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Fiscal Policy: A Brazilian case-study within the President Lula's first government 2003-2006

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1. Abstract

Brazil has made considerable progress in recent years towards consolidating macroeconomic stability, which is a key framework condition for sustained growth. The Fiscal Policy has been guided by debt sustainability considerations, delivering primary budget surpluses that have often exceeded the end-year targets. However, while the public debt-to-GDP has been reduced, it remains high, especially in comparison with other emerging-market economies. Brazil's overarching macroeconomic challenge is, therefore, to continue to reduce the public debt overhang while improving the quality of fiscal adjustment, which has so far been underpinned by revenues hikes, rather than a retrenchment of expenditure commitments. This paper discusses fiscal adjustment in Lula's first government (2003-2006) and the real effects of this policy within the domestic market. Moreover, it also discusses the composition of fiscal adjustment, based predominantly on tax revenue hikes, against the backdrop of Brazil's still high public debt-to-GDP ratio. Finally, this paper concludes that the hard-won fiscal discipline will have to be entrenched in fiscal institutions and the quality of the fiscal adjustment improved to support higher and sustainable economic growth.

2. Introduction

The public debt assumed, over time, an important role in financing the economic development of various countries. In general, the importance of public debt is - greater the larger - is the inadequacy of mechanisms of revenue collection to meet the needs of investment and the inefficiency of mechanisms to capture savings. In addition, this study analyzes the fiscal policy in Brazil's recent history (2003 to 2006) and the main results of these four years of government.

However, although the recommendations for fiscal policy for the Brazilian economy in recent times have been based on the notion of debt sustainability and the generation of primary surpluses, this dissertation will focus more on a critical view of the results of this policy. Brazil has faced some of the tightest fiscal constraints in recent years. These constraints have resulted in a significant reduction in public expenditure, on private consumption and on infrastructure.

Thus, in Session 3 I will analyze the fiscal policy in Brazil in recent years, in Lula's first administration as well as the structural reforms and fiscal adjustment. This session also presents the results of this strict fiscal policy on the domestic market and the tools used by the federal government to tackle these main problems.

In Session 4 I will show the policy recommendations and, in addition, I conclude that the political parties now have a reasonable degree of agreement (not unanimity) on the need for fiscal austerity. My main conclusion is that, after a decade of structural and fiscal adjustment, there is still a need to consolidate the progress achieved by building solid fiscal institutions and improving the quality of fiscal adjustment in support of higher, sustainable economic growth. In addition, to improve the quality of this fiscal policy adjustment, further reforms of the social security system will be unavoidable.

According to these ideas, there is a consensus that improvements in public policies are questions of crucial importance to both economic stability and to regaining the dynamics of sustained development. Moreover, the country needs an opportunity for combining economic growth with the promotion of public policies to fight poverty and

inequality and for this to be a success, it is necessary to remove key obstacles to growth. Here, I would like to focus on investments, which are essential to increasing systemic competitiveness and to supporting a new cycle of growth.

Finally, this paper does not pretend to provide a ready-made solution for such large and varied challenges. Instead it hopes, in a small way, to stimulate debate, starting by raising and systemizing information and pointing out possible alternatives, be it in a preliminary and even perhaps a somewhat provocative manner.

3. The Lula administration: Structural reform and fiscal adjustment

The Lula administration took office in January 2003 under the pressure of rising inflation (12.5% on a year-on-year basis in 2002) and public indebtedness, associated with the impact of the exchange rate depreciation that took place in the run-up to the presidential election in October 2002. Within this scenario, the new government quickly took four crucial measures to overcome its challenges in the beginning of 2003, including high inflation, strong pressure of the real exchange rate and elevated *"Risco-Brasil":*[1]

1. announced the revised inflation targets[2] (IPCA) of 8.5% for 2003 and 5.5% for 2004, representing a strong reduction from the 12.5% of 2002;

2. increased by 26.5% the nominal interest rate *Selic* [3] to combat the inflationary threat;

3. raised from 3.75% to 4.25% of the GPD the target for the primary surplus of the public sector in 2003;

4. submitted to the appreciation of the Congress two Constitutional Amendments, (PEC) subsequently approved, referring to the social welfare and to the tax system.

These structural reforms defined in greater details in an official document of the General office of Economical Politics [SPE (2003)], can be resumed as follows:

In the case of the social security system reform, the taxation of inactive recipients was approved: the lowest age for the retirement was set at 55 years for women and 60 for men. With this reform, the federal government expected to increase the social security contributions and, therefore, the total revenues.

In the case of the tax reform, the government has tried to reduce budget rigidity: On

[1] A Brazil's security for private investment
[2] Inflation is measured by the IPCA index, calculated by the Brazilian Institute of Geography and Statistics(IBGE)
[3] Interbank rate target set by the Central Bank (BCB)

the revenue side, portions of the earmarked revenues at federal level have been "de-earmarked" in an arrangement now called DRU (Withholding federal earmarked revenues) allowing the government a certain edge of maneuver in order not to be so limited by the weight of the limits;

The tax on financial transactions (CPMF)[4] of 0.38% was extended to 2007. And, in addition, a change was implemented in the tax for the financing social security (COFINS) [5] to substitute the turnover tax by the tax of the added value, which represented a powerful increase in tax revenue from the date of its introduction to 2004.

3.1 The First results at the end of 2003.

There is no doubt that the continuity and the elevated degree of orthodox economic policies restored the IMF and the international financial community's confidence in Brazil. This confidence was seen translated in the dizzying fall of the "*Risco-Brasil*" and in the return of the inflow of short term capital. Also, the end of real currency speculation, and the consequent large increase in the value of the titles of the foreign debt (C- Bonds) in the international market.

Other results of the economic policies, in this first year of mandate, can summarized as follows : on one side, the inflation rate, measured by the IPCA[6] of the IBGE, closed 2003 at 9.3%, (in spite of having been below two digits, it exceeded the inflation target of the government, that was 6.5%); on the other hand, the growth of the GDP - which can be defined as the market value of final goods and services newly produced within a nation during a fix period of time - was expected at the end of 2003 for a rate between 2 and 3%; however it was, actually, negative (-0.2%). In fact, the GDP might not be different, it will be been considered the fall of the investments in the Brazilian economy on recent years. As a result, the ratio of investments/GDP which was on the order of 22.5% in the half of the

[4] To close the financing gap of the ever increasing social security expenditures, the government created a new contribution, the CPMF, which has become a very important source of revenue for the federal government.
[5] Contribution level on revenues and sales for social security
[6] Broad consumer price index

decade of 90, reached 17.0% at the end of 2003.

Within this scenario, the basic interest rate of the economy, that was already high at the end of 2002, was raised more in the beginning of the new government. As a function of that, in 2003, to an annual average rate was on the order of 23%, while the average real interest rate was were still around 12.5% for the year, i.e., an extremely high rate conjured to the national patterns.

As a consequence of the fall of the investments and of the cooling of the economy, the average rate of unemployment broke the record: 12.3% in 2003. Thus, the fiscal policy in Lula's first administration maintained untouched: the primary surplus regarding the GDP increased from 4.0% in 2002 to 4.3% in 2003. In other words, this vigorous fiscal agreement to pay the cost of the interest rate was obtained by decreasing funding for investments. However, not even that was sufficient to stabilize the ratio of the net public debt to GDP, which increased to 56.5% in 2002 and to 58.7% in 2003.

3.2 The Fiscal Policy between 2004 and 2006 and the impacts of Financial Debt.

The hardening of the orthodoxy of macroeconomic policies caused the fiscal policy to become a basic factor for stabilizing prices. In the academic and political environments, spreading the idea that fiscal solvency was an important target of the agents 'expectations, positively influenced their decisions.

The ratio between Public Debt and GDP became, then, the principal reference to indicate the future nature of the fiscal situation. This reference consists of maintaining the current policy aimed at generating primary budget surpluses in the neighborhood of 4.5% of GDP. Thus, this ratio is important to bring the public debt-to-GDP[7] ratio to a level that is acceptable to the markets and consistent with the amount of "debt intolerance" faced in Brazil.

[7] Countries with a high GDP have relative more resources available to pay the principal and the interest on the government's bonds, a useful measure of government indebtedness is the quantity of government debt outstanding divided by the GDP, or the debt-GDP ratio.

In addition, according to Biasoto (2003), the consolidation of the primary surplus as the main action of fiscal policy was based on two elements meant to structurally change the behavior of the public Brazilian sector. The first element concerned the promise of the federal government in promoting the policies that were necessary to reach the established targets, such as, maintaining the revenue of some taxes, including the CPMF and COFINS.

The second element was connected to public expenditures. The DRU (Withholding federal earmarked revenues) allowed the fiscal administration to release resources that, according to constitutional law, would have a specific destination of expense, especially in education and health. In this way, the Union was forced to get 20% of the total amount of revenues with taxes and contributions; however it had higher freedom in driving the fiscal policy.

The introduction of "structural reforms" and the adoption of strict fiscal rules which were inhibiting the discretionary action of the economic authorities provoked alterations in the structural dimensions of the public budget. Among them, Gentil (2006) points out:

1. The Annual Budget Guidelines Law (LDO) represents the forecast for the next three years of revenue. However, if the first year the revenue target has not been met, it mandates a cut in expenses in order to guarantee the fulfillment of the surplus primary target;

2. The Fiscal Responsibility Law (FRL) defined, fixed and standardized rules of fiscal agreement for three levels of government (union, states and local). This law limited the current expenditures, made difficult the realization of public investments and restricted the generation of new expenses within the public sector. Additionally, it imposed the compensation of any resignation of receipts and it induced getting primary surplus target for reduction the public debt;

3. The Tax Reform, connected to the Constitutional Amendment, PEC 42/2003, was intended to rationalize the system of taxation in four aspects: balanced the legislation of the VAT[8], contributing to reduction in the means of fiscal escape; extended

[8] Value aggregate tax

the DRU; reformed the CPMF, which would be expire in 2004 and changed COFINS into a taxation on the added value, instead of a system of cascading taxes.[9]

During Lula's first government (2003 -2006), all the public expenses were specially restricted by the Fiscal Responsibility Law (FRL). As a result, the tax burden expanded from 24.43% in early 1990s to 41% in 2004. The primary result became progressively positive starting from 1999. The generation of growing primary surplus was necessary to compensate the high expenses with nominal interest rate of public debt. This way, in 1999, the public debt reached a primary surplus of 2.92% of GDP, whereas it reached the peak of 4.35% in 2005.

Meanwhile, the strict monetary policy[10] of the period resulted in an increase in the cost of public debt and, thus, contributed to its growth. So, the policy of high interest rate, combined with the excessive tax burden and the low level of public investment, caused negative impacts on output and income and resulted in recessive macroeconomic environment.

The primary surplus target was not enough to compensate the effects of the high interest rate. According to Gentil (2005):

"The fiscal adjustment would not be reached by the generation of primary surplus compressing expenses and increasing the tax burden, once that effort doesn't correct the financial problems that are unchained starting from the strict monetary policy. (...) the increase of the fiscal effort (...) doesn't have any effectiveness, it is mining the joined demand, provoking severe recession and it is socially undesirable ". (Gentil, 2005, pp. 26).

From 2004, a reduction of the total public debt was motivated by: (1) the appreciation of the domestic exchange rate, which was caused by the liquidity in the international financial market; furthermore, it not only reduced the external debt, but also the internal debt connected with the dollar; (2) amortization of duties to multilateral organizations and (3) increase of the international reserves by gain in international trades.

[9] On the tax revenue side, since the early 1980s, the cascading taxes have recovered importance, combined with the expansion of the social security system and progressive improvements in income taxation on the direct tax side.

[10] The Central Bank (BCB) regulated the money supply of the financial market, reducing its credit. See Andrew ABEL& Ben BERNANKE," Macroeconomics – Fifth edition", 2005, Chapter 9

(Gentile,2006). In 2005, the external debt dropped 2005 by 2.3% of the GDP, whereas the internal debt grew in 2005, causing the rise of the internal interest rate.

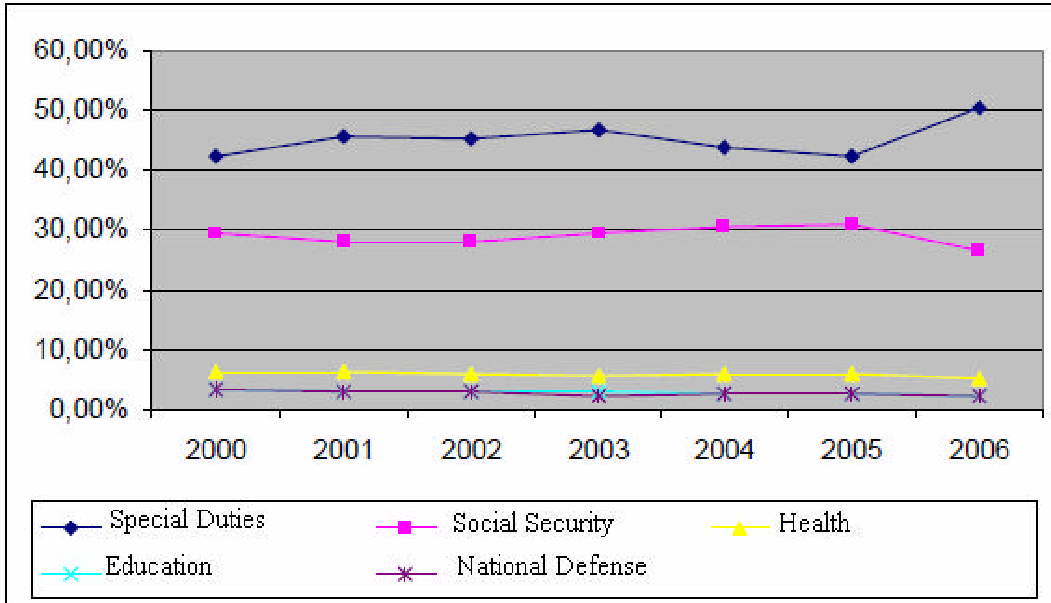
In addition, from 2002, had an improved the management of the public debt; the participation of the external debt linked to the exchange rate was strongly reduced. On the other hand, the participation of the fix-rate headings grew. Both diminished the exposition of public accounts to the market risk. However, the *Selic* interest rate still constitutes the majority of the federal public debt (more than 40% of the total amount), which ruins the financial conditions of the federal government by the adoption of high interest rate policy.

3.3 A descriptive analysis of the federal public expenses and tax revenue

Between 2000 and 2005, the federal public expenses was nearly R$ 621.987 million. However, in 2006, the federal public expense jumped to R$ 826.850 million - an increase of 29% in relation to 2005. The social security benefits represented 31% of the public expenses in 2005.

Some social expenses, such as, habitation, social assistance, sport and leisure increased. However, the expenses with special duties (blue line) grew 53.25% in comparison with 2005-2006. These special duties are the item of the expenditure with bigger participation percentage (which is included in the total payments of public debt). It represents 45.24% of the total of the expenditure in the period between 2000 and 2006. In 2000, the especial duties represented 42.36% of federal public expense and, in 2006, reached more than half of the total expenses (50.35%).

The Social Security Benefits (pink line) represented 29.05%. It grew to 31.06% in 2005; however, in 2006, it dropped to 26.63%, the minor value of the period. With the exception of the Health Program (yellow line), which was 5.85%, all the social expenses represented a lowest point parcel of the total expense as shown in figure 1:



In terms of efficiency or effectiveness, evidence abounds that a sizable portion of Brazil's social spending is ineffectual in reducing poverty. A World Bank estimate found that only 14% of the resources dedicated to social programs in the mid 1990s accrued to the first quintile of the income distribution (World Bank 2001). A study by IPEA estimated that in 2002 the elimination of poverty would have cost R$ 36.5 billion or 2.7 percent of GDP, if perfect targeting were possible. There is also evidence that the available resources in the social sectors are not always utilized in the most prudent and efficient manner.[11]

On the other hand, the expenses with the interest rate and duties of the external and internal debt were the biggest expenses of the federal budget. Furthermore, with the crisis in the international financial market, the primary generation of surplus exceeded 10% of the GPD in 2006.

For tax receipts figure 2 below presents the evolution of the total tax burden of the Brazilian economy over the past 60 years:

[11] An ongoing World Bank study on public expenditure management in health sector has documented widespread weaknesses in public resource management at the states and local governments.

Source: the Federal Revenue Secretariat

Between 1999 and 2006, the Federal union kept 70% of tax receipts, leaving 25% to the states and 5% to the local governments. Moreover, the main amount of these tax receipts was from contributions for social insurance such as INSS[12] and COFINS[13]. The second largest category of tax receipts was from personal taxes which are primarily personal income taxes and property taxes.

In Brazil, more than 70% of the tax receipts come from indirect taxes, which happen on consumption and on production (such as sales tax). Meanwhile 25% falls on the Federal income tax and property tax. Therefore this tax system is highly regressive and unfair; the source of its collection comes from indirect taxes, which do not distinguish the consumers in accordance with their tax-paying abilities.

Figure 3 shows this distortion:

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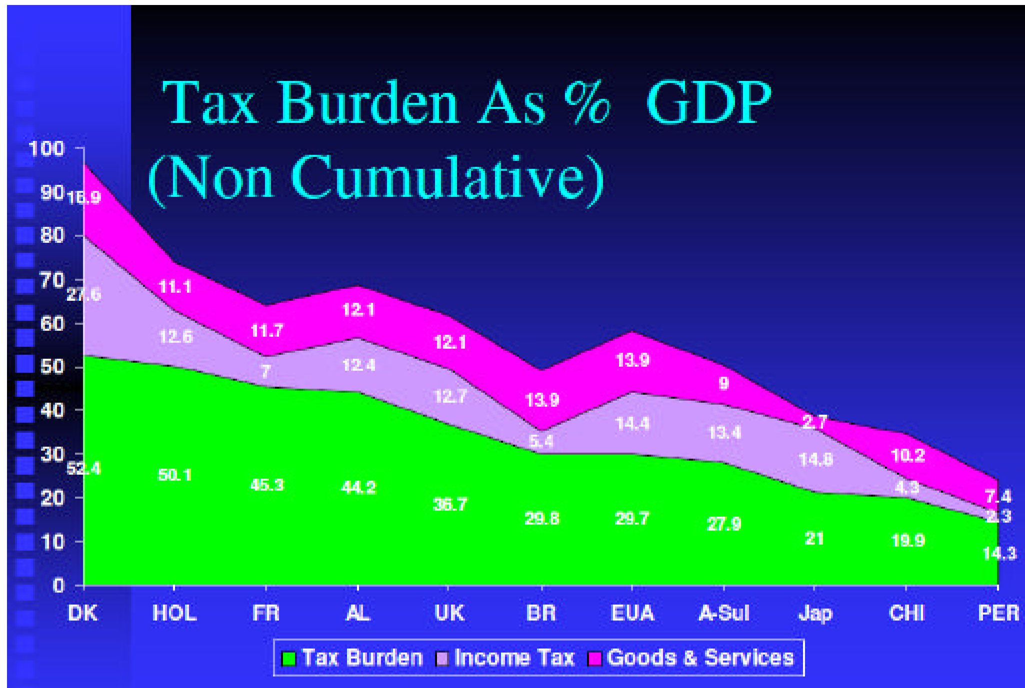
[12] Social security system for private employees

[13] Overall, the factor which explains the increase of these contributions is the need for more resources to finance the social security budget.



Source: the Federal Revenue Secretariat

Brazil's tax burden is extremely high when compared with developed countries, such as Netherlands (50%), United Kingdom (37%) and France (45%), but without the same level of investments in infrastructure. Also, Brazil's tax system is huge complex and inefficient.

Finally, Brazilian tax structure is focused strongly on production taxes (CPMF, COFINS, and PIS[14]) which results in a more expensive product. As a result, the same product in the international market does not face this tax burden and, therefore, it becomes this product in Brazil less competitive than the similar imported.

[14] Contribution levied on general revenue (financing for the FAT)

4. Policy recommendations

Brazil's progress in strengthening the institutional foundations for macroeconomic policymaking within these four years is unquestionable, delivering historically low - and falling - rates of inflation and entrenching fiscal responsibility. However, the public debt-to-GDP ratio remains high, and the fiscal adjustment has been achieved predominantly through revenue hikes, rather than a retrenchment of current expenditure commitments.

The main policy challenge in the macroeconomic area is, hence, to improve the quality of the fiscal adjustment that will be needed to further reduce the public debt overhang, paying the way for alleviating the tax burden over the long run, which is high by emerging-market standards. In doing so, the authorities will be taking the necessary steps to fulfill an important framework condition for sustained growth, while at the same time freeing, such as, the monetary policy from the constraints that currently impede a faster reduction in real interest rates. Given the composition and the average maturity of the traded public debt stock, despite recent improvements, only a sustained reduction in indebtedness will make the economy more resilient to shocks and permit the channeling of domestic saving to finance growth-enhancing investment in the private sector. Meanwhile, fiscal policy is likely to be more stabilizing in a low-debt environment, allowing the automatic stabilizers to work unimpeded over the business cycle, lending to lower macroeconomic volatility.

4.1 Improving the quality of fiscal adjustment

A sustained reduction in public indebtedness depends on the containment of current expenditure commitments. This is a particularly important in the case of social security, given Brazil's already high level of public spending on pensions against the background of a relatively young population. Because outlays on pension paid to private-sector workers account for about one-third of federal primary spending, there is much to gain from further

parametric changes in the social security system, while recognizing that most benefits of reform will materialize only over the long term. Nevertheless, progress has been made in this area, such as, the reform of the minimum pension and the minimum wage, which the National Congress is working to change the law. Another reform options should include introduction of a minimum retirement age in the regime for private-sector workers, preferably the same for males and females; and an increase in the period of contribution for old-age pensions.

The containment of current expenditure growth, which is essential for raising government saving, would benefit from the introduction of an expenditure cap in the fiscal rule. The inclusion of a ceiling on federal primary current expenditure in relation to GDP in the 2006 and 2008 budget Guidelines Law (LDO) was a considerable step forward. It signaled the authorities' commitment to tackling this problem. The ceiling was maintained in the draft 2007-09 LDO, submitted to Congress in May 2006, which calls for a small reduction of 0.1 % of GDP in federal current spending in 2007 relative to 2006 to 17.6 % of GDP. A cap on non-wage benefits paid to civil servants and restrictions on the creation of new careers in the civil service were also included in the draft 2007-09 LDO. It would be advisable to keep these ceilings in the 2007-09 and in the 2007 budget law, when approved by Congress, because these measures reflect an on-going effort on the part of the authorities to arrest the rise in this category of spending, which has accounted for most of the increase in primary expenditure in recent years.

In addition, the option of re-defining the expenditure cap in nominal terms, rather than in relation to GDP. Could be more considered, because inflation is now well anchored around the target. In any case, the introduction of an expenditure ceiling consistent with a more ambitious, yet attainable, retrenchment of current outlays would be advisable in the draft 2008-10 LDO, to be submitted to Congress in mid-2007.

At the same time, the need for alleviating rigidity, which is noticeable in Brazil, should not be underestimated. Budgetary flexibility is essential for durable retrenchment. Also, it may allow for a reprioritization of budgetary allocation in favor more cost-effective programmes, such as those focused on improving human and physical capital accumulation. Ideally, policy should be focused on the gradual reduction of revenue

earmarking and the elimination of aggregate minimum spending floors, a task that would require a considerable legislative effort, including through amendments to the Constitution. A comprehensive assessment of existing revenue earmarking and mandated spending requirements against the achievement of their intended policy objectives would be an important first step. Thus, the mechanism for withholding part of the earmarked spending at the federal level (DRU), should be extended beyond 2007, when it is due to expire, preferably for at least another four years. The withholding coefficient, currently at 20% could be raised to 30% and subsequently reduce as the policy effort to reduce expenditure rigidity yields results. It should be recognized that this measure would not tackle the root causes of budget rigidity, but would be instrumental in facilitating fiscal management until further structural reform comes to fruition.

A reduction in the tax burden would be appropriate, but only once the public debt-to-GDP- ratio has been lowered in a sustained manner and the ratio of current expenditure to GDP has been stabilized. Brazil has a high tax-to-GDP ratio for a country of its income level, and a sustained alleviation of the tax burden, which has risen over time, would render fiscal policy more growth-enhancing. In addition, tax policy could be geared towards minimizing the existing distortions in the tax code. The experience of gradually converting the cascading the federal taxes on enterprise turnover- PIS and COFINS- into value added taxes since 2002 has yielded positive results. On the other hand, efforts to make the state-level VAT (ICMS) legislation homogeneous across the states, with uniform rates and bases, would be essential to reduce predatory tax competition among the states, which has arisen from use of the ICMS as an industrial policy instrument by the states. The option of subsequently replacing the ICMS and the federal VATs (PIS/COFINS and IPI) by a single VAT could be considered in future tax reform.

4.2 Strengthening public debt management

Considerable progress has been made to date to reduce the public debt's exposure to exchange-rate risk. Favorable international financial conditions have facilitated this task, coupled with Brazil's impressive external adjustment in recent years, which has been

buttressed by sustained high foreign trade and current-account surpluses. Public debt management should now focus on consolidating these gains, while working towards increasing the share of fixed-rate and inflation-indexed in the public debt stock. It would be recognized that an increase in the share of fixed-rate securities when the policy interest rate is coming down could raise future debt service costs. However, these costs are likely to be outweighed by the longer-term benefit of improving the composition of the outstanding domestic debt.

A recent effort to reduce the tax burden on foreign investment in the domestic fixed-income and equity markets is laudable. It can make for a reduction in the cost of debt re-financing and an increase in the average maturity of the debt cost. This is important because previous attempts to reduce reliance on floating rate securities have been constrained by a composition-maturity trade off: demand for fixed-rate instruments tends to be strongest for relatively shorter maturities. Acceptance of long-dated, fixed-rate instruments denominated in *reais*, rather than indexed to the exchange and the policy interest rates, is the ultimate test of confidence in the policy framework. Steps should also be taken to create a yield curve for real-denominated bonds in foreign markets, financial conditions permitting, and to foster the development of hedge instruments for investment in long-dated securities as a means of facilitating risk management and boosting liquidity in this market segment.

On external public debt management, the authorities should continue to unwind their outstanding liabilities. The announcement in February 2006 of the intended buyback of up to USD 20 billion of sovereign liabilities coming due by 2010, including the Brady bonds, was welcome, as well as the early repayment of debt to the International Monetary Fund (December 2005) and the Paris Club (January 2006). As a result of these operations, the stock of net external public debt (taking international reserves into account) declined from 7.5% of GDP at end-2004 to 2.6% of GDP at end-2005 and about 0.5% at end-April 2006. Consistent with this strategy, the National Treasury Secretariat(STN) announced in early June its intention to buy back up to USD 4 billion of sovereign bonds denominated in USD and EUR maturing during 2007-30, while setting a maximum clearing spread as a means of improving confidence in their ability to maintain a liquid market for those bonds. This debt-reduction strategy is a sensible use of Brazil's large external current account

surpluses and is complementary to the on-going effort to reduce the exposure of the public sector's debt to exchange-rate risk, including through the retirement of domestic indexed to the exchange rate.

At the same time, greater access by foreign investors to the domestic fixed-income market, as discussed above, should facilitate the exchange of external bonds for a range of domestic fixed-rate securities, which should contribute to lengthening maturities and reducing refinancing costs. The authorities would be advised to increase the debt buyback programme, should market conditions improve further.

A durable reduction in public indebtedness would serve to facilitate a swifter fall unreal interest rates and to permit the channeling of domestic saving to finance growth-enhancing investment. It would lay the groundwork for removing distortions in the tax system, including by broadening tax bases, and is likely to result in better credit ratings for the sovereign and a reduction in country risk. An analysis of Brazil's latest sovereign credit upgrades and downgrades suggests that the authorities' efforts to reduce external vulnerability, benefiting from the still auspicious global financial environment, are warranted. But further progress in needed in fiscal consolidation because Brazil's public debt-to-GDP ratio remains above-average in comparison with the other sovereigns in Brazil's credit class. Attainment of investment grade for Brazil's sovereign debt placements will, therefore, be the ultimate reward for fiscal consolidation.

Once the composition of the traded domestic debt stock has improved further and the share of floating-rate securities has been reduced, the option of targeting the headline budget balance, instead of the primary budget surplus, should be considered. Despite progress in recent years, fiscal policy remains overly sensitive to the monetary stance and short-term developments in financial markets because floating-rate securities account for the lion's share of the traded debt stock. Under the circumstances, a fiscal rule that targets the primary budget surplus excludes from the assessment of fiscal performance the short-term impact of monetary policy on public finances. But the public debt dynamics depends ultimately on trends in the headline budget balance over time. As a result, a fiscal rule that targets the headline balance would allow for a direct link between fiscal performance and debt sustainability.

Thus, to make this policy option operational, a target for the nominal budget balance could be set and the corresponding primary surplus could be calculated (and enshrined in the three-year LDO and the annual budget laws) on the basis of market projections for GDP growth, inflation and monetary policy parameters. The use of market, rather than government, projections to set these key macroeconomic parameters would strengthen credibility in the policy regime. However, it should be recognized that a change in the target would need to be communicated clearly and transparently to the public to avoid any loss of confidence in the fiscal regime.

Meanwhile, the primary budget surplus target could be re-defined as a floor, at least for the central government. This would allow higher-than-targeted primary surpluses to be saved and used to retire debt, when economic conditions permit, instead of financing further increases in expenditure. Another consideration is that the accumulation of primary budget surpluses has traditionally been frontloaded within fiscal years. This is essentially due to prudence in financial management as a means of ensuring that unforeseen circumstances towards year-end, including revenue shortfalls and weaker-than-expected fiscal performance at the sub-national government level, such as, do not put the achievement of the consolidated fiscal target in jeopardy. As a result, when these contingencies do not materialize, attainment of the fiscal target leads to sometimes undesirable fiscal expansions towards the end of the year. The possibility of savings these above-target balances would, therefore, facilitates financial management within the year.

Finally, an additional important policy question concerns the level of the inflation rate to be targeted by the central bank over the medium term. The current target of 4.5% was maintained for 2007-2008 by the National Monetary Council (CMN), as well as the + 2 percentage-point tolerance band. It can be argued that stability of the inflation target over the next years, following a path of targeted disinflation since 2003, could contribute to lower volatility in the monetary stance and to consolidating the disinflation achieved to date. However, although the 4.5 mid-point of the inflation target is not too high by emerging-market standards, this is not in case of the ceiling of the tolerance band, currently at 6.5%. Over time, once actual and expected inflation has been safely anchored at the current level, the monetary authority could pursue a narrower band around a lower mid-point.

4.3 Summary of Recommendations

This chapter's main policy recommendations are present in box below:

Improve the quality of fiscal adjustment

1. Implement further parametric changes in the social security system
2. Redefine the expenditure cap in nominal growth terms, rather than in relation to GDP.
3. Increase budget flexibility by gradually reducing revenue earmarking and eliminating aggregate spending floors.
4. Extend the withholding federal earmarked revenues (DRU) beyond, preferably for another four years, and consider the option of raising the withholding coefficient to 30% of share revenue.
5. Make the rates and bases of the sate-level VAT (ICMS) uniform across the states.

Strengthen public debt management

1. Foster the development of hedge instruments for investment in long-date securities as a means of facilitating risk management and boosting liquidity in this market segment.
2. Continue to reduce external public indebtedness when market conditions permit.
3. Consider the option of targeting the nominal budget balance. The corresponding primary surplus could be calculated (and enshrined in the three-year LDO and the annual budget laws) on the basis of market projections for GDP growth and inflation.

4.4 The future of fiscal sustainability

In this relatively favorable economic environment, which are the most important challenges ahead for Brazil's public finances? After four years of structural and fiscal adjustment, there is still a need to consolidate the progress achieved so far by strengthening

the fiscal institutions and improving the quality of fiscal adjustment in support of higher, sustainable economic growth. In case of Brazil, four challenges seem to be particularly relevant: restoring confidence in the public debt, increasing public savings, deepening the social security reforms and reducing the tax burden. Achieving these objectives would create room for reducing interest rates and maintaining low inflation target, which would foster investment and growth. Meanwhile, there is a need to improve the quality of fiscal adjustment by containing public current expenditure, increasing public investment and reducing the tax burden on the private sector.

Restoring the government's creditworthiness

Even considering that gradually reducing the gross public debt-to-GDP ratio is a sensible strategy to restore credibility, a more ambitious policy objective should be considered. The combination of an additional small increase in the primary budget surplus and a gradual decline of the interest burden, without an offsetting increase in expenditure, would allow the authorities to carry out an aggressive liability management strategy by retiring debt, increasing the average maturity of the debt stock and reducing foreign-exchanged period of falling debt-to-GDP ratio would have tremendous implications for reducing country risk and lengthening private investment horizons.

Increasing public saving

Low public saving contributed to aggravating Brazil's relatively low domestic saving rate. Maintaining growth rates of more than 4% per year will require a substantial increase in domestic saving, and the government will need to make an effort to cut down its current expenditure to finance more public investment in infrastructure. This change in the composition of government expenditure in favor of capital outlays would deliver a significant improvement in the quality of the fiscal adjustment accomplished so far.

Deepening the social security reforms

Despite the reforms implemented by Lula administration, social security entitlements carry on to be relatively generous from an international perspective, putting upward pressure on government expenditure. Thus, containing social security expenditure by curbing the increase in the value of benefits is a necessary condition for maintaining fiscal prudence over the years. A minimum retirement age for private-sector employees, preferably the same as that already in place for public-sector workers, and changing the eligibility conditions for retirement for women, are likely to be part of the agenda of reform over the next years.

Reducing the tax burden

As the government successfully contains the increase in current outlays and improves the quality of public expenditure in the years to come, it will have to cut back to some extent Brazil's tax burden to promote job creation and growth. Brazil's tax burden is considerably higher than that of other emerging countries, which are typically lower than 20% of the GDP, such as Chile (17%) and Mexico (18%). Brazil's tax burden is comparable to that of developed countries, such as Germany (36%), United Kingdom (37%) and Canada (35%), but without the same level of public services and economic infrastructure. Reducing the tax burden is the first step for improving the quality of fiscal adjustment, which has so far relied more on tax increases than containing expenditure. This will by no means be an easy task, which is related to the more fundamental policy question about the appropriateness of the size of the public sector and the quality of its services and economic infrastructure.

5. Conclusion

The changes in Brazilian economic policies have shown an unequivocal, and as everything suggests, irreversible tendency to reinforce the role of fiscal austerity in stabilizing the expectations of financial agents. In 2004, when President Lula's newly-elected government faced major challenges, there was severe concern (reflected to the "*Risco-Brasil*" being 2300 points after his election in September 2002) regarding the commitment of the Government to fiscal stability; Brazil has relatively low foreign exchange reserves and was thus vulnerable to external shocks; and it was unclear how the government would develop programs to meet its election commitment of attacking inequality. After the first four years, Brazil's progress has been impressive in terms of meeting these challenges. The country's fiscal outlook, debt situation and fiscal sector health are far different than they were before first Lula's administration. The government has consolidated the country's commitment to fiscal responsibility, with the "*Risco-Brasil*" down about 200 basis points. Furthermore, on April 30, 2008, Brazil has obtained an investment grade rating from Standard & Poor's, opening the way for a further acceleration of investment. In September, 2009, Brazil has obtained the investment grade from Moody's agency.

Brazil's international reserves have grown to $190 billion, sufficient to cover 18 months of imports and 280 percent of short-term foreign debt. The commitment to a high primary surplus and improvement of debt management along with reduction of the debt/GDP ratio has been systematically achieved. It has thus helped to compensate the strong volatility in the exchange rate and the chronically high levels of interest rate to the domestic public sector debt pile.

The fiscal measures adopted by the central government have not limited to handling of the classical instruments of fiscal adjustment, such as a (higher) increase in the tax burden, a (smaller) squeeze on spending and (last) control at the "cash till", but have also included a (severe) restriction of sub national government and indirect administration entity indebtedness.

Structural changes at fiscal institutions have had a leading role, with perhaps even

efficacy than the short-term measures adopted - The size and the functions of the state have been radically altered, through the privatization of a large part of the state productive sector, the near extinction of individual state financial institutions and the significant progress in the concession of services to be exploited by private initiative, without counting the balancing of contingent liabilities (the so-called “skeletons”), the renegotiation of the state and local debts by the National Treasury Secretariat (eliminating the possibility of debt defaults) and the implementation of a new standard of planning and control of public finances.

On the other hand, given the apparent absence of a solid consensus, a first step must be construction of a political agreement among key factors as to the direction of the country’s fiscal policy. In-depth debates about the need for and the desirable content of specific reform measures such as social security reform are absolutely necessary. But, it may also beneficial if the country had an institutional arrangement that fostered such policy debates with both macro-fiscal and sectoral implications of a given proposal taken into account. Once in place, such a framework would allow policy-makers to manage inevitable fiscal and policy trade-offs in a rational a manner as can be expected.

Another crucial point, the Fiscal Responsibility Law (FRL) achieved the consolidation of a whole process of rearrangement of public accounts at the three levels of government with a great impact on their inter-temporal sustainability. This law requires that the government include an annex on fiscal targets to its LDO bill. The main fiscal target is expressed in terms of primary surpluses for the three years including the budget years. The annex discusses implications of a given level of primary surplus target for other key fiscal variables, namely the ratio of net consolidated debt to GDP, based on certain macroeconomic assumptions. On the other hand, the FRL rules - the level of personnel expenditures and the level of net consolidated debt - seem to be effective in restraining government behavior. However, the apparent effectiveness of these rules may depend on factors, some of which lie outside the FRL itself. For example, the fact that these expenditure and debt ceiling are expressed in terms of a share of the net current revenues means that the governments can meet the required levels by either reducing the numerator (personnel expenditures or net consolidated debt) or by increasing the denominator (net current revenues). This gives the governments somewhat greater flexibility. In other words,

the federal government needs to keep in mind the importance of following the strict FRL to maintain to control the public expenditures within the three levels of government.

Moreover, the dimension and the depth of the fiscal adjustment carried out, need however to provide space for the revision of some of the existing practices and rules in order to avoid transforming short-term rationality into long-term perversity. One needs to be careful to avoid transforming measures that are necessary to deal with an emergency crisis into permanent rules, without first evaluating the structural elements of the different realities of the economy.

In addition, the international experiences, suggest that a fiscal adjustment in the short-term tends to affect public spending on fixed investments in a disproportionably severe manner, and the study of the Brazilian case shows how this practice can be taken to its limits. Some countries manage to ensure that, for a number of reasons, the private sector is able to substitute the public sector in carrying out a lot of the investment. In other cases, generally in countries with larger and denser economies, the lack of transition avoids global investment from getting to adequate levels.

It should be of greater interest to Brazil than to other countries to define a new agenda for debate that can focus on the format of fiscal adjustments and the solutions that can, at the same time, maintain the achievements of fiscal order and permit interventions in areas where private insertion is still weak, in such a way as to stop the formation of bottlenecks to the balanced growth of the productive structure.

In summary, in the case of the Brazilian economy, the depth of the adjustment carried out and various elements of a conceptual nature, such as the coverage of the concept, the formatting of the net debt pile, intra-public sector accounts, amongst others, offer space for a broader reflection, to search for alternatives that do not break the fundamental concepts of fiscal policy, but allow for a leveraging of public sector investment in greater volume and at the fastest pace possible. Concluding, this paper defends different theses for exact alterations in the structure of fiscal policy, which could, without detriment to austerity, be reread in the context of a long-term adjustment.

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7. Glossary

Abbreviations and acronyms

BCB - Central Bank (Central Bank of Brazil)

COFINS - Contribution levied on revenues and sales for social security

CMN – National Monetary Council

CPMF – Provisory Contribution on Financial Transactions

DRU - withholding federal earmarked revenues

FRL – Fiscal Responsibility Law

GDP – Gross domestic product

IBGE – Brazilian Institute for Geography and Statistics

ICMS- State value added tax (tax goods and only services about communications and transportation between cities)

IPCA – Broad consumer price index

IMF – International Monetary Fund

INSS – Social Security system for private employees

LDO – Annual budget guidelines law

PIS –Contribution levied on general revenue (financing for the FAT)

Risco-Brasil – A Brazil's security for private investment

SPE – Economical Politics Secretariat

STN – National Treasury Secretariat

SELIC – Interbank rate target set by the Central Bank (BCB)

VAT – Value aggregate tax