MINERVA PROGRAM

THEORY AND OPERATION OF A MODERN NATIONAL ECONOMY

The Treasury of State of Rio Grande do Sul: New functions and their consequences for the fiscal adjustment process

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GRAPHS AND TABLES INDEX

INTRODUCTION

This paper presents the structure and activities of the Expenditure Department and how they changed in a period of fiscal adjustment of State of Rio Grande do Sul (RGS) from 2007 to 2010.

It is organize into five chapters: the first describes the situation of state finances and how former governments managed to deal with the structural deficit. Following it, the second chapter presents the origins and structure of the former RGS Expenditure Department. The third presents the fiscal adjustment process that has taken place since 2007 and the main measures that contributed for it to succeed.

Chapter four is about the new functions of the Expenditure Department and the process that transformed it into Treasury Sub secretariat. In this chapter the new diagram is presented. The final chapter shows some theories about fiscal policy and competitiveness.

In conclusion, it will summarize the importance of the Treasury for the Fiscal Adjustment in State of Rio Grande do Sul and the most important functions that need to be covered for a modern Treasury. It does not cover functions related to monetary policy because it is out of state level control.

The method will consist in a review of articles, books, legal and administrative reports, produced by Treasury Staff and external consultants, documents and law analyses, charts and tables with official data of RGS finance will be presented.

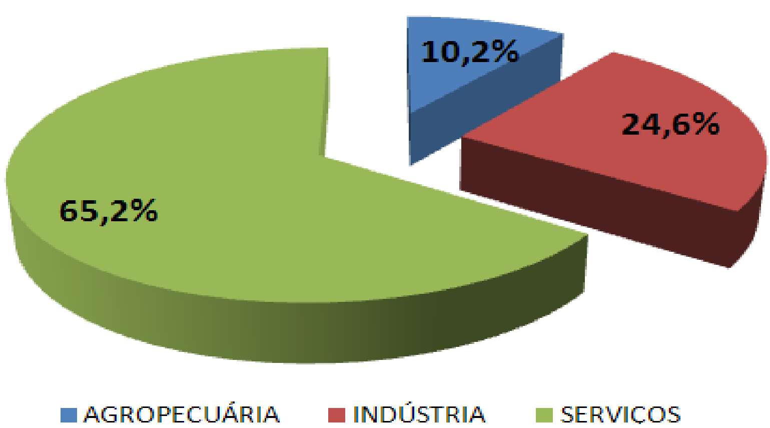
CHAPTER I – FINANCE OF STATE OF RIO GRANDE DO SUL

The state of Rio Grande do Sul (RGS) is the southernmost state of Republic Federative of Brazil. This geographic location means a lot about the way that this particular state operates, many times in opposition to the central government. The citizens call themselves “Gauchos” and they have some customs very similar to the borders countries: Uruguay and Argentina. The state’s history involves a revolution between Rio Grande do Sul and the central government fought over raising taxes. Nevertheless, the Gauchos chose to be Brazilians, fighting for the borders of the country.

a) THE RIO GRANDE DO SUL INDICATORS

The State of Rio Grande do Sul shows a high standard of living in comparison with the others states. For a long time it has developed a kind of welfare state. The RGS population is 10,576,758, about 5.7% of the Brazilian population1 of 185.712.713. The state GDP reached a growth rate in 2010 of 7.8%, slightly larger than Brazil 7.3%. It is the fourth largest state economy in Brazil and the largest in south region. The composition of the RGS economy is shown in the graph below. The industry sector represents 24% and services represent 65% of total production.

GRAPH 1 - STRUCTURE OF PRODUCTION OF RGS



Source: FEE/ Centro de Informações Estatísticas/ Núcleo de Contabilidade Social

The RGS economy is affected by exports, and also by agriculture.

1 Source: IBGE, data 2010, http://www.ibge.gov.br/home/.

The most important industries are carmakers, and also include buses and trucks, harvest machines (70% of Brazilian production), and auto parts (second largest of Brazil). Many multinational companies are locating operations in RGS, such as GM, Dell, HP. The industry of high technologies, such as semiconductors, is developing around the Universities.

The petrochemical and metallurgic industries are well developed in the state economy, and also the traditional sectors have prosperous industries in RGS, like food, furniture, shoes and tobacco. In exports, RGS represents 7.6% of Brazilian exports, the fourth largest in Brazil. In 2008 the exports represented 9.2% of production in RGS, and now, two years later, is reduced to 7%.

The economy of RGS still relies on agriculture, especially on the household incomes. Thus, either drought or flood can seriously damage the economy, as the graph below shows in the year of 2005. The main crops are soy, rice, corn, wheat, grape, apple and tobacco. The agribusiness sector is very developed and that includes the production of milk and meat (pork, poultry, and cattle). Currently, the export sector in Brazil in general has been negatively affected by the real exchange rate appreciation.

The GDP per capita is 12,696 USD (2010), about 17% higher than the national average indicator that is 10,825 USD. The health and education indicators are well above national averages. We can notice that RGS is close to reaching the called demographic bonus, because its fertility ratio is now 1.6. The state capital, Porto Alegre city was two decades ago the fifth largest city of Brazil in population and now is the eleventh.

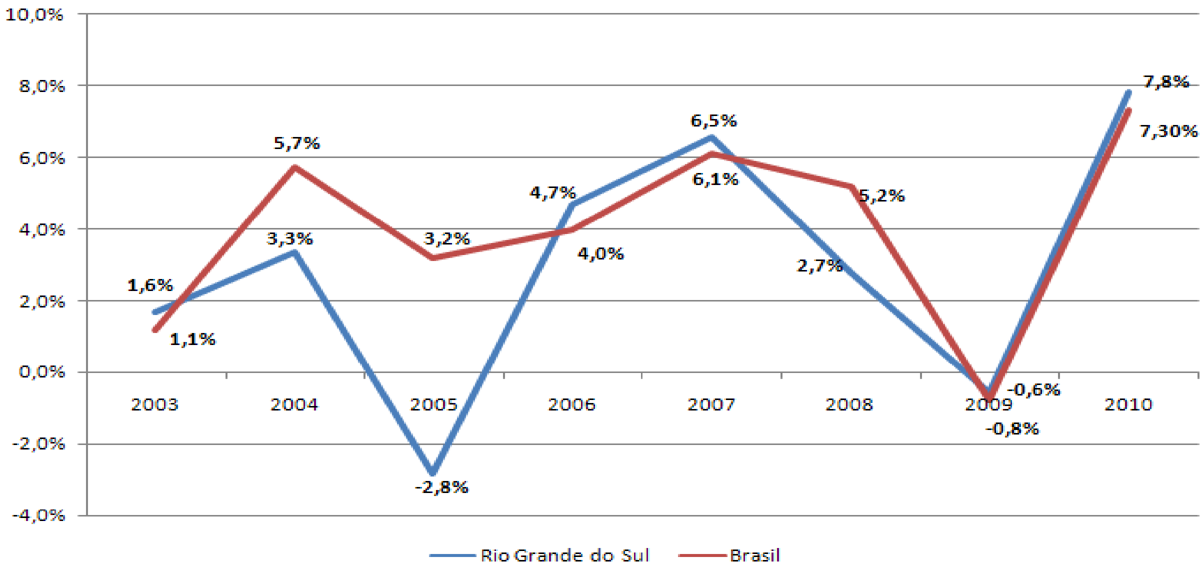
TABLE 1 - RIO GRANDE DO SUL AND BRAZIL SOCIO-ECONOMIC INDICATORS

Indicators (most recent figures)	**RGS**	**BRAZIL**
Population (2010-million)	10.5	185
GDP (2010 - US$ billion)	134	2,01
GDP per Capita (2008 - US$ thousand)	12.6	10.8
HDI (2005)	0.832	0.807
Poverty (2007 % population)	17.1	25.6
Gini index (2005)	0.52	0.56
Life expectancy (2006 - years)	74.8	72.4
Infant mortality rate (2006 - deaths /1,000 live births)	13.9	25.1
Illiteracy (2006 - %)	5.2	10.4
Average years of education (2006)	7.5	7.2
Fertility rate	1.6	2.0

Source: Instituto Brasileiro de Geografia e Estatistica – IBGE

Despite this higher standard of living in RGS vis-a-vis the national level, the RGS' economy has developed below Brazil's growth rate and it has been quite vulnerable to domestic and external shocks. As the graph 2 shows, the economy can be hit by some temporary downturns. In 2005, RGS economy had a serious problem in agriculture because of an extended drought. It shows some dependence of the primary sector. In 2009, the international crisis had a strong negative impact on the RGS economy

GRAPH 2 - RGS & BRAZIL GDP GROWTH RATE 2002-2010



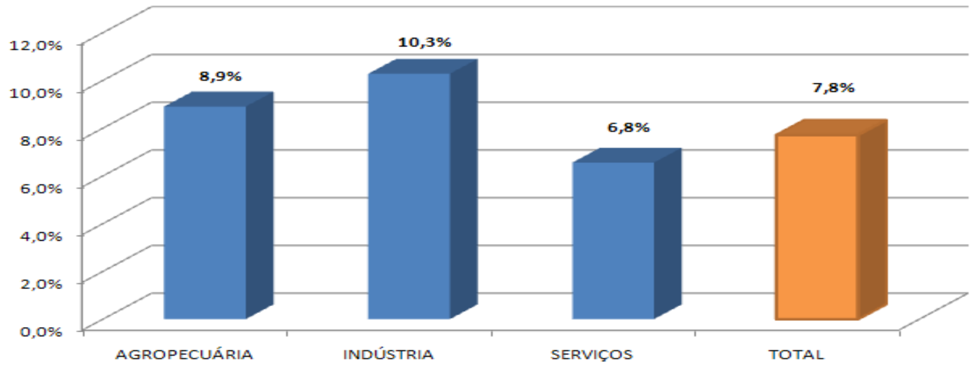
Source: Fundação de Economia e Estatistica (FEE). http:// http://www.fee.tche.br/
Year 2010 forecasts for Brazil Growth (Central Bank)

At the beginning of the decade the RGS economy represented 7.1% of Brazilian GDP and fell to 6.7%. As a developed state we can expect a more dynamic and competitive economy, although the expansion of new frontiers in Brazil Middle West and Northeast certainly will decrease the share of the others states in domestic production. We have to consider the extraordinary performance of RGS (7.8%) economy growth in 2010.

To put it into perspective, the size of the RGS state economy is slightly larger than Peru, Hungary or New Zealand. If the RGS economy were included in the World Rank of economies by size, it would be the 51st economy in that ranking (with a GDP of 134 billion USD in 2010).

The industry and agriculture sectors had an outstanding growth in 2010 as shown in graph 3.

GRAPH 3 - ECONOMIC GROWTH OF RGS BY SECTOR 2010

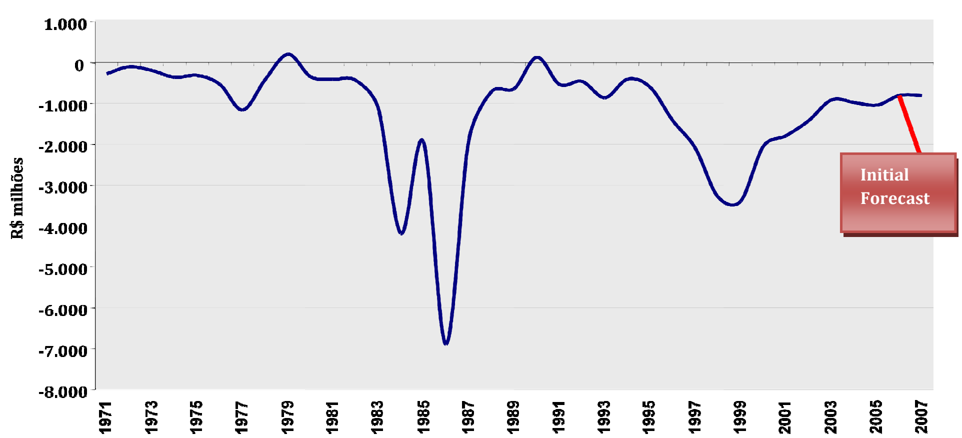


Source: FEE. http:// http://www.fee.tche.br/

b) PUBLIC FINANCE OF STATE OF RIO GRANDE DO SUL

The state of RGS had one of the most dire public finance situations of all of the Brazilian states. At the beginning of 2007, some forecasts indicated a deficit in overall balance superior to 2 billion of reais. The state has been running successive budget deficits over three decades, and the negative results were around one billion of reais in the last three years, that means 0,63% of GDP on average. The graph 4 shows the results of overall balance of RGS state, it includes revenues related to capital transfers and assets. The period in the graph includes the years of 1997 and 1998 which were characterized for privatization of state companies.

GRAPH 4 - RGS`S OVERALL BALANCE RESULTS 1971 – 2007

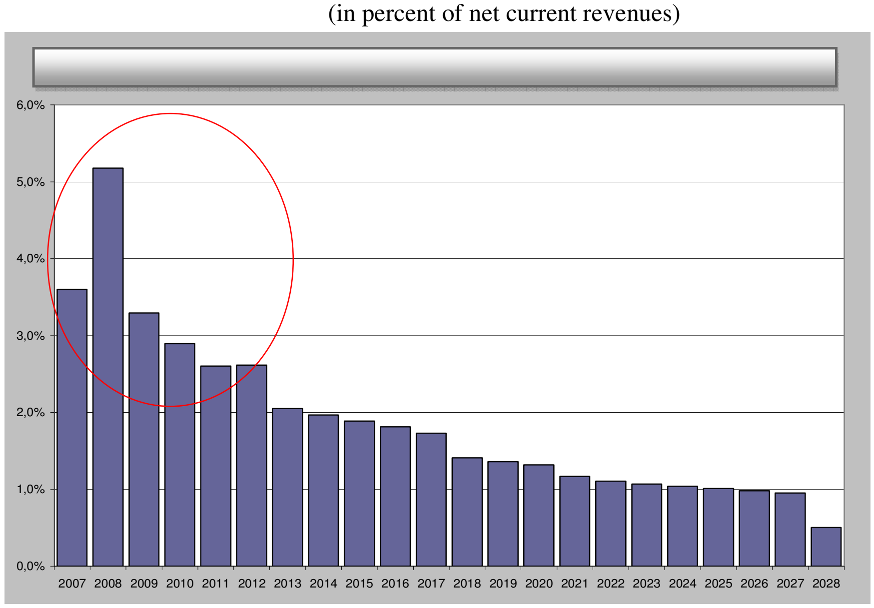


Source: RGS Expenditure Department

Another critical situation has to do with the debt service. In 1997, when the Federal Government established the debt refinancing agreement with RGS state, the state debt was divided in two components: intra-limit and extra-limit. The intra-limit debt, which is all debt covered under the 1997 restructuring program, represents about 90 percent o f the state's total debt. Under the Law 9496, the real interest rate was set at 6 percent, and nominal value of the debt was indexed to index inflation (IGP-DI). The bailout promoted by the Federal Government with Brazilian states in 1997, established a limit of net real revenues (in the case of RGS 13%) that should be paid monthly to the Federal Government2.

The extra-limit debt includes all the remaining debts that were not renegotiated with the National Treasury and any new debt contracted after the debt renegotiation of 1997. According to the Annual Debt Report (2009), the federal government owned 95.46% of the RGS debt. In 2006, the total debt was 36.8 billion of reais (2009 prices) and that means a debt-net current revenues ratio of 2.5, above the limit imposed by the Federal Senate. The external debt was 3% of debt stock in 2006. The service of extra-limit debt would have a peak in 2008 that could compromise the solvency of state, so the fiscal pressure would be rising even more. The graph below shows the amount of extra-limit debt service.

GRAPH 5 – RGS: EXTRA-LIMIT DEBT SERVICE PROFILE 2007-2028
(in percent of net current revenues)



Source: RGS Expenditure Department

[2] The dynamic of the public debt of RGS under this law was analyzed by Nelson Roncarati in a Minerva paper (2010).

The bailout imposed a costly debt with high debt service obligation in intra-limit debt and that added with an inadequate profile of extra limit debt constrains the budget even more. The graph 5 shows a debt trap ahead. This should be removed immediately.

In comparison with other states, RGS presents an uncomfortable situation. The state investment of 4.7% of the net current revenues was the lowest in all twenty seven (27) Brazilians states. Most of the indicators of RGS show a lack in fiscal policy administration, although it presented a primary surplus that was way lower than was required for a balance budget. The result of the overall balance was a deficit of 6.4 percent of net current revenues**.**

TABLE 2 - COMPARISON OF RGS WITH OTHERS STATES – 2006

INDICATORS	%NCR	NATIONAL RANK
PAYROLL TOTAL	67,5	1º
PENSION SYSTEM	31,5	1º
INVESTMENTS	4,7	27º
DEBT SERVICE	12,5	7°
CURRENT EXPENSES	24,0	18º
OVERALL BALANCE	-6,4	27º
PRIMARY SURPLUS	2,2	20º

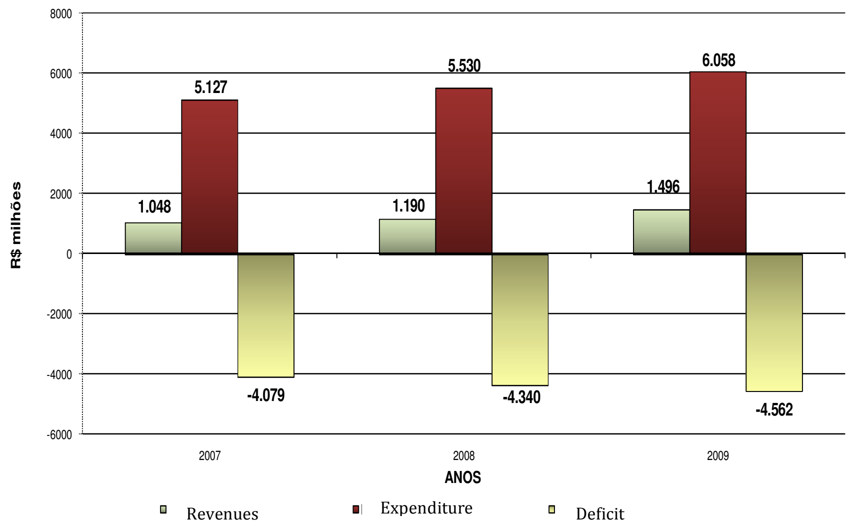
Source: National Treasury Secretariat (STN) – States Balance

On the other hand, the situation was still more delicate because expenditures like pension system and payroll cannot be reduced. The retirement of civil servants is in an increasing process, and the financial complement of the Treasury, to cover the pension system deficit, is around 4 billion of reais per year. The expenses with retired civil servants are almost equal to expenses with active workers in public services. The graph 6 shows a deficit in pension system over 4 billion reais per year.

The RGS state provides a diversified set of services and in order to accomplish this, the state has a large number of entities, among them 24 ministries (Secretaries), 19 foundations, 9 autarky entities, and 7 state enterprises (water, energy, information technology, gas etc.).

This scenario of chronic fiscal imbalances shows a deteriorated ability of the government to execute social and economical policies. The fiscal space has been squeezed by high debt service, high personnel expenditures and the pension and retirement system.

GRAPH 6 – PENSION SYSTEM- REVENUES, EXPENDITURES AND DEFICIT



Source: RGS Expenditure Department

c) RESPONSABILITY FISCAL LAW AND THE NEW FRAMEWORK

In 2000, the Federal Government of Brazil published the Complementary Law 101, on May, 4th. This Complementary Law (LC 101) became known as Responsibility Fiscal Law, and it had in its goals the adjustment of public finance in Federal, State and local level of the government. The LC 101 defines limits and conditions to expenditure with payroll, public debt, loans, and to renounce revenues. That was a turning point in Public Finance in Brazil. The LC 101 brings to Public Administration a roadmap to transparency, and it has been implemented in all levels of Brazilian public administration.

The main points at the state level that concern this paper are the articles 8th and 9th that commands some government action that took place in 2007. These articles define that, until thirty days after the budget publication, the executive power will set the financial programming and the schedule of monthly disbursement execution. If the revenues decrease, which is checked every two months, the powers and the Public Prosecutor will promote by his own act and in the size that are needed, proportionally, some measures to limit their commitments and financial transactions, otherwise the target of primary surplus will not be reached. If the Legislative and Judiciary powers do not promote the limitation, the Executive is authorized to limit the financial transfers.

The LC 101 determines a periodical evaluation of the fiscal targets in a public session of House of Representatives.

Regarding the debt management, the articles 30° (thirty) and the following ones establish several rules on limits of public debt in all levels. The limits are set by the Senate. If one state exceeds the limit, this entity will be forbidden to make new operations. The law prescribes an exception that does not allow the interest refinancing, but also prescribes that primary surplus must be run in order to bring back the level of debt to the limit.

After the currency stabilization (1994), the bailout of States debt (1997) and the privatization process of a large amount of sub national state companies in the end of decade, the Responsibility Fiscal Law, in 2000, completed a new framework that could enforce the process of balancing the finances of the most Brazilian states.

CHAPTER II – THE ROLL OF THE EXPENDITURE DEPARTMENT

The former structure of Finance Secretariat was very peculiar. It was divided in three executive departments: Superintendence of Tax Administration, Superintendence of Finance Administration and Accounting and Audit-General Office and at the same level there were the Budget and Finance Office, and as a support department the Superintendence Administrative[3].

When the reform took place, the Finance Secretariat lost significant amount of power. The construction of the budget was sent to the Planning Secretariat. The procurement and the management of the physical assets were sent to the Administration Secretariat.

a) ORIGINS OF THE EXPENDITURE DEPARTMENT

The structure of the Expenditure Department that took place in 1997 was a patchwork, where former divisions of many Departments were combined in a new department.

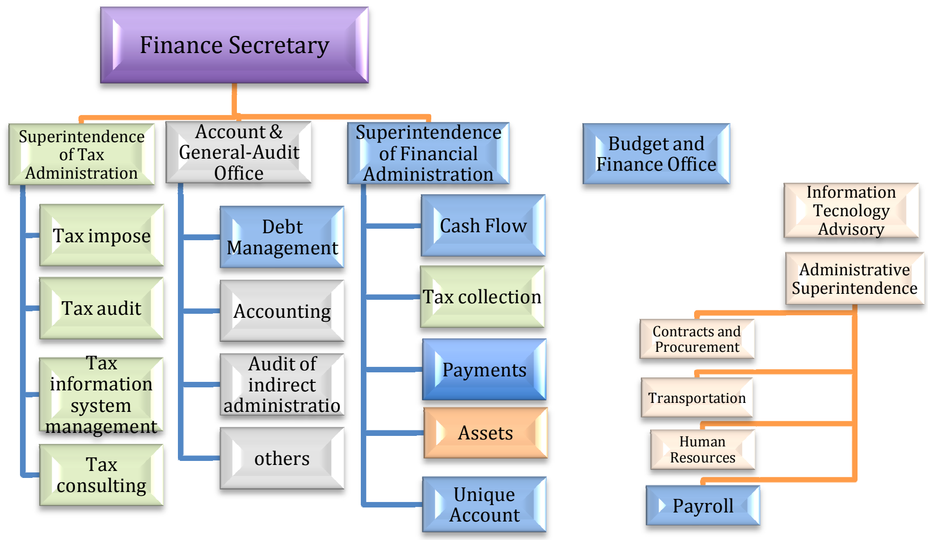
In 1997 the Division of debt management was moved from the Accounting and Audit Office to the Expenditure Department. In fact, the Expenditure Department has been created by mixing the most divisions of the Superintendence of Financial Administration with remaining sectors of the Budget and Finance Office and also including the Division of Debt Management and the Division of payroll.

The diagram below shows the old organization, before the 1997 reform. Note that in the graph 7, the blue boxes represent the areas that composed the new Expenditure Department that took place in 1997 reform.

The Expenditure Department model was a transition to the Treasury model. In the fourth chapter, the diagram of the Treasury Sub Secretariat will be presented.

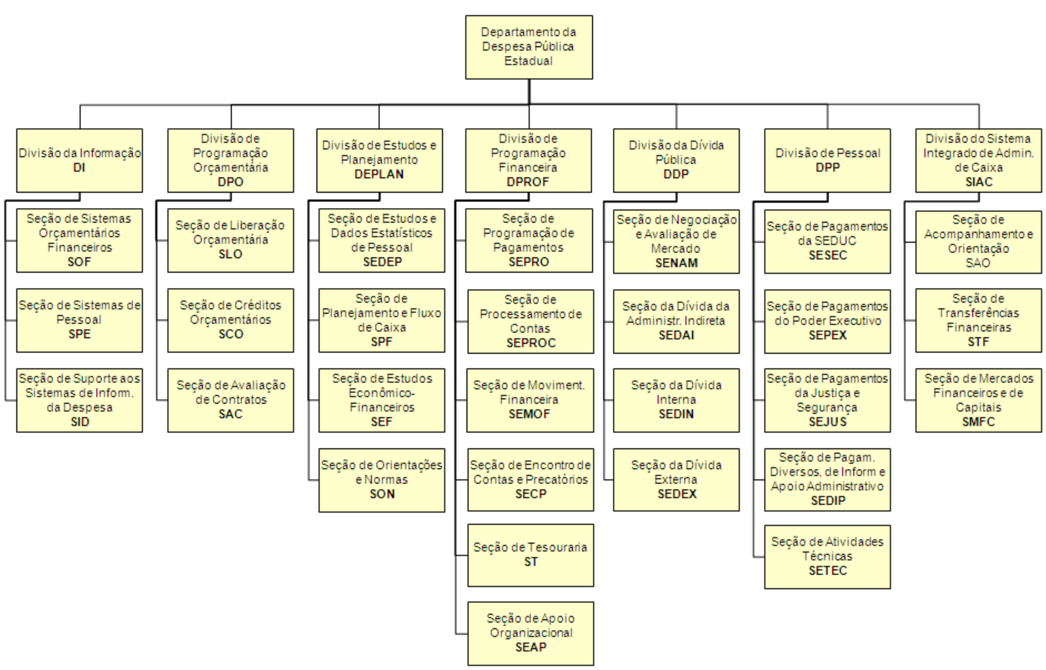
[3] The Administrative Superintendence (SAP) took care of human resources and administrative things like contracts, transportations, procurement. Another function related to SAP was the payroll of direct administration of state.

GRAPH 7 – SUMMARY ORGANIZATIONAL CHART – BEFORE 1997



The official chart of The Expenditure Department is showed below, in graph 8, with seven (7) divisions and twenty seven (27) sections. The seven divisions were: Information Technology, Budget Programming, Studies and Planning (projection of scenarios and cash flow), Financial Programming, Debt Management, Payroll and Unique Account Administration.

GRAPH 8 – THE EXPENDITURE DEPARTMENT DIAGRAM



Although the different cultures that come from these three sources, are still present today, they are becoming weaker and in some workspace do not exist anymore. The core work of the Expenditure Department was concentrated in the payments and in the cash flow projection. These were the main constraints of the government and the main expertise of the Expenditure Department.

b) THE CULTURE OF LIVING DAY BY DAY

The last decade was only dedicated to financial matters, as paying the suppliers and the payroll. The cash flow projected for a year was the principal product of the Expenditure Department. Other regular duties were concentrated on registering and rarely on analyzing. The big challenge of the last administration was to get money to payroll each month. The table below presents the significance of this expenditure that in 2002 was around seventy eight percent of net current revenue (NCR).

TABLE 3 - TOTAL EXPENDITURE WITH PAYROLL AND CHARGES, CONSOLIDATED

Especification	2001	2002	2003	2004	2005	2006
Net current revenue - R$ thousand (1)	7.512.695	8.558.340	9.859.597	10.736.732	12.349.352	13.312.373
Payroll and charges - R$ thousand (2)	5.686.913	6.653.327	7.496.237	7.831.123	8.541.619	9.557.429
% of COMMITMENT OF NCR	75,7%	77,7%	76,0%	72,9%	69,2%	71,8%

(1) Net Current Revenue (NCR), criteria Audit Office (Tribunal de Contas/RS)
(2) Total of group payroll and charges ("Pessoal e Encargos"), included expenses with retired, pensioners, judgments and expenses of previous exercises of Social Security State System.

The payroll expenses plus public debt service represented a huge percentage of the budget, so previous Governments usually estimated some extraordinary revenues in order to send the law project of the annual public budget with no deficit and some investment, however in the following year the projected expenses materialized but not the projected revenues. Some financial engineering helped the Expenditure Department to go on.

In the early 90's the inflation helped the government to manage the budget, but after the real plan, the governments had to use privatization or to make withdrawals from the Unique Account[4], what drives the Government in debt with Public Companies and Indirect Administration Entities. In the last administration there were a combined uses of Unique Account, delay in payroll for some moments, an increase in tax revenues by law for two years, delay in debt service with a serious damage to public finance through penalties, and arrears with suppliers above of up to 12(twelve) months in some cases, that causes an increase in cost of state procurement. In fact the RGS State was unable to produce a primary surplus for a long time and that produced a frozen administration with huge debt and hidden liabilities ("skeletons").

c) SOME INOVATIONS TOOK PLACE IN THE EXPENDITURE DEPARTMENT

Although the chaotic situation of finance, through a Modernization Program of Inter-American Development Bank (IDB), the Finance Secretary could go on with some projects that were really important for a base of better quality of information.

In 1999, the Expenditure Department had four systems operating separately and uncoordinated. One system was to budget operations, another for Unique Account, another for payments and another for debt management, and after all a fifth system of accounting, that belonged to the Accounting and General-Audit Office (Contadoria e Auditoria-Geral do Estado – CAGE). All systems had an interface with the others systems, although they operated in different platforms.

All these systems provided stats and data to Expenditure Department and were afterwards manipulated in the program Excel-MS to project financial scenarios and cash flow. The first action was to create a Division of Information Technology (DI) that was in charge of integration databases and applications. This Division was able to provide a new integrate system that unified the databases and the main applications, with additional modules of specialization when that mattered. The process put together people that operate in the same chain of the process but never had spoken to each other, in a proposal of interaction and unification of concepts.

[4] The State of Rio Grande do Sul has a Unique Account that consolidates all government accounts and money. It was created in 1991 as financial measure to give more leverage and thus obtain better returns in the financial market. The Treasury participates of this set of accounts with their own accounts (revenues, federal transfers, etc.) and it has the power of borrowing from this total amount. When that happens the Government position is reduced as well as the account's balance, which implies some costs.

The new system took place in 2003 and some modules in 2004. Today, the Financial Public of State (FPE) system is operating in all levels of State of Rio Grande do Sul Public Administration, except the Companies that operates under other rules. In 2004, the Expenditure Department led the project of a new payroll System, with Human Resources and Administration Secretariat and IT State Company (PROCERGS).

The old system was made in the early 80's, and its technology was tremendously outdated, with enormous costs of reworking and several risks in the process. The first step was a review of the entire payroll process and, secondly, the definition of a new system. In 2006 the new system was implemented, with the most up to date technologies, such as data warehouses and data marts that contribute to an advanced model of financial analyses in personal payments.

CHAPTER III – THE FISCAL ADJUSTMENT PROCESS

In 2007, a new government took office in RGS State, which stressed the main objective of achieving a "zero deficit". That goal became an obsession in all levels and staffs of the Government. In practice, it was inspired in a well executed experience in Minas Gerais State that could transform the finances and the structure of state in a four years term of office[5].

The situation of Rio Grande do Sul Finance at the beginning of 2007 showed a projected deficit of 2.4 billions of reais. As showed in table 1, the expenses with payroll were about 72% of NCR. A share of the revenues, that the former government had in 2005-2006, was not available in the next budget (2007). Some raises in payroll were still set by law for the next budget. The budget of 2007 also included overestimated revenues, in order to accomplish with a formal balanced budget. The table 2 shows a deficit of almost a billion of reais in three years in a row.

TABLE 4 – DEMONSTRATION OF CONSOLIDATE BUDGET RESULTS 2001-06

(Direct Administration, Foundations and Autarkies)

Item/year	2001	2002	2003	2004	2005	2006
Overall Balance	-676.826	-379.985	-382.401	-919.680	-918.348	-899.599

Source: RS Finance Secretariat.
http://www.sefaz.rs.gov.br/Site/MontaMenu.aspx?MenuAlias=m_transp_fiscal (indicadores de desempenho fiscal)

Actually the Rio Grande do Sul finance had a history of four decades of deficits causing the state of RGS to be in one of the worst fiscal situations among the 27 Brazilian state. The fiscal problems of Rio Grande do Sul has been the result of perennial poor management of fiscal policy.

Before the new term starts, the new government (2007-2010) asked its predecessor to send to the House of Representatives a project which the main goal was maintaining the level of revenues of 2006, because some aliquots should drop at the end of year.

[5] Minas Gerais: Fiscal Adjustment . For more informations there is a book: "O choque de gestão em Minas Gerais" (Renata Vilhena & Humberto Falcao Martins & Caio Marini & Et Al.). The management shock is a government policy that had as a goal first of all, the promotion of development through a reversion sucessives budgets deficit, with expenses reduction and institutional rezising and modernization of the state and the search of a new model for state management.

The previous government had extra revenues that originated in an increased tax burden in 2005 and 2006[6]. These revenues were allocated to the last two years of the administrative term, because the situation was completely chaotic. The House of Representatives refused the new project under intense debate. It would have helped the new government in a process of smooth adjustment. As a result, the new government had to implement more radical measures.

a) ADJUSTMENT AS A PRIORITY

At the beginning of 2007, some governmental structures in financial matters were changed, the most important of which was assigning the coordination of fiscal policy to Finance Secretariat. Many duties were assigned to the Expenditure Department.

The Government reorganized the board of budget and financial coordination (JUNCOF)[7] and its functions, passing the presidency of the board to the Finance Secretary and the executive secretary to the Expenditure Department Director. The same structure was replicated in the personal expenditure policy that was coordinated by the Finance Secretary and supported by the Expenditure Department Director. The former group of expenses control was transformed into a committee that was in charge of opinion in projects that could have a strong impact in the finance of the state.

The JUNCOF was composed of the Secretaries of Finance (President), Planning, Human Resources and Administration, Civil House and other secretaries were invited occasionally. In monthly meetings, the behavior and the trends of revenues and expenses were presented by the Finance Secretary and Expenditure Department Director to the committee.

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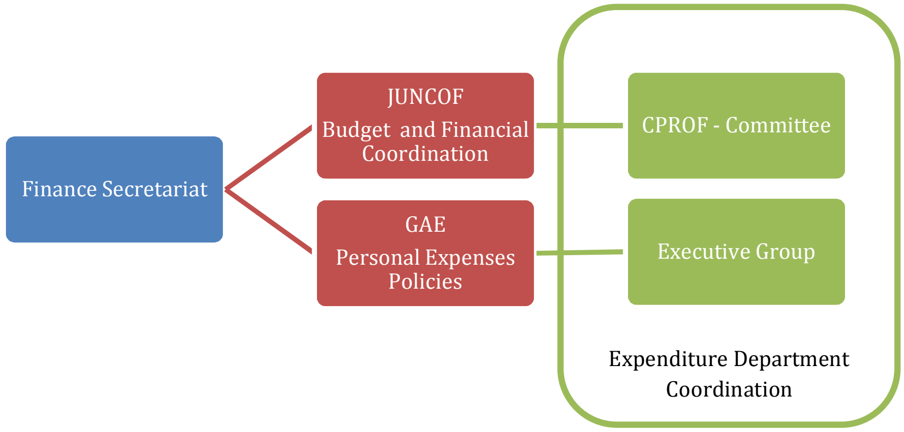
[6] Text of the Law Nº 12.209, from December 29, 2004.
III - no artigo 12, ficam acrescentados os §§ 10 e 11, com a seguinte redação:
“Art. 12 - ....
§ 10 - Nos exercícios de 2005 e 2006, não prevalecerão as alíquotas previstas no inciso II deste artigo nas operações com as mercadorias e nas prestações de serviços previstas nos números 7, 8 e 10 da alínea “a”, hipótese em que serão fixadas nos percentuais de 30% (trinta por cento) e 29% (vinte e nove por cento), respectivamente nos exercícios de 2005 e 2006.
§ 11 - As alíquotas das operações e prestações mencionadas no § 10 serão reduzidas, até o limite dos percentuais vigentes em 31 de dezembro de 2004, na hipótese de a União transferir ao Estado os créditos que lhe são devidos e em valores adequados, inclusive a título de ressarcimento por perdas decorrentes da desoneração das exportações realizadas por contribuintes do Estado.”

[7] Junta de Coordenação Orçamentária e Financeira - JUNCOF

The coordinators presented the budget result projected, negative or positive, and the committee suggested measures to achieve a balanced budget. The committee presented the summary to the Governor in the monthly appointment, a couple of days later.

GRAPH 9 – DIAGRAM OF FINANCIAL COORDINATION



Beyond this high level coordination many policy actions have been taken. One of the first moves was the Hundred Days Act. The act included the suspensions of volunteer agreement that include money transfers, suspension of hiring people and other sort of measures.

Another important measure was reestablishing the payments for the suppliers, and the priority was given for the payables below eight thousands reais. Others measures were auctioning of the debt, whereby the government suppliers that had receivables would bid a discount. The suppliers offering the biggest discount were paid. At the time of procurement, the suppliers expected that the Government will delay the payment, which induced suppliers to raise the prices of goods and services provides to the government. These overpriced goods and services as well as the shortage of resources where the main justification for public auctioning of debt.

At the same time the government started to reorganize the State Procurement. The priority was given to electronic biddings to improve transparency and efficiency. In addition the government guaranteed the payments without any delay.

As a result of these initiatives, the prices of the goods and services provided to the government went down instantly and the number of suppliers bidding in public auctions increased tenfold. For example some medicines prices declined over 50%. Through these initiatives the Finance Secretariat started the project "Doing More with Less" managed by the Expenditure Department. The adjustment process started in 2007, and also included many actions to increase revenues. The approach of improving the government management and the efficiency of spending were very important during the period of the last government (2007-2010) in order to achieve and keep the balance of RGS finances.

b) ACQUIRING THE ZERO DIFICIT

In 2008, the State had a budgetary surplus after three decades of unbalanced budgets, which was a huge achievement[8]. In 2009, the Treasury had the challenge of keeping this particular political commitment in a period of international crisis. This was especially important after the counter cyclical tax policy of the Federal Government that reduced the revenues of States, even though this federal policy intended to boost GDP and employment. The Government concentrated its efforts on two priorities: in the short run implementation of a strong fiscal adjustment and in the long run modernizing the state`s public administration system. This was double planning.

The fiscal adjustment program of RGS was put in practice in three projects: transparency, revenues and expenditure. The Accounting and General-Audit Office managed the transparency project. The revenue side was named “Revenue to Grow”, and it was managed by the Revenue Department. The expenditure side was named “Doing More with Less” and it was managed by the Expenditure Department.

As an improvement in transparency, a sizable amount of information about government expenses and revenues was published on the web. The citizens could follow the details regarding expenses and where the money goes9.

The main revenue of state of RGS is the tax on the circulation of goods and services (ICMS). The ICMS represents more than 85% of the state tax revenues and about 62% of the budget resources.

Table 5 shows that the collection of ICMS decreased in 2007, it occurred because the drop in some aliquots, although in the following year it had recovered. In 2009, the outcome was almost the same as 2008, but it could be considered extraordinary in the context of the world economic crisis. Table 5 also shows another good performance in tax collection of the main source of state revenues in 2010.

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[8] The Fiscal Adjustment Program of RGS was analyzed by Rafael Bartoli Liberalino in a Minerva paper (2010).

[9] This site provides information for the citizens of RGS. http://www.transparencia.rs.gov.br.

The main actions were the combat tax evasion, the cooperation between states in exchanging information, the replacement to industries the incidence and collection of tax, the use of matrix management that put focus in indicators and the massive use of electronic instruments.

TABLE 5 – TAX REVENUES ABOUT CIRCULATION OF GOODS AND SERVICES (ICMS)

Years	Total ICMS Constant values by IGP-DI	Variation
1997	R$ 12.862.707.533,36	
1998	R$ 13.074.160.802,22	+1,64 %
1999	R$ 12.920.820.765,64	-1,17 %
2000	R$ 13.760.735.904,50	+6,50 %
2001	R$ 14.816.586.337,85	+7,67 %
2002	R$ 14.442.847.232,94	-2,52 %
2003	R$ 14.246.508.717,59	-1,36 %
2004	R$ 13.943.447.446,33	-2,13 %
2005	R$ 15.572.557.095,92	+11,68 %
2006	R$ 15.881.789.468,21	+1,99 %
2007	R$ 15.671.619.012,08	-1,32 %
2008	R$ 17.051.741.570,89	+8,81 %
2009	R$ 17.052.135.378,41	+0,00 %
2010	R$ 19.144.123.888,94	+12,27 %

Source: RGS Finance Secretariat

The RGS state was a pioneer in the implementation of the electronic fiscal receipts. These measures combined were able to get good results in the revenue side, although that was not enough to cover the extreme situation of fiscal crisis.

The more difficult case was the expenditure side, because the personal expenditure has a vegetative growth and investments were low in the last period, below 5% of net current revenues. Some opportunities for budget cuts were discovered in current expenses that used to grow in average 12% per years. The state public debt had few possibilities at first sight. Although many initiatives were taking in 2007, they were not sufficient to stop the deficit.

In 2008, the project “Doing more with less” had many actions and the target was to cut 30% of discretionary current expenses. As part of debt management strategy, a loan by World Bank reduced the debt service and improved the portfolio profile.

The JUNCOF approved in the following years a ceiling in current expenses of all the government entities. These limits were connected with the target of 300 million reais of budgetary economy. That was a reduction of 30% in discretionary current expenses. The

Expenditure Department faced the challenge to create a sustainable environment that could help the adjustment process. Some techniques helped a lot.

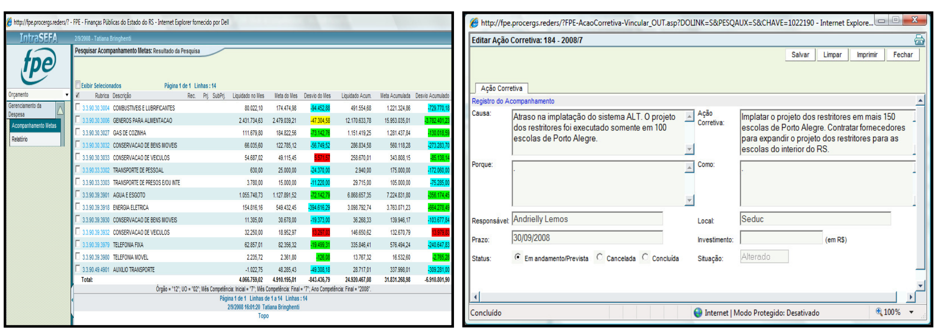
For maintenance of the level of current expenses below the limits, the technique of matrix management of expenses (GMD) was used, that is an arrangement of cross data by types of expenses (transportation, electricity, water, gas, telephone, meals, etc.) and by units of state. Some clusters were necessary to compare and with the analysis of the data the limit was set with the participation and agreement of the manager of each secretariat.

The focus was on 20% of the items that represent 80% of total expenses. As a result an important concept of "current expenses discretionary" was created, because some expenses are mandatory and others are out of the authority of the manager. The discretionary expenses were absolute priority to analyze.

A new module of FPE named expenditure control was developed with the limits/goals and the results of the month and accumulated in year and the deviations. The anomalies had to be reported as well as the ensuing measures. The following diagram shows two windows of the system. The meetings were monthly with the managers and quarterly with the project coordination. A government act was necessary to enforce the project and the specific action of GMD was named[10].

GRAPH 10 - WINDOWS OF THE EXPENDITURE CONTROL MODULE

Matrix limits Vs realized **Anomaly report**



The GMD was supported by an agreement between the Executive branch and the private sector that was represented by the Gaucho Program to Quality and Competitiveness (PGQP[11] - Qualidade RS). This agreement had two main points in the expenditure side: the GMD and the restructuring of entities and process. The same logic was present, so the

[10] Decreto Nº 45.273, de 04 de Outubro de 2007.
[11] http://www.mbc.org.br/mbc/pgqp/

restructuring had focus on 10 entities and 25 processes that could help to reduce and to qualify the State expenses.

The staffs of the Expenditure Department and PGQP worked together as a unique team and the methodology was passed in the period.

Another important measure was based in the technique of planning and decision-making called Zero-based budgeting. This technique reverses the working process of traditional budgeting. In the traditional incremental budgeting the departmental manager justify the increase in budget with inflation and the last year amount, in order to have a previous approval. It happens often in the public sector, although in private sector can happens too.

In Zero-based budgeting every department function is reviewed comprehensively and all expenditures must be approved, rather than just increased. No reference is made to the previous level of expenditure. The previous duty is the strategic plan if the organization does not have one, so during the process of budgeting the projects and action can be aligned to have more synergy and better outcomes.

The main advantages are the detection of inflated budgets and the efficient allocation of resources, to eliminate wasteful and obsolete operations. An important positive side effect is the motivation of the staff that contributed with ideas and new projects. Unfortunately that could not be replicated in all entities, although an important job was made in Health Secretariat, Education Secretariat, Commerce Agency and Finance Secretariat.

A similar example of reforms in budgeting come from the United Sates, the Democratic governor of the state of New York is concerned about an increase in 13% in Medicaid and 13% in the Education Fund, it was published in The Wall Street Journal on February 3, 2011. The Governor Andrew Cuomo sent a new budget searching for fiscal sanity and exposing the fraud of baseline budgeting, that is based in formulas that created a rigged-game of baseline budgeting, which are increasing expenses automatically each year. This kind of budgeting is the opposite of zero-based budgeting.

Under the automatic baseline formulas, the New York State budget deficit this year is estimated to be 10 billion dollars. A new budget based in the expenses of the previous year project a deficit of 2 billion dollars. The Governor is proposing a reform that would deflate the baselines.

> The Governor reduces education aid by 7.3% and tells schools to get their costs under control, thin bloated payrolls and do more with less (Wall Street Journal, feb 3, 2011).

Actually the New York State situation is worst than what we saw in RGS. The governor of state of New York State would be pleased of budgeting based in the previous year expenditure. In RGS the possibilities of budgeting under the constitutional requirements for education (35%) and health (12%) could guide the State beyond the deficit, maybe to insolvency.

At the US Federal level, the Office of Management and Budget has been building new tools especially to evaluate and measure programs and to integrate the budget with performance. The efforts include the improvement in indicators of products, in monitoring programs and also in capturing the real costs[12].

Another successful action in RGS finance adjustment, in order to agglutinate the positive initiatives of several state entities, and to communicate the progress and the outcomes, was workshops to reeducate for public expenditure. It was promoted by the Expenditure Department quarterly. This action had a strong impact in motivation and it created an environment to replicate the best policies. The experience in some Foundations was replicated in others, and the objective was increasing their own revenues in order to decrease the dependency of the Treasury. Many Foundations were successful in these actions.

The Environment Foundation (FEPAM) was the most expressive result it could refund the Treasury in over 7 million of reais in 2008. This money the Treasury used to transfer to Environment Foundation each year to its payroll and from that day on it could help to cover the deficit. Other examples come from Liberato Salzano Foundation and Zoobotanical Foundation, both institutions could apply fees to their services and through that they could recover the investment capacity.

The salary ceiling in the public administration was set in 2007 and that was a measure beyond the economy itself, because has a moral effect. This measure could directly affect the pension system too.

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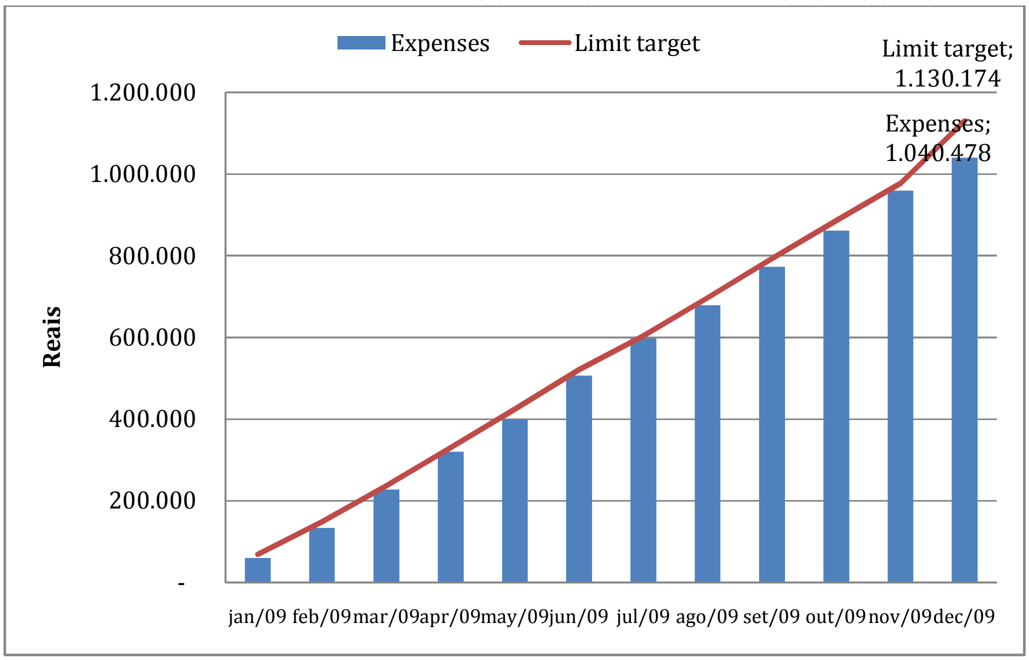
[12] See more about the topic in Llosas, Hernan Pablo. Reformas recientes em el sistema presupuestario de los Estados Unidos. Revista Internacional de Presupuesto Publico N°73. Argentina. Julio - Agosto, 2010.

The goal of cutting 30% current discretionary expenses was achieved in 2008, so a new rule was to fix current discretionary expenses as a percentage of net current revenue. In 2008, the result was 6%, what was much lower than the 9% of previous period. So in order to make some adjustment possible, in 2009 the limit to discretionary expenses was target at 6.5% of net current revenue. This limit was monitored monthly by the authorities.

The graph below shows the behavior of the discretionary current expenses. These expenses usually reach a peach in December as a result of historical behavior of finances managers, but it did not occur in 2009. The expenses started to become more linear as an effect of a stable financial situation. The expenses remained at 6% in 2009, the same percentage as in 2008.

GRAPH 11 – THE LIMIT AND THE DISCRETIONARY EXPENSES ACUMULATED



Source: Expenditure Department.

Another important action was the IPO of state bank (Banrisul), which occurred in July of 2007 and raised 2.086 billion reais. The House of Representative approved that measure, but that amount was to increase the bank landing resources in 800 millions and to provide resources for pension system in 1.2 billion.

The pension system amount was deposited in two funds. One fund was created to complement the pension for new civil servants entering the state public sector after 2003. The new servants would be in a new system which should have a ceiling in benefits and contributions, the complement would depend of the savings. Unfortunately this new system still remains unregulated. The other fund could be withdrawn monthly in 84 parts that will consume the total amount in 7 years. It contributed to reduce the deficit of the state pension system.

The state`s public debt was an important part of the project, in fact it was a priority for the state authorities. Suddenly a negotiation started with the National Treasury Secretariat (STN) and the World Bank which is explained in the following section. The Expenditure department was mobilized to this operation.

As a result of all these revenue and expenditure initiatives, in 2008 the Zero-deficit goal was achieved. The huge objective reached was recognized by fiscal experts and the press. Meneghetti Netto author of many essays about RGS public finance recognized the accomplishment of the Zero-deficit target[13].

In 2008, the thirteenth salary for the civil servants was paid in advance, that was an important improvement over previous years that civil servants were paid with loans given to them by the state bank in the date required by law, and the interest and the principal were paid by the government in the next year.

In 2009, despite of the international world crisis, the RGS could keep the overall balance adjusted. The revenues collection was almost the same as in 2008 and the expenses at the end of year were 10 million less than the revenues. Thus, 2009 was the second year in a row with no deficit. The investments in both years were around 600 million of reais, equivalent to 4% of NCR, almost the same amount of the years of 2006 and 2005.

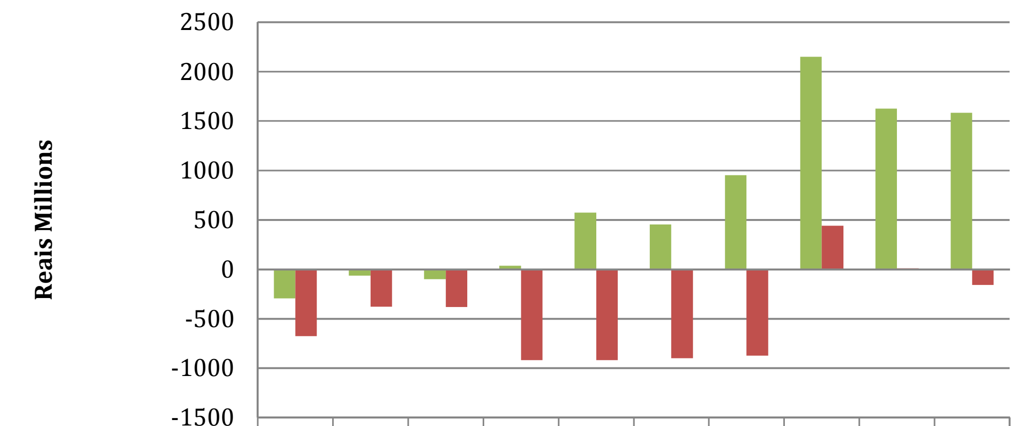
In 2010, the economy takes off with the revenues following the upward trend. The investments were 1.936 billion of reais, or 9.54% of NCR. The last time that the state had investment of this magnitude was in 1999. The primary surplus of 1.582 billion reais was an impressive result, although not enough to balance the budget. The overall balance presented a deficit of 156 million of reais, or 0.07% of state GDP.

The graph below shows the primary surplus and the budgetary results of RGS state finance. In fact, the state was pushing along the years to pursuit a primary surplus in order to keep the budget adjusted.

[13] No ano de 2008, foi cumprida a meta do déficit zero, que significa dizer que o Governo gaúcho conseguiu ter um superávit primário e orçamentário sem a utilização de receitas extraordinárias. Assim, todas as despesas do setor público estadual foram pagas com a receita oficial daquele mesmo ano (Meneghetti Neto, pg3, 2010).

The financial approach age was finishing, and the new framework that required fiscal austerity and better policies starts. So the zero-deficit was pursuit and reached in RGS state. An important observation is that it happened without satisfying the mandatory expense in education set in State Constitution (35%), what have been occurring even in the periods of large deficit.

GRAPH 12: FISCAL ADJUSTMENT RESULTS



	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Primary Surplus	-294	-64,5	-99,6	36,0	572,1	454,2	954,2	2.150	1.627	1.582
Budgetary Result	-676	-380,	-382,	-919,	-918,	-899,	-873,	442,7	10,4	-156,

Source: RS Treasury Department

Another important observation is related about the quality of the RGS adjustment. In 2007, the official accounting budgetary result was positive because included the Banrisul IPO what had consequences in the overall balance. In fact, the Government didn't consider as an adjustment, although it acquired a large primary surplus. The year of 2007 could be labeled as an illusory adjustment[14] .

Actually when the adjustment is acquired by lowering the assets accumulation (privatization) or increasing hidden liabilities, it could not be called adjustment because the net worth was worst off. The years of 2008 and 2009, the RGS finance showed a zero deficit and also many contingent liabilities were faced, as judicial liabilities and old payroll liabilities, what make these years as genuine adjustments.

[14] See more in the paper from William Easterly. When is fiscal adjustment an illusion? World Bank. Development Research Group. Macroeconomics and Growth. May, 1999

c) WORLD BANK LOAN

The situation of state debt was delicate and it needed a fast action. The debt service would have a peak in 2008 in extra-limit debt what could compromise the fiscal adjustment process. After the bailout in 1997 the states were forbidden of issuing new debt until the ratio debt to net current revenue to be lower or equal to 1. A new Senate resolution has postponed it, so the states have to wait until 2020, to issue new debt, even those with a debt-revenue ratio below 1.

There was a law commitment about the state payments to federal the government, which is the main creditor of the RGS debt. The payments is limited to 13% of real net revenues, as it was explained in chapter one, but imposed just in the intra-limit debt.

Few opportunities were available. There is an exception that allows the sates to make a loan in order to restructure the outstanding debt, but with the permission of the National Treasury (§7º of Art.7º Federal Senate Resolution nº 43-2001). The extra-limit debt was elected to a restructuring operation.

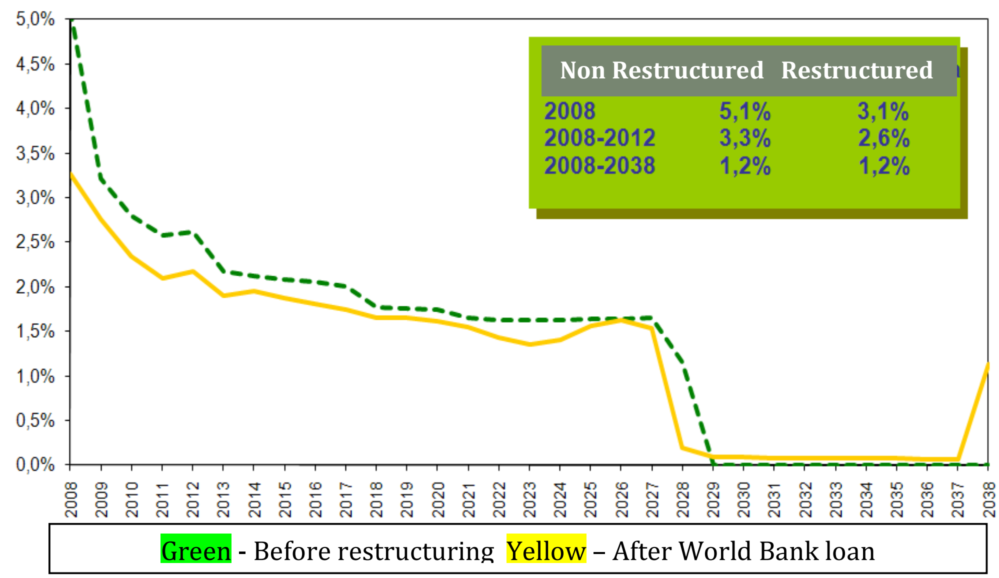
The RGS state submitted an operation of 1.1 billion of dollars with World Bank to National Treasury and after to the Senate. This operation was approved. The RGS was the first Brazilian sub national to access a restructuring loan with World Bank after the Fiscal Responsibility Law. In addition, the 1.1 billion dollars was the largest loan that the World Bank to a sub national entity. The loan was disbursed in two tranches, the first in 2008 of 650 million of dollars and the second in 2010 of 450 million of dollars.

The main problems were the concentration of payments in the next period and in particular the maturity of 160 millions of reais in LFT-E in 2008. Another problem was the debt with the Banrisul Foundation that makes the state responsible for the deficit in their pension fund for the employee of Banrisul State Bank. The operation consisted in the payment in advance these two debts, and substitutes them for a new debt with lower cost and longer maturity.

The RGS debt was not exposed to currency risk and international interest rate, actually the external debt was less than 4% of the total debt on average in the last 15 years. The conditions of the loan can be summarized as follows: floating interest rate (LIBOR 1 month), fixed spread between 0.11 and 0.14%, denominated in US dollar (the exchange rate update the debt), total time 30 years, average time 18 years, no grace period, the amortizations would be smaller in the beginning.

The operation substituted an old debt with higher interest rates (6% plus inflation) for a new debt with lower interest rates and at the same time could smooth the cash flow in the following years. A second objective was a gain of net present value. The graph below shows the old payment flow of the extra-limit debt e the new cash flow with the World Bank loan, it shows a smooth debt service profile.

GRAPH 13 - RGS: NON RESTRUCTURED AND RESTRUCTURED EXTRA-LIMIT DEBT SERVICE, 2008-2038
(in percent of net current revenues)

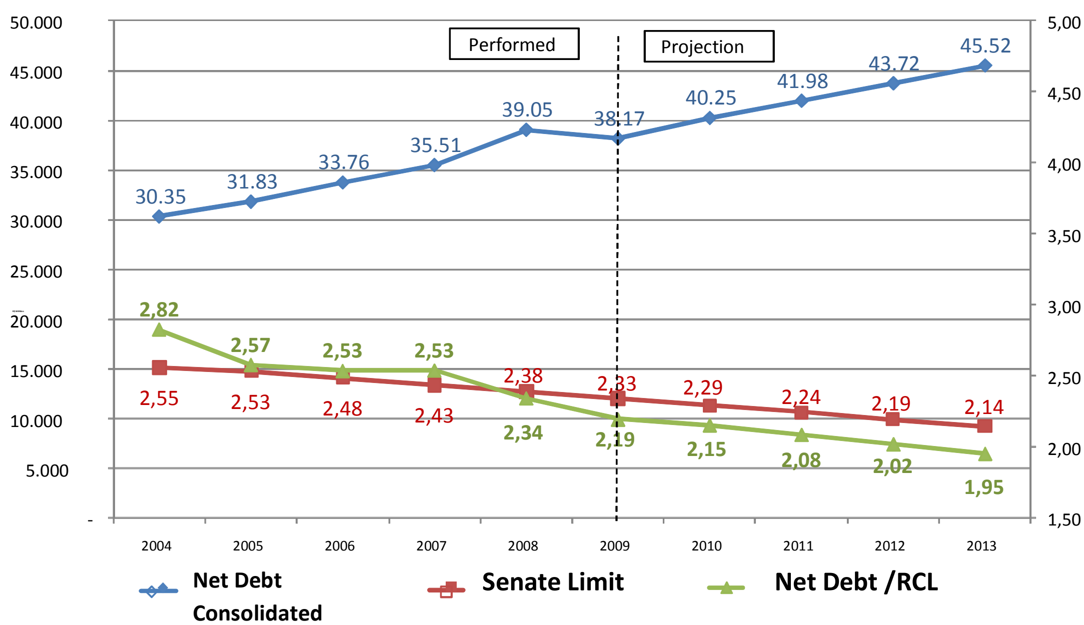


Source: Treasury RGS

The loan could reduce the net service of debt in 270 million reais, this outcome was verified until December 2009, just with first tranche. The liberation of the second tranche occurred in 2010. There were some conditions that the RGS state was committed in order to receive the second tranche of the loan. These conditions were about the fiscal policy, particularly primary surplus results; reforms in pension system and modernization of the state. Many of them were implemented in the period, but some were not. The State surplus, the growth of revenues, the structural reforms in many entities, in purchase and electronic bidding system particularly, the new law about military pension, the agreements about results and indicators with several state companies, the austerity in the public expenses, the programs that took place to elevate the efficiency of the state, these results and actions had a strong influence in the liberation of the second tranche by the World Bank[15].

Many others action happened in the Debt Management Department of the RGS Treasury. The Treasury could be refund by the Ministry of National Integration the amount of 7.2 million reais. The floating interest rate of debt with Pro-Rural 2000 was converting in a fix interest rate of 2,32%, in the last amount paid before the change the floating rate was 7,39%. A study work of the Debt Management Department got reduction in the payments with National Social Security Institute, and many actions started to flow. As a result of these adjustments, in 2008 and 2009 the amount of the net debt was below the limit to convergence imposed by Federal Senate.

GRAPH 14 - NET DEBT CONSOLIDATED AND ADEQUACY TO SENATE LIMIT



Source: Treasury RGS

[15] More information are available in the World Bank Report: Fiscal Sustainability for Growth Program Release of the Second Tranche, (analyses). 2010

CHAPTER IV – NEW FUNCTIONS BUILD THE STATE TREASURY

The adjustment processes consolidated many new functions in the Expenditure Department. A new approach and a new mission were in the mind of the high staff. These changes started to shape a completely different organization. The obsession for new technologies and techniques as well as the focus on austerity and sustainability of fiscal policy were instilled in the way of think and act.

a) FISCAL POLICY, DEBT MANAGEMENT AND EFFICIENCY OF SPENDING

The three main point in which the Expenditure Department have been improving in the adjustment processes are Fiscal Policy, Debt Management and Efficiency of the Expenses. The focus in monitoring the behavior of the two aggregates, revenues and expenses, and the learning process about what could interfere in the final result in primary balance and overall balance in a short period was an important knowledge acquired by the staff (a case of "learning by doing").

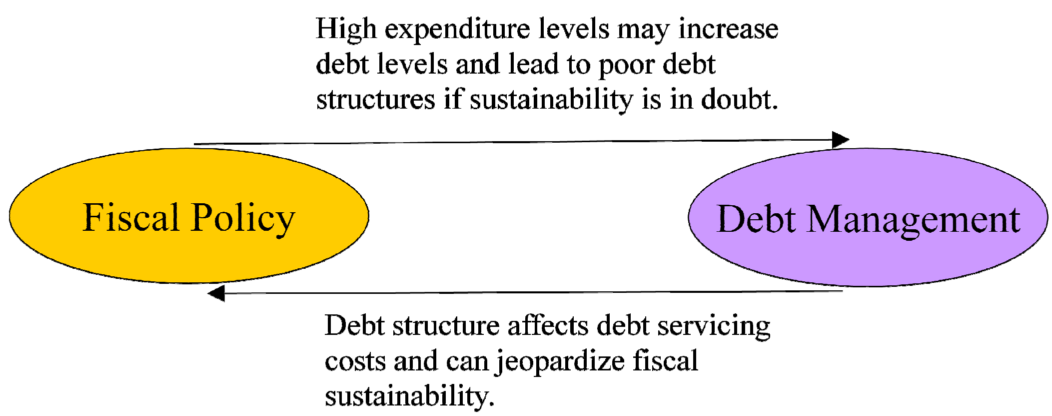
The Government needs that kind of job and it was developing day by day with the challenges that were coming along. The Expenditure Department was becoming a real Treasury in this process of fiscal adjust. In the World Bank loan was required a support to restructure the debt management department and the staff training for activities of middle office. The reorganization of the Expenditure Department was object of the PGQP consulting. Through the support and ideas of these two institutions, one that knows the core business and the other that has the management expertise, with these background the high administration of the Expenditure Department proposes to the Finance Secretary and to the Government a Treasury Sub secretariat that become a law in 2010.

The World Bank consultants pointed out the need to have a Division in charge of Fiscal Policy with a well prepared staff for that, not just temporary advisories. The consultants also recommended a division with staff from the Treasury and the Revenue Sub secretariat. Unfortunately the border lines of reform were narrower and the Treasury decided to absorb the main functions of this division inside the Sub secretariat in a sector of studies and monitoring the fiscal indicators.

The Fiscal Policy and the Debt Management should be consistent. Besides that he management of both should be apart in order to setting clear objectives for each area or division.

The Debt management is not a solution for poor fiscal policy, even more in a context where you cannot borrow money. In accord with the update debt management guidelines, the debt management office should have at least three areas: Back office (control, payments and statistics), Middle office (planning and strategies) and front office (issuance and new operations). The recommendation is to have another area that should be concerned about hidden liabilities and risk.

GRAPH 15 – RELATIONSHIP BETWEEN FISCAL POLICY AND DEBT MANAGEMENT



Source: World Bank presentation, Course for sub nationals, Brasilia may, 2010.

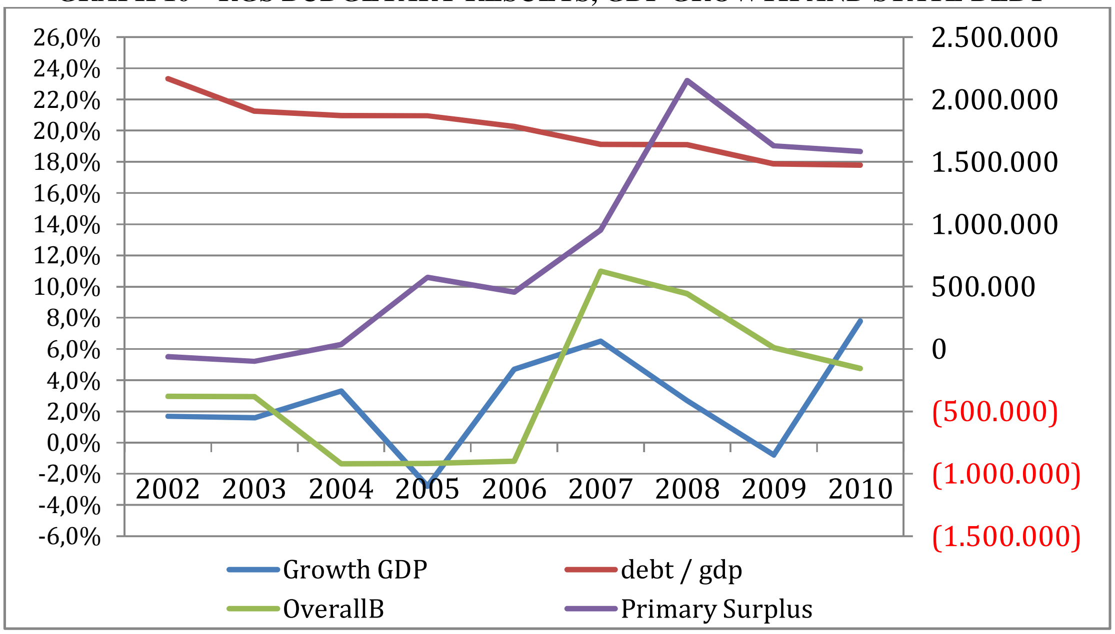
The debt management should be focus in minimize long-term debt servicing cost, subject to a prudent level of risk. The main tool for that is the composition of the debt portfolio. On the other side the Fiscal Policy should be focus on to achieve the least distorting budgetary policy to improve the resource allocation and achieve distributive objectives, subjects to prudent and sustainable debt levels. The main tool is the composition of spending and taxation. The deficit and the level of debt are given for the Fiscal Policy.

Both are faces of the same coin, they are attached but they have their own tools and objectives. The public sector overall balance must be equal to the change in its net financial assets. Excess of expenditure over revenue cause deficit that must be financed by either increasing liabilities (domestic or foreign) or by reducing assets

One objective of macroeconomic policy can be to stabilize the economy during the economic cycles (reduce the output gap), however in a negative output gap (crisis) an unsustainable fiscal situation limit the possibility of using countercyclical fiscal measures, because there is no fiscal space.

The RGS is acquiring a better fiscal situation, but still delicate. The Treasury can provide for the Finance Secretary and for the Governor the limits and the consequences of the measures in fiscal policy.

GRAPH 16 – RGS BUDGETARY RESULTS, GDP GROWTH AND STATE DEBT



Source: RGS Treasury

Many objectives can be pursuit, one is accelerating the adjustment process in order to have in the future a much higher level of investment, another can be stabilized the ratio Debt-GBP, or it can be increasing gradually the level of the public investment with sustainability. The graph above shows what the theory says, the level of debt depends of the GDP growth and the primary surplus. The formula below represents the budget constraint[16].

$$R - G = \Delta\ Af - \Delta\ D$$

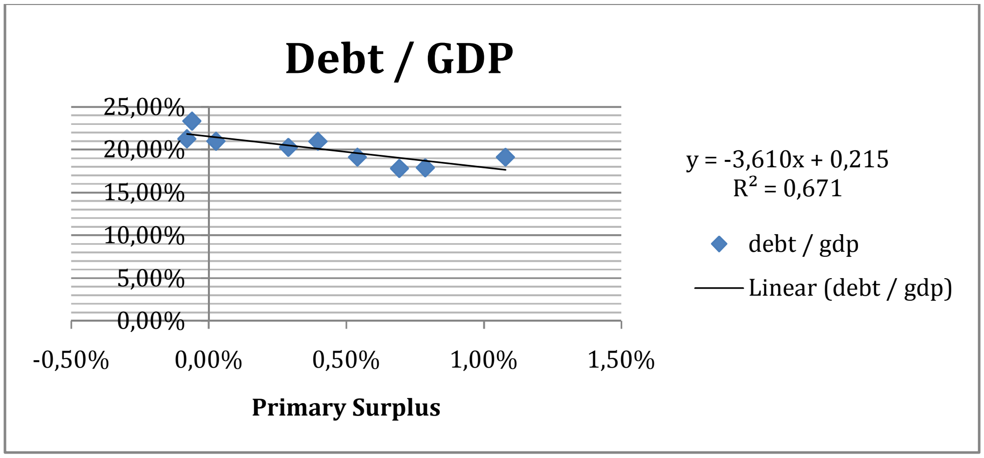
Assuming no changes in financial assets, the debt dynamics and the budget constraint will be represent in the following formula:

$$D_t = -PS_t + (1+i_t)D_{t-1}$$

[16] Revenues minus expenses equal to financial assets variation minus variation in public debt.

If we consider the data of the last nine years we can see a linear relation between the primary surplus and the ratio debt-GDP.

GRAPH 17 – REGRESSION DEBT/GDP AND PRIMARY SURPLUS



The projections shows a primary surplus requirement of 0.7% of GDP for stabilize the ratio debt-GDP. The assumption is an economic growth rate of 2%. A higher economic growth can pull down the Debt/GDP, and if it is combined to austerity program the fiscal space in the future can be enough to sustained counter cyclical policies and a great level of the investments. A primary surplus of 0.94 of GDP combined with a GDP growth rate of 5% could in ten years decrease the debt/GDP ratio to around 10%, what means a ratio of 1 to net current revenues. Also the fiscal space for investments would be sustainable at 10% of net current revenues.

Beyond the sustainability analyses, in a microeconomic level, it is important the quality of the spending. The RGS Treasury acquired many experience in zero-based budgeting; workshops to spread best practices, and the most important evaluation and monitoring public policies. Many activities that now are supported by the Treasury staff are focus in to get more results with same amount of spending. The indicators of each State entity have been collected and analyzed. This path will provide a tuning in the expenses with more results to society.

b) THE NEW STRUCTURE SHAPE THE TREASURY

The focus in the fiscal adjustment created new opportunities to the Expenditure Department in it roll in the state governance. According with the new approach the Expenditure Department becomes the Treasury Sub secretariat. The process included guidelines that were given by the high administration, the consultancy support of the PGQP, a couple of suggestions from World Bank and two benchmarking (National Treasury and Minas Gerais Finance State Secretariat).

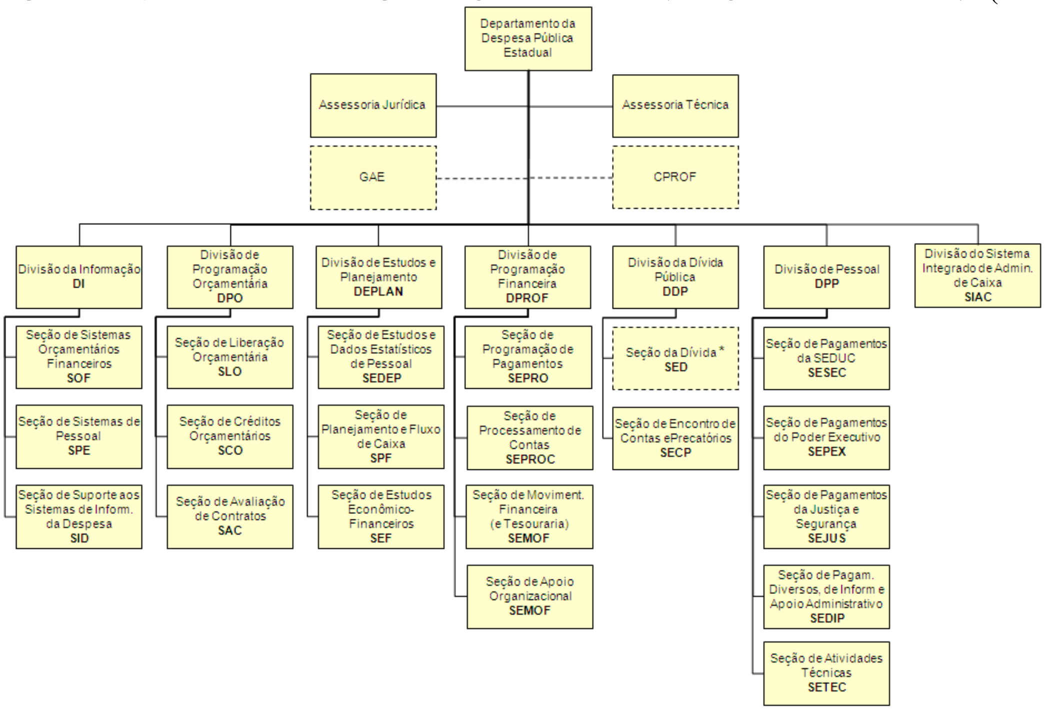
After helping the reorganization of many entities, the Treasury rebuilt itself. The process started with a detailed diagnosis. The financial approach should be combined with the sustainability of fiscal policy. The financial would be still very important, but from now on the fiscal situation would be at the same level of importance. The consequences were not just to do the payments and the controls, but to contribute for the strategic and sustainable development of the state. The diagnosis revealed a debt management focus in operational problems without any knowledge about indicators of risk, currency exposure or planning and strategy. Many sectors were disconnected of his upper level. There were many compilations of data but no one was creating scenarios for the decision makers. Many areas used to do a complementary job but there was no coordination.

Some concepts were unknown for the most people and that required an evolution in technical skills and in management too. The World Bank under the broad contract could provide substantial help in debt management and in fiscal policy. The multiple origins of the organization were still present. For example, many people were allocated to activities of low priority. Even the Director, main authority, was involved in operational matters what cause a shortage in time for the biggest things.

The staff was getting old; almost 30% qualify for retired within 5 years, which could collapse the organization without proper replacements. The reform doesn't touch the three executive branches of Finance Secretariat. Both three would be denominate as Sub secretariat because they will have more autonomy than a simple department. For the Treasury that was really important, in fact because of its functions it often has confrontation about budget liberation with general and administrative departments of others Secretariats and through this higher level could be empower its position. The organization has been getting a part of the official diagram. Actually the real diagram had

7 divisions, 20 sections and 2 advisories. The official diagram had 7 division and 27 sections.

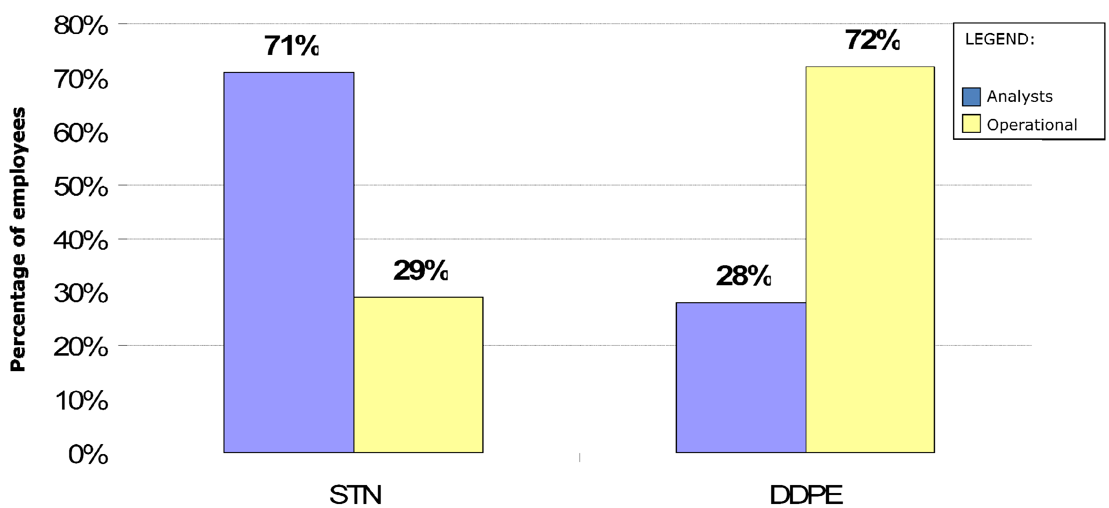
GRAPH 18 - THE REAL DIAGRAM OF THE EXPENDITURE DEPARTMENT (DDPE)



Source: Research and interviews by PGQP

The new organization should be more connected with reality and with the challenges of the Treasury Department. The work fragmentation should be rebuilt in a compact and coordinated model. The analysis of the staff report that the number of higher analyst was 26% and the employee at operational level represented 68% of total staff.

GRAPH 19 – STAFF PROFILE COMPARISON



Source: Benchmarking.

The benchmarking showed that the National Treasury (STN) has the opposite profile with 71% of staff working as analyst and 29% in operational activities. Some special activities that the State Treasury is in charge explain that mismatch, e.g. like the payroll.

The National Treasury model had a strong influence because it was a successful model. Through a visit of benchmarking, the need of a particular division that could keep the focus in institutional development becomes clear. This new area should improve the planning, the project management, and it should consolidate a homogeneous group with a high standard performance.

The idea of creating sub secretariats comes from the state of Minas Gerais, and that model was implemented in National Treasury afterwards. The functions of the Treasury Sub secretariat of Minas Gerais included accounting, and the same happens in the National Treasury. Unfortunately the RGS model couldn't follow the same pattern; the accounting remained in Account and General-Audit Office, because that is settled in the RGS Constitution. The Minas Gerais model concentrate power in Planning Secretariat, so the Treasury Sub secretariat doesn't have the control of the liberation of the budget, but still set the limits.

The model of RGS was too dependent of the Director interventions, and that's absorbed his time in less important matters. In order to create more dynamic and to have more coordination, the high administration was split in three main areas: 1) Budgeting planning that includes the monitoring of result of fiscal policy, the qualification of spending and the fixation of the limits in the budget; 2) Financial planning includes to do payments, to project cash flow and scenarios, to manage unique account and debt management; 3) Corporate Affairs (Institutional Development and Technology) that includes the project office management, the strategic plan implementation, the staff training and the information system management.

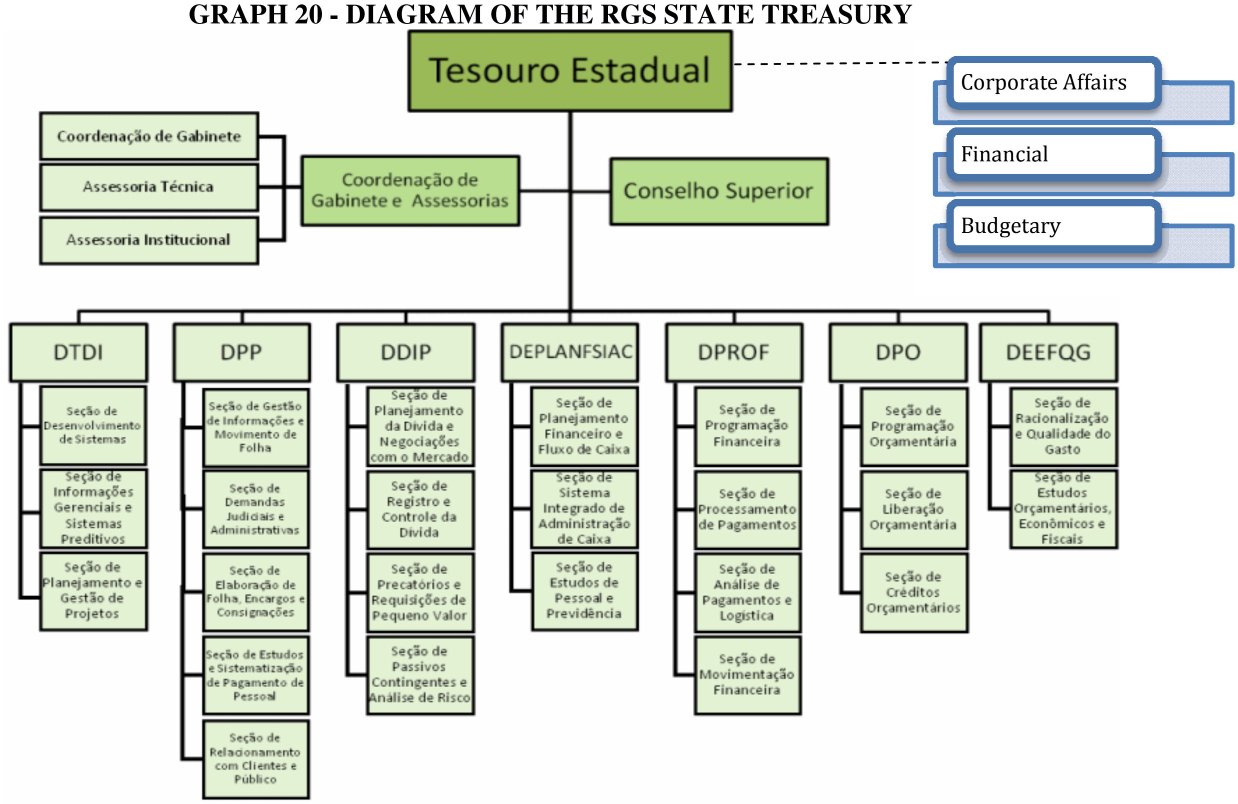
Thus the Treasury will work with an area to above the line matters, another to below the line matters and the third with focus in institutional and technology development.

The new model should keep focus in fiscal sustainability in the medium term with prudent level of risk, in order to achieve the resources for education, health, security and infrastructure. The improvement of spending efficiency would be the second big task. So these two main objectives put the RGS Treasury in a strategic role for the future of next generation of RGS citizens, to insurance a platform to higher standards of living.

The Finance Secretariat was also reorganized, but continued with three main branches. The old three departments were elevated to a level of sub secretaries with specialized carriers with functional autonomy. The model will provide more guidance for Sub secretariats because were introduced the figure of superior councils in each branch. The new model has innovations in the carriers too. The unique superior carrier was split in three, one to each Sub secretariat. The model follows the International standards where the tax administration is specialized in one single carrier, and the control has its own carrier, as well as the Treasury.

The structure and the function of the RGS Treasury and his carrier were consolidates in the Complementary Law 13,453, published in April 27 2010. The graph 19 shows the new structure of the RGS State Treasury. This was consolidated in the Decree 47,590 of November 23, 2010[17]. The Treasury has still 7 division, but with 24 sections.

GRAPH 20 - DIAGRAM OF THE RGS STATE TREASURY



Source: Finance Secretariat

[17] This Decree consolidates the position of the Treasury Sub secretary in the JUNCOF (fiscal policy coordination) and GAE (personal policy) as executive secretary of the both boards.

The Decree and this new structure consolidate the role in efficient spending as well as in fiscal policy monitoring, with good participation in the strategic decision. The debt management structure was updated for a new model. It included specifics areas to middle Office, contingent liabilities and risk analysis.

This model also consolidate in one area two divisions, the medium term cash flow planning with the unique account management what will bring more accuracy to measure potential financial risk. This created space for set a specific area to fiscal policy and efficient spending that through this could consolidate its work. The assumption of the new model was fulfilled it was not create additional structure. In order to create a new one, another had to be cut.

The gap in staff skills and the imminent retirement of many people was solved with new hiring through public contest when over 20 new analysts joined the RGS Treasury.

CHAPTER V – ECONOMIC THEORIES ABOUT DEVELOPMENT

The development of economies has been studied along the last century because of the effects of greats depressions in economy. Many theories about business cycles and growth were developed and here will address some of them. First of all we have to consider that there are some automatic stabilizers that work to reduce fluctuations. One of them is the progressive taxation that provides a reduction in the amount due when the income goes down.

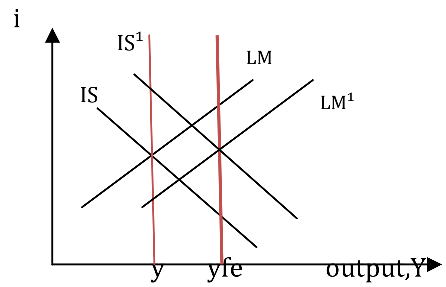
a) THE KEYNESIAN MODEL

According to Keynesians the problems of economy fluctuation is due in first source to aggregate demand. It comes from the expected future of marginal product of capital, the changes in consumer confidence and the changes in fiscal policy. The manner of smooth the business cycle for the government perspective could be increasing government purchase or cutting tax. Both can change a IS curve shifts up and rightward in order to achieve a new equilibrium. The Keynesians believe that the government purchase will have an effect superior of amount of expenditure, through a multiplier higher than one (1), the classics don't agree with that, considering at maximum an effect equals one, that for a different reason, because a increasing government purchases require higher current or future taxes to pay the extra expending. Higher taxes make the workers poorer, which induces them to supply more labor, thus, the output rise. For Keynesians, which model doesn't depend of labor supply, the government purchases affect the output by raising aggregate demand. These effects can last several years until the adjustment of the price level. In the long run the increasing of government purchase doesn't raise the output.

The effect of tax cut will stimulate consumers to spend part of it in consumption, and the raise of desire consumption will raise aggregate demand, so likewise the increase of government purchase. A reduction in tax will be expansionary. In long run, after price adjustment the economy return to full employment with a higher real interest rate. The only difference of the two options is that one use the government purchase and the other use consumption.

For Keynesians the reason of try to reduce large fluctuation is because in a recession the employment may be far below the amount of labor that workers want to supply. For Keynesians the price adjustment to downwards will not happen or it will take longer, so the equilibrium will be far below of natural level of unemployment. The government can use fiscal and monetary policy to stimulate demand. The states in Brazil can only use fiscal policy, because the monetary policy is at federal level. The graph below shows the expansionary movements of the curves, IS and LM, in order to achieve the equilibrium at level of full employment.

GRAPH 21 – KEYNESIAN MODEL



The Keynesian model was developed during the Great Depression, where fiscal policy helped the economy return to normal. Until the 1970s, the Keynesian model had focus only in demand, when the stagflation happened and the Keynesian model failed, because there was inflation with recession together. After that they recast the theory in order to analyze supply and demand shocks.

In the last decade some classics economist have been incorporating Keynesians ideas, and the contrary also happened. Although there is connection between Classics economist and Keynesians, some differences remain. Keynesians think that prices and wages are slow to adjust, and classics think they adjust fast; Keynesians have more faith in government policy to improve people welfare, while classical economist think just the opposite.

However, the Keynesian model analyze short-term output fluctuations, it does not explain long term growth. One of the first famous models to analyze long term growth was the Solow model which we will address below.

b) SOLOW'S MODEL AND ENDOGENOUS GROWTH

The Solow's model, try to explain the output as a result of the total factor of productivity and as a function of capital and labor.

In fact, Solow's model for the economic growth does not explain the total factor of productivity. The expression developed by the model is: Y= A f(K, L) , where A is total factor of productivity, K is Stock of capital and L is total worker employed in that period. The model is a residual model and it calculates the total factor of productivity.

The Solow model of economic growth examines the relations between growth, capital accumulation and saving. An important conclusion of the model is that in the absence of productivity growth the economy will reach a steady state. This steady state is a condition in which output per worker, consumption per worker, and capital per worker are constant, thus it creates stagnation in the economy.

According to the Solow model a higher output and standard of living can be reached increasing the saving rate or increasing productivity and also when the population decline. The Solow's model had become a start point for the new researches.

Endogenous growth theory tries to explain the productivity growth. One approach is the human capital formation and it includes the acquisition of skills and training by workers. A second strand is based on research and development (R&D) activity by firms. The theory sustains that the growth in output and in capital produces improvements in human capital and innovations, and because of that the law of diminishing marginal returns may not be present in the economy as a whole. For this theory the saving rate can affect the economic growth in the long run.

Many theories agree that for raising the long-run living standards, the government should set policies to increase the saving rate and productivity. In order to raise productivity the government should invest in infrastructure, education and R&D.

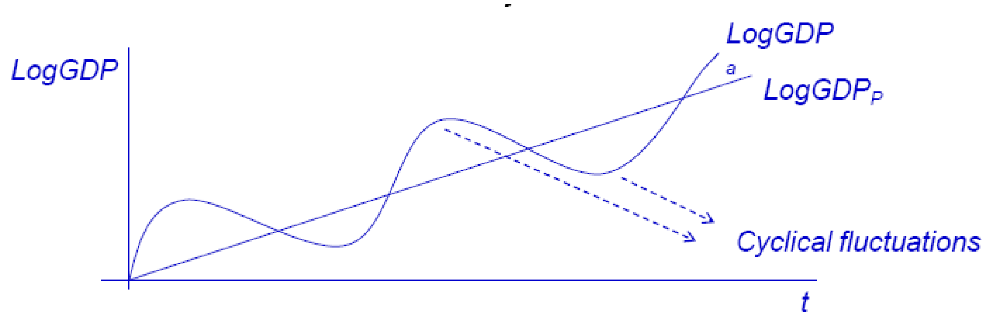
c) COMPETITIVENESS AND FISCAL POLICY

Beyond the theories we have to consider some new researches that are pointing out the government role as a factor of competitiveness. A document published last year that measure competitiveness in countries shows twelve points considered as pillars of competitiveness. One of them is the macroeconomic environment that is important for business and through this to competitiveness of countries. Picking up just fiscal policy, we can demonstrate the importance of the Government for prosperity.

> In addition, proper management of public finances is also critical to ensuring trust in the national business environment. Indicators capturing the quality of government management of public finances are included here to complement the measures of macroeconomic stability …(Schwab, pg 4, 2010)

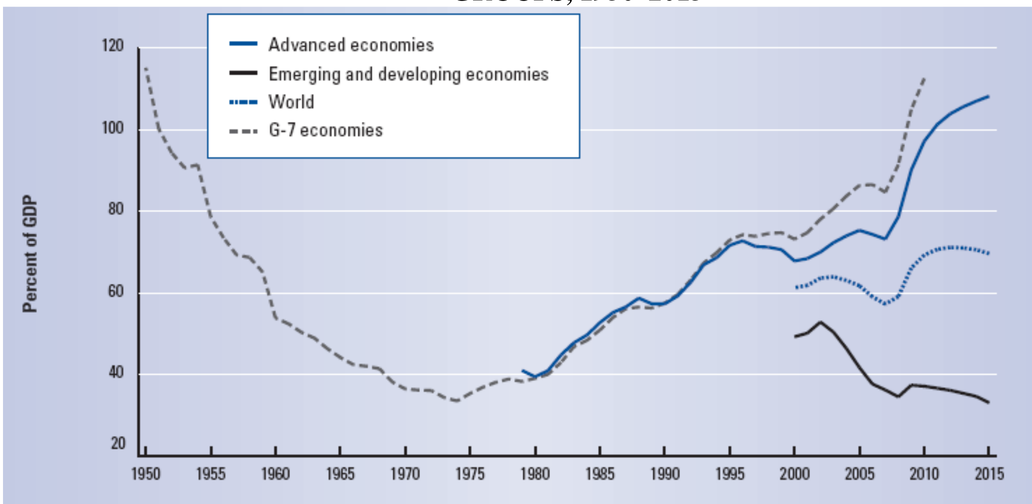
The importance of the fiscal policy can be demonstrated by the consequences of running deficits indefinitely. It will reduce the ability to react to business cycles. We can consider yet the problems that the companies face when there is inflation around. For a sustainable growth it is necessary a stable macroeconomic environment. A lot of big economies are facing huge deficit what cause doubts if they can held it. The deterioration of fiscal accounts is becoming visible and is raising questions about the consequences for longer-term. The difficulties of management the debt can cause a higher interest rate that raise the cost of capital for companies what can refrain investments and grow. In general, fiscal policy was used to dampen the effect of cyclical downturns but was no cut back when business cycle went up again. The graph below shows the Cyclical fluctuation of GDP around the GDPp (GDP potencial).

GRAPH 22 – CYCLICAL FLUTUATION



The deficit of today means more tax in the future or less government services and investments. The successive deficits are raising fast the debt-to-GDP ratio in developed countries. According to research by Reinhardt and Rogoff, these levels will have a serious impact on future growth rates of these economies. They estimate that median GDP growth rates in developed economies fall by about one (1) percentage point a year once a debt-to-GDP ratio of 90 percent is reached. In comparison GDP growth at low debt levels (below 30 percent of GDP), the average rate of growth falls by 0.4 percentage points.

GRAPH 23 - THE EVOLUTION OF PUBLIC DEBT IN G-7 AND OTHER COUNTRY GROUPS, 1950–2015



Source: IMF, 2010a.
Note: Data are shown for the longest available period for each country group.

The macroeconomic environment can be deteriorated for a bad fiscal policy, and that can hit the economic growth and even it can drive to insolvency and default.

A Treasury should focus not only in macro fiscal policy, but also in indicator to qualifying expenditures that have tremendous value for the business environment. The ability to measure the impact of current policy, investments and social programs is also a big task.

CONCLUSION

The importance of the fiscal policy for sustainable growth and higher living standard is becoming a broadly consensus among academics and policy makers.

In addition fiscal policy cannot violate the budget constraint, particularly a multiple year constraint, without dire consequences such as high indebtedness or increase risk premium. The macroeconomic stability of Brazil conquered in the last decade constituted a new framework for the states and its finances. At the state level, poor fiscal policies are any longer possible.

In order to achieve better budgetary results the government of RGS reorganized itself. The outstanding outcomes that happened in RGS fiscal policy are due to the creation of two high level committees subordinated to the State Finance Secretariat, and, in particularly, to new functions performed by the new Treasury Sub secretariat.

The RGS Finance Secretariat reform in 1997 was an important first step. It created the Expenditure Department. Ten years later, the challenges in fiscal policy created the perfect environment to increase capacity and performance in this institution. The Expenditure Department became the RGS Treasury.

The RGS Treasury that was comprised by many disconnected areas became more integrated, more focused and more strategic for the government. New concepts and techniques were developed internally by the Treasury staff or adapted from external sources as consultants and international financial institutions.

The RGS Treasury answered the government needs in fiscal policy in order to acquire the deficit zero. Many other state entities implemented measures to that objective.

The new structure, from now on, is able to help any government to keep a good fiscal policy that can sustain a higher level of social and economical development in long run, what will bring a higher standard of living to the RGS citizens and to Brazil.

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