

Fiscal Targets in the Brazilian Budgetary Process

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1. Introduction

In the period before the implementation of the Real Plan (set of measures taken to stabilize the Brazilian Economy in early 1994), aged distinguished for its elevated inflation rates, the seigniorage and the significant expenditure corrosion were essential to keep the sustainability of Brazilian public. During a short period of time, after the Real Plan's consummation and the subsequent downfall of inflation rates, the privatization revenue compensated the earnings originated at high inflation rates.

Following the substantial reduction of the privatization revenues and the beginning of the floating exchange rate regime, the Brazilian government forcefully initiated its fiscal adjustment. Hence, since 1999, in Brazil, the fiscal policy abides by primary surplus generation, which is a political instrument whose objective is to assure the sustainability of public debt. With such fiscal policy regime, it was perceived an elevation in the budget rigidity and a deterioration in the volume of public investment, which is basically consisted of discretionary expenses.

In fact, since the establishment of the primary surplus target, which is measured as a GDP percentage, there were created incentives for several groups pursuing to maintain or increase their respective participations in the government budget, considering the fact that since then a determined fraction of the budget would already

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had its destination predetermined beforehand. In this manner, during this period, there was a substantial increase of binding budget and mandatory expenses. Furthermore, one of the consequences of such legal framework is the reduction of the public investment volume, which due to its discretionary nature, became one of the main adjustment variables in the attainment of the primary surplus target.

Such facts are well known by the Brazilian Public Finance experts. However, what is little discussed are the incentives that this rule generates to the pro-cyclical expenses execution. Therefore, this essay, in a brief manner, suggests that the effective system that guides the Brazilian budgetary process incentivizes the pro-cyclical expenses. Furthermore, we will demonstrate de facto that throughout recent years, the expenses have been behaved in a pro-cyclical manner within the in the Brazilian Federal Government. Finally, we will suggest a fiscal policy rule that motivates a countercyclical execution in the National Government expenses.

2. Incentives to the Pro-Cyclical Expenses

Initially, it will be discoursed briefly how the budgetary cycle stages are delineated regarding the process of elaborating (by the Executive Branch) and evaluating (by the Legislative Branch) the Annual Draft Budget Law (Projeto de Lei Orçamentária Anual - PLOA). During the elaboration process, it is valid to mention that first the revenue is estimated and then, from the total, the expenses are subsequently settled. The Brazilian Internal Revenue Service (Secretaria da Receita Federal - SRF) is responsible for the revenue estimation while the Federal Budgetary Secretariat (Secretaria de Orçamento Federal – SOF) is accountable for determining the budgetary expenses, starting from the several Central Government agencies and entities budgetary demands consolidation.

In thesis, in the PLOA's elaboration stage, there are two incentives for the revenue underestimation. First is the fact that part of the SRF's civil servants remuneration is based on the tax collection excess. In such a way that the lower the

collection is estimated, the bigger is the probability that will surpass it, implying then on a bigger excessiveness likelihood. Second, in a proper measure, it is a consequence of the first fact, which proceeds from tendency of the Executive Branch to stipulate a lower level budget in order to increase its discretionary power through additional credits, especially towards special and/or extraordinary credits, as it can be observed in the table below. De facto, the table shows that in the last three years, the special and extraordinary credit has increased its participation in the Federal Government's total expenditure.

Table 1

Valores em R\$ milhões

Ano	Despesa Executada(A)	Crédito Normal (B)	Créditos (Especial e Extraordinário) (C)	B/A	C/A	total
2003	247.381,9	244.627,5	2.754,5	98,9%	1,1%	100,0%
2004	285.524,7	283.075,7	2.449,0	99,1%	0,9%	100,0%
2005	335.596,0	328.866,2	6.729,8	98,0%	2,0%	100,0%
2006	381.997,3	362.203,3	19.794,0	94,8%	5,2%	100,0%

Budgetary Execution by Credit Type

Source: SIGA BRASIL/Brazilian Federal Senate.

In the PLOA's evaluation stage, accomplished by the Legislative Branch, the National Congress naturally tends to seek ways of enhancing the revenue estimation in furtherance of the legislators to attend their "electoral bases" countless demands. In practice, it is innocuous though, since the Executive Branch responds right in the beginning of the year with strong contingency in order to adequate the Annual Budgetary Law (Lei Orçamentária Anual - LOA) to its proposal of PLOA. This new estimation (for higher) revenue elevates the Executive Branch discretionary power. Indeed, the bargain between the Executive and the Legislative is dealt by means of parliamentary amendments, which were added in result of the revenue estimation revision by the National Congress.

Our hypothesis is that this institutional legal framework, created from a substantial proportion of the primary surplus target, induces the pro-cyclical expenditures execution. Likewise, due to the high percentage (about 92%) of linked revenues, mandatory outlays and primary surplus target, it is left little flexibility for the budgetary execution. Besides that, this counterbalance of interest between the Executive and the Legislative ends up transforming the LOA into an unrealistic instrument regarding planning, in such a way that part of the LOA's not compromised actual revenues are spent according to the evolution of the GDP. If such indicator increases (decreases), in average, more (less) revenues are collected. Consequently, more (less) discretionary expenses and more (less) additional credits are provided.

In another words, through the budgetary rigidity or by the way the bargain between the Executive and the Legislative is conceived, the incentives are always towards the pro-cyclical expenditure manner, e.g., there is no rules inducing the National Government to execute its budget in a countercyclical approach.

3. Pro-cyclical Budgetary Expenses Behavior

Before we propose the adoption of some fiscal rule in Brazil that eliminates or reduces the pro-cyclical bias of the Federal Government's expenses, it is important to inquire, in a synthetical method, how some factors contribute to such behavior:

- a) Minimum wage: its value impacts directly in about 60% of social security benefits (35% in value) and in the value of total assistance benefits paid by the Brazilian Social Security National Institute (INSS in Portuguese). Furthermore, the unemployment benefits, which is equivalent to one minimum wage for those who earned up to 1.25 minimum wage before loosen their jobs, follow in a large measure the value of this base pay since such low paid workers are more likely to become unemployed. Annually the workers that earn up to two minimum wages in average receive one additional salary, which is equivalent to one lowest wage. It is estimated that almost 20% of the

Federal Government expenses are adjusted according to such base pay. It occurs that during periods of higher growth, there is more fiscal flexibility to handle pressures over elevated real fiscal adjustments measured by the lowest wage, creating a correlation, with some seasonal discrepancy, between the economic cycle and the assistance and social security expenses;

- b) Education and healthcare minimum spending rules: the Constitution determines that healthcare and education are not inferior to the value accrued in the previous year by GDP variation and 18% of tax collection, respectively. In this case, it is very clear the pro-cyclical character of these rules;
- c) Civil servant expenditure: in a similar way to the expenditures indexed to the minimum wage, the government grants bigger salary adjustments to the civil servants and hires more employees during higher growth periods. However, in this case, the pro-cyclical expenditure execution is much lower since in these actions, the time set for having impacts over the public finances is long in both cases.

In pursuance of ratifying the indications of the Federal Government pro-cyclical expenditure execution, in real terms, the table below evidences the strong positive correlation between the GDP growth rates and the Federal Government's primary expenses.

Table 2

GDP Growth Rates and Federal Government's Primary Expenses (%)

	Despesa Primária	PIB
1998	7,81	0,04
1999	-2,71	0,25
2000	1,33	4,31
2001	7,05	1,31
2002	3,64	2,66
2003	-7,94	1,15
2004	8,87	5,71

2005	8,89	2,94
2006	11,09	3,70

Source : MF/STN e IPEADATA..

4- A Countercyclical Target

Fiscal rules where the primary and/or nominal target results are adjusted to the economic cycle and where the fiscal policy applies a countercyclical approach are highly recommended for the Brazilian case. In practical terms, a principle that must guide the formulation of the fiscal rule is the simplicity of the rule itself and the operational proceedings necessary to its implementation. Hard understanding and little intuitive rules that demands complex calculations to their operationalization causes low interest to society and to the Legislative Branch when inspecting the accomplishment of rules and themes related to fiscal policy in general. Moreover, they could facilitate the adoption of “creative accounting” and other procedures condemnable by the fiscal authority.

In the Brazil's case, it is valid to mention the Kandir's Law example. From a technical standpoint, the law is brilliant, however, the complexity of its formulas made it ineffective. From another point of view, it is important to acknowledge that the inflation targets system owes a considerable part of its success and vast acceptance by society to the adoption of a very simple rule, even tough several others (e.g. core of inflation, inflation over 12 or 24-months rolling window, etc.) were technically more adequated to economies with the Brazilian characteristics. That said, beforehand, we will try to propose, as much as possible, a countercyclical fiscal policy rule with an easy calculation and operationalization.

Usually, countercyclical fiscal rules translate into refined fiscal target results related to the structural balance, which is calculated when breaking down the revenues and the expenses into their cyclical and structural components:

$$B_t = R_t - D_t$$

$$B_t = (R_t^e + R_t^c) - (D_t^e + D_t^c) = (R_t^e - D_t^e) + (R_t^c - D_t^c)$$

Where B, R and D represent the fiscal result, revenues and expenses, respectively, and the indexes “e” and “c”, the cyclical and structural components.

Although, exactly in relation to determining the cyclical and structural components, past and forecast, it is where resides, at the same time, the bigger incidence of discretionary and technical complexity of the process. In the Chilean case, the revenues are adjusted accordingly to the potential product and the coppers price, meanwhile the cyclical expenditure component is considered null.

In the Brazilian case, regarding the tax revenues situation, the literature points that it is not accepted, in the case of the indirect tributes, the hypothesis of collection-product elasticity being different from one. Likewise, in the case of the direct tributes, this same measure is significantly superior to such unit, as much for people's as for firm's taxable income, which accordingly it is smaller than the social security contributions quantity. Other estimates that consider the tributes all together show that the collection-product elasticity is lightly superior to one. Due to simplicity purposes and considering the prevalence of the indirect tributes in the tax structure, we can consider the elasticity being equal to one for effects of the implementation of a fiscal rule.

On the side of the expenses, it can be affirmed that the pro-cyclical behavior is due substantially to the factors that were pointed along this article so that other effects of the cycle, as the increment in the unemployment requests for instance, are valueless.

Hence, we suggested the embracement of a primary result rule adjusted by the economic cycle for the Central Government, with the following characteristics:

- a) Establishment of the primary result target, balancing the incomes and expenses of the economic cycle by the National Congress through the Budget Guidelines Law. A suggestion is that for each percentile point of GDP forecast above potential GDP, would result on an additional percentile point of increment in the primary result to be considered; mutatis mutandis, for each

percentile point of GDP forecast below potential GDP, there should have been a decrease of a percentile point in the primary result goal;

- b) The structural component of the income calculated, considering the unitary elasticity in relation to the product, or being $R_{te} = R_{t-1} (1 + y_t^*) + R_{tl}$ in that y_t^* represents the potential economic growth rate and R_{tl} the effects of the changes in the tax collection legislation. In this case, $R_{tc} = R_{t-1} (y_t - y_t^*)$;
- c) The potential growth rate should be calculated by the executive branch through a known model, which would be revised annually by a chosen group of economists that were indicated for such purpose;
- d) There would not be made adjustments in the expenses due to the economic cycle, in other words, it is considered that the cyclical component of the expenses is null, which implicates that the expenses are limited to the difference between R_{te} and the result target established in (a); and
- e) The value of the income portions that corresponds to a collection-product elasticity superior to one and that was not captured in R_{tl} , subtracted from the expense values that exceeded the established limit in (d), is accumulated and can be used for expenditure expansion, if the economy is operating below potential GDP.

It happens that this systematic operation demands change on the education and healthcare pro-cyclical spending rules. We suggested that such outlays should be substituted by expenditure per inhabitant, which would consider the relative participation of age groups within the population and their respective needs of education and healthcare services. The goals would be reached gradually in a planning horizon of 10 to 20 years, without having the current economic issues determining the volume of expenses designated to those functions in the short-term.

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