How long will fiscal discipline last?



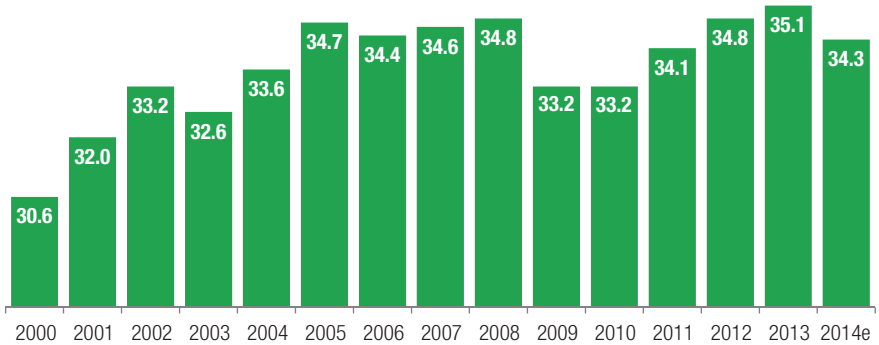
Recession and falling government revenues are putting the Fiscal Responsibility Law to the test.

Solange Monteiro

THE ECONOMIC DOWNTURN not only makes it more difficult for Brazil to meet the fiscal primary surplus target—reduced in July from the previous guesstimate for 2015 of 1.2% of GDP to a mere 0.15%—it is also testing whether the Fiscal Responsibility Law (FRL) can continue to be effective. Created in May 2000 to set limits in order to promote long-run fiscal stability, the law has supported fiscal management and been fairly successful for 15 years. The main goal in creating the FRL was to reduce the indebtedness of states, and indeed the number of states that had more debt than the FRL limit of 200% of net current revenue has since dropped from seven in 2000 to just one in 2013.

This positive result, however, points out José Roberto Afonso, IBRE researcher and member of the government team that drafted the FRL bill, was driven by a dramatic rise in taxes. Afonso and his colleague economist Kleber Castro estimate that the tax burden went up from 30.6% of GDP in 2000 to 35.1% in 2013. But as all Brazilians are aware, in recent years the situation has changed. "The reality of the last 15 months is not the same as it was in the previous 15 years," Afonso says. "Last year the government collected taxes amounting to 34.3% of GDP, the same as in 2007; if the trend of falling tax revenue in the first half of this year continues, tax revenues would decline another 1 percentage point of GDP, back to where we were in 2005." Today the government has little room to increase taxes, as is clear from the difficulty it is having in rolling

Brazil's tax burden post-Fiscal Responsibility Law, 2000-2014
(% of GDP)



Source: IBRE.

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back tax exemptions. "Corporate income tax revenue is falling because of the slowdown in economic activity, and expectations of a new federal tax amnesty," Vilma da Conceição Pinto, IBRE researcher, explains. From January to June 2015, the total revenue of the federal government was 4.6% lower than in the same period of 2014 but revenues from corporate income tax plunged 16.1%.

Afonso believes that the current economic slowdown, rising unemployment, and falling consumption and revenue, are making clear the cost of postponing FRL reforms, noting that "So far it has been assumed that managing fiscal policy was enough, and the rules were ancillary. We did not even push for reforms in the first term of President Lula, when the government had a large majority in Congress and popular support."

Among the shortcomings of the FRL is that there is no ceiling for federal government debt. The limit for states is 200% of current net revenue and for municipalities it is 120%, but there is no such limit for the federal government. Afonso also notes that the recording and accountability of federal fiscal accounts is seriously deficient. "If we were to record the fiscal balance on an accrual basis, we would certainly have more consistency and accountability, and there would be no accounting gimmicks involving the use of the funds of state-owned banks to make up the federal budget—something now being investigated by the Court of Audit [TCU]," he says. The TCU is also concerned about the lack of consistency in the accounts of the federal government, the states, and municipalities. The federal government records its accounts on a cash basis; state and municipality accounts are more transparent because they are kept on an accrual basis, as the FRL requires.

Temporary truce

With the loss of dynamism of the economy, states and municipalities are finding it difficult to meet the limits on personnel spending. So far this year, 26 states and the Federal District have gone over the personnel cap of 49.1% of net current revenue—among them Mato Grosso, Tocantins, Rio Grande do Norte, and Alagoas states—and another 18 states hit the prudential limits of 46.55% and the alert limits of 44.1%.

However, when the economy slows, states and municipalities that violate spending limits are not penalized by cut-backs in federal resource transfers and loans. The FRL allows states and municipalities twice as much time to bring their spending back under the limits when GDP growth is less than 1%: In normal situations, they have two quarters to get spending back under control, but when GDP growth is low, it can take up to four quarters. Also, as long as GDP does not recover, the spending limits will continue to be pushed forward, giving more time to states to meet their spending limits. So "If we take into account the current growth projections, states and municipalities would have until at least 2018 to meet the spending limits," calculates Afonso.

In four years, the Treasury more than tripled its guarantees of state and municipal borrowing, from 0.5% of GDP in 2010 to 2% in 2013. The situation is aggravated by the fact that a significant portion of these loans were from Brazilian state-owned banks. Afonso points out that "In 1998-99, Treasury guarantees were for states and municipalities negotiating loans with international financial institutions like the World Bank and the Inter-American Development Bank. No one thought the Treasury would guarantee loans from national state banks. This is serious." He says that the grace period of these state bank loans is ending and servicing debt may take 15% to 20% of state revenues.

States feeling the resource pinch are withdrawing escrow deposits related to pending court trial against them such as taxes. Earlier this year, Senator José Serra (PSDB party-São Paulo state) proposed a bill to regulate this practice, allowing states to withdraw 70% of these deposits but creating a reserve fund with the remaining deposits. Serra pointed out that in 2015 the arrangement could bring in R$21.5 billion to state and municipal budgets. In late July, President Dilma Rousseff signaled her intention to sanction the use of escrow deposits for court-ordered payments of the debts of states and municipalities. Afonso comments that "It is not clear how much has already been drawn down, but there is concern that the practice may already be problematic in macroeconomic terms, and deserves attention."



Reduction in state debt levels was accompanied by increases in personnel expenses, generating fiscal imbalances.

Considering the number of potential time bombs, to preserve the FRL, Afonso argues that priority should be given to reforms that would improve monitoring of fiscal performance. His recommendations: (1) Set debt limits for the federal government, as had been envisaged in the FRL, but has never been actualized (2) Review yearly the limits prescribed by the FRL—which have never been honored. (3) Create the fiscal management council that is also mandated by the FRL, though it was never established. The council would have a regulatory role, setting budget and accounting classifications and the consolidation of public accounts. This change would make the public accounts more credible.

Afonso also suggested other reforms to correct flaws in established practices and specify regulations currently lacking in the FRL. Among them might be regular review of Treasury guarantees for state and municipal loans and assessing the debt sustainability of states and municipalities whose revenue outlook is questionable. Conceição Pinto is also troubled by the rigidity of required spending: "When revenues are falling, we see many problems arising because revenues are earmarked for specific purposes when other sectors need that money more." At the end of the day, giving more attention to reform would bring about more fiscal transparency and strengthen the credibility of the FRL.



In the first half, the federal government accumulated a fiscal primary deficit of **US$1.6** billion

Afonso believes that today Congress has more desire to make reforms: FRL reform projects are being considered in both houses of Congress, and there are initiatives in the most indebted states to adopt state fiscal responsibility laws. His conclusion is that "This signals a disposition for structural reforms—and we must seize it."