possible future scenarios. That lesson is so basic, it seems obvious, but apparently not to governments. A budget —federal, state, or municipal—is both fundamental for planning actions and policies and a way to communicate government spending priorities to society. But that is barely raised when budgets are being prepared. The problem was discussed recently at two seminars, "Evaluation of the Credit Risk of State and Local Governments" at the Brazilian Institute of Economic (IBRE) and "Budget Reform and Public Management: Beyond the Fiscal Adjustment," at the Brazilian School of Business and Public Administration of Getulio Vargas Foundation (EBAPE).

Since the fiscal adjustment at the end of the 1990s, government budget management has been criticized for its rigidity in the allocation of funds and for imbalances in the various demands for funds. These aspects of financial management hinder investment and make it impossible to make necessary changes to the budget, which increases risks. Advocates of budget reform argue for more transparency and less stringent regulations to give states and municipalities more freedom, especially with regard to borrowing.

"We made the fiscal adjustment in 1998, but like any medication taken for a long time, it ends up generating side effects," said Fernando Rezende, lecturer at EBAPE. He pointed out that the idea was to allow more flexibility in order to get out of the low-growth trap set by the current budget: almost 90% of resources are allocated according to constitutional rules for spending on health and education. Resources allocated but not spent in the previous year's budget ("unpaid spending") have become part of a parallel budget, playing havoc with current-year budget execution and making public spending unpredictable. As a result, policy makers and public sector managers have less than perfect knowledge of their cash flow.

Competing demands

According to Rezende, the budget is constructed in response to three distinct demands: health and education social needs; parliamentarians' political demands for government appropriations for local projects; and macroeconomic requirements related to government's need to generate primary budget surpluses to pay debts. These three demands have been balanced in a sort of arrangement of convenience that works very well when the economy grows above 3%. However, when economic growth falls below 3%, the informal budget agreement becomes unworkable.

"Street protests have created an additional demand on the budget: improvement of public services. This demand hits the core: how to improve management of public funds," said Gabriel Leal de Barros, an IBRE researcher, who pointed out that so much spending is earmarked that the budget has been immobilized.

For the federal government, for example, 18% of tax revenues should be invested in education, which is a substantial amount considering that Brazil has one of the highest tax burdens in the world (as of September, annual tax revenues exceeded US$520 billion). Barros said as an example, "When the federal government reduces the tax on industrial products and on financial transactions to boost the economy, it affects tax revenue and can reduce the amount that should be invested in education."

In this regard, current discussions in Congress that can lead to more spending rigidities are worrying. A constitutional amendment currently proposed would require the government to carry out the individual amendments of legislators. The proposal is unrealistic, Barros contended, because it will reduce to only 15% the federal budget spending that will not be earmarked: "There is no more budget space to meet all the various demands; on the contrary, we must revisit and reconsider the demands in the face of budget constraints." The discussions of most concern relate to oil royalties, changes in the VAT rules, a new federative pact, and the National Education Plan. Congress often uses political debates to pressure the executive, and that affects every aspect of public administration.

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"We live in a time of uncertainty, especially in terms of revenue, as some states are losing resources from the state tax on goods and service. So we live with national ceilings that further tighten public finance because we do not have resources to meet all demands. What we do is put out fires," complained Célia

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Maria Silva Carvalho, president of the State Finance Managers Group (GEFIN). She added: "We cannot plan or think long-term. . . . To have better public financial management, we need greater certainty from the federal legislature about public cash flow. "

State and municipal borrowing

The budget rigidities affecting state and municipal governments are the result of measures adopted in the late 1990s, when the federal government had to bail out many local administrations because they had contracted so much debt. State and municipal budgets were further tightened in the early 2000s with passage of the Fiscal Responsibility Law (LRF) and Treasury monitoring of local borrowing. The result was budget management that to pay debt service prioritizes the generation of a primary surplus at the expense of public investment.

However, in recent years this scenario has been changing since states and some cities have sought financing from national and international public banks. With the endorsement of the federal government, the volume of their foreign loans in the first half of 2013 increased almost 50% compared to 2012. State and municipal debt has increased since April 2012 from US$12 billion to US$19 billion.

"The federal government acknowledged its own difficulties in carrying out investments and has used the fiscal space that the LRF allows to increase the debt limit of states so they can invest in infrastructure," said IBRE's Leal de Barros.

"Before, borrowing abroad was discreditable; it would mean you could not manage your finances well. This changed with the unprecedented event in recent history of a Brazilian municipal bond issue placed on the international market without a federal government guarantee—supported only by the balance of the municipality and best practices," Renato Villela, finance secretary, Rio de Janeiro State, said, pointing out that Rio has not just borrowed abroad, but rating agencies have also assessed its state and municipal finances. Villela's analysis throws light on states and municipalities that have potential for dealing with transactions like these." It does not make sense for a country like Brazil," he said, "with its sophisticated production structure and financial services, not to have a responsibly developed market for state and local government bonds."

Other experts also argue for greater borrowing autonomy for state and local governments. Rating agencies and assessment by banks like the Inter-

American Development Bank and the World Bank have greatly improved government financial management.

Lindbergh Farias, president of the Senate Economic Affairs Committee, believes that the time has come to shift funding today, which is concentrated in the hands of the Federal Government; since 2008 the National Bank for Economic and Social Development (BNDES) has become a major lender. To do so, he argues for changing the law to allow state and local administration to contract debt so they have capacity to carry out investments in major public works.

Confidence

One way to strengthen state and local governments and create a market for their bonds in Brazil is to submit government accounts to the scrutiny of international banks and rating agencies. This could bring about more transparency and better management of state and local administrations

For Maria Rita Gonçalves, senior director at Fitch Ratings, there is currently a transition and the Brazilian profile is evolving: "We are clearly in a moment of an improved credit profile of state and local governments, and credit expansion for infrastructure, "she said. Daniela Brandazza, Standard & Poor's director of public finances, agreed: "We are optimistic about the possibility that if Brazilian local governments have an opportunity to explore the rating process, they can improve long-term financial planning."

Even in a scenario where state and local governments continue to have relatively high debt service and low capital expenditures, the assessment of the volume of their own revenues is positive. "When we look at capital expenditures and infrastructure needs, what we can say is that state governments show a good level of own revenues and stable financial performance, especially when we look at operational results and cash flow requirements," said Alejandro Olivo, analyst for Moody's Latin America and Canada.

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Nevertheless, rating agencies and lenders have concerns. The transparency of Brazilian public accounts is neither ideal nor standardized. In addition, measures being discussed in Congress could alter the cash flow of local governments, such as long-term social security liabilities that need more balanced management.

"The Brazilian population is aging while the yield on collateral assets that will cope with these obligations is no longer the same, so this challenge will become more important as Brazil moves to an environment of lower interest rates," Gonçalves said.

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for both sides," Adriano Mendes, BNDES, pointed out, adding "Transparency has to do with data." There is strong advocacy for standardizing the way data are reported in Brazil. Another factor that prevents transparent analysis of public accounts is the fact that some local administrations follow the LRF while others are guided by the Treasury's decisions. "We need to standardize, correct, and put forward at least some [organizing] concepts," Mendes says.

José Roberto Afonso, an IBRE expert in public finance, advocates standardizing and disseminating fiscal data in a system that covers states, municipalities, banks, lenders, and rating agencies. "What we see is that everyone involved complains about the time it takes to evaluate the data," he said, noting that it is essential that local governments become better able to manage public debt.

The moment appears to be ideal for Brazil to rethink its budget and tax issues. "We have a very interventionist government," said Zeina Latif, a partner at Gibraltar Consulting, "and it has taken a long time for us to realize that the formula did not work." She believes the next government will have to make a change in economic policy: "We have to leave ideology aside and take the path that must be taken . . . . We have room and stronger institutions to make that course correction."

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