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CHAPTER 4

BUDGETARY RIGIDITY AND RULES FOR INCREASING FISCAL FLEXIBILITY

Maurício Saboya*

The importance of discussing the theme of budgetary rigidity[1] in Brazil becomes clear in the context of the recent history of the Brazilian economy, marked by a transition towards consolidated macroeconomic stability and by the creation of conditions for sustained growth. One of these conditions is the structural fiscal adjustment of the public sector, a process strongly driven by the 1998 Fiscal Stability Program, with which significant and increasing primary surpluses are being achieved in the scope of the Federal Government. This movement was consolidated after the enactment of the Law of Fiscal Responsibility in 2000.

However, the Brazilian fiscal adjustment process also presents problems, mainly on the side of expenditure. For several years, a growth of non-financial current expenses of the Federal Government has been observed, particularly of obligatory items, i.e. those not subject to restrictions or cuts.

The continuous growth of obligatory expenses reflects the increased degree of rigidity of the Brazilian budgetary structure, where an increasing share of obligatory expenditures is covered with an increasing share of earmarked revenues. Consequently, the degrees of freedom of the fiscal policy as regards cuts in public spending are reduced (graph 1). This causes, among other consequences, loss of capacity of the fiscal policy to play its role as an instrument of macroeconomic stabilization. The results of this loss of degrees of freedom of the fiscal policy should be investigated, considering the pros and cons of the different policy strategies and options.

Graph 1 shows that the discretionary expenditures, which allow room for manoeuvre to the fiscal policy on the side of expenditure, are increasingly compressed by the obligatory expenditures and the primary surplus.

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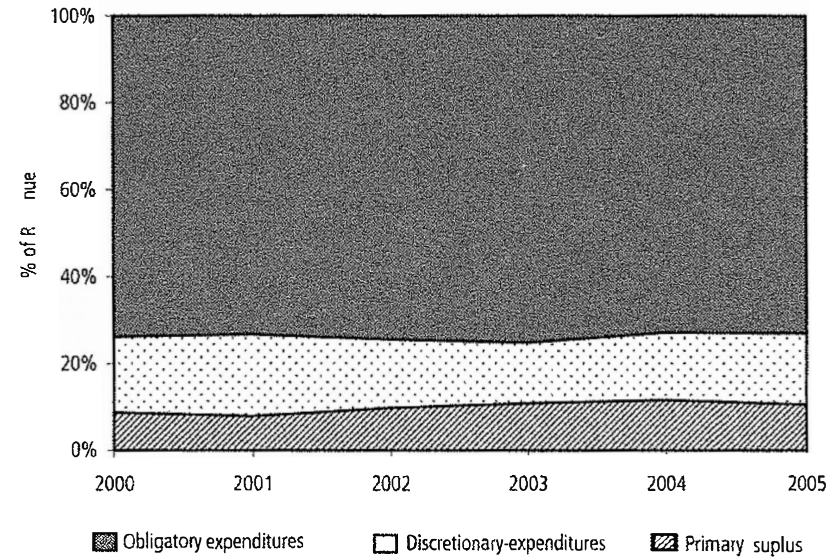
1. Budgetary rigidity (or fiscal rigidity) is understood as an attribute of the public budget characterized by the existence of earmarked revenue and obligatory expenditures. A budget can be rigid to different degrees, while in practice there is no completely rigid or completely flexible budget, i.e. without any earmarked revenue or obligatory expenditure.

This means that the government's capacity to increase its primary surplus beyond the current levels is quite reduced, because the discretionary expenditures are already at a low level and, in practice, cannot be totally eliminated – this would cause paralysis of the public apparatus. Moreover, public revenues have been growing – for example, the tax burden has just beat a new record in 2005, reaching about 37.8% of GDP, and it is not reasonable to expect them to grow indefinitely.

GRAPH 1
Brazil: budgetary rigidity in % of non-financial federal revenue (2000-2005)



Source: Ministry of Planning – Federal Budget Secretariat.
Prepared by Ipea/Dirur/CFP.

When emphasizing the effect of budgetary rigidity over the stabilizing role of the fiscal policy, it is claimed that, in the presence of economic shocks, fiscal rigidity can promote the growth of the public debt to GDP ratio. Although there are no empirical studies that associate budgetary rigidity with growth of the public debt, this relationship is justified in the light of current intuition concerning the behaviour of economic agents, because their perception concerning fiscal rigidity provides the bases for the belief that the government, sooner or later, will not be able to achieve a primary surplus – at least not the necessary amount or with the necessary speed – sufficient to maintain the debt/GDP ratio on a sustainable course. The result is that economic agents frequently take on a "defensive attitude" towards government bonds, preferring short-term papers, with high risk premiums and/or indexed to the basic interest rate (over-selic).[2] In turn, this post-fixed nature of the public debt stimulates the growth of its supply, whenever the Central Bank, faced with inflationary pressures caused by shocks that are transmitted to foreign exchange, has to raise the target of the over-selic rate. Consequently, the net debt of the public sector remains highly sensitive to interest rate variations, which becomes a kind of vicious circle, particularly in the presence of the said economic shocks.

Considering only expenditure, the main burden of the fiscal adjustment befell a small share of discretionary expenditures (other financing and capital expenditures), including investments. In the 1995-2005 period, Federal Government investment was kept at a minimum level (table 1). Regardless of public investment not playing the crucial role it had in the past in Brazilian economic growth (e.g. 1970's), and regardless of the creation of alternative mechanisms to increase private participation in the provision of public services (e.g. public-private partnerships), it is hard to imagine how to achieve the standards of economic and social development yearned for by society, without the support of public investment.

TABLE 1
Brazil: execution of non-financial expenditure of the Federal Government

Period	1995-1998	1999-2005	1995-2005
Personnel and Social Burdens	5.37	5.22	5.27
Social Security Benefits	5.18	6.48	6.01
LOAS and RMV	0.26	0.38	0.34
Other Social Assistance Expenditures	0.15	0.24	0.21
Unemployment Insurance and Salary Allowance	0.51	0.51	0.51
Other Health Costing	1.37	1.51	1.46
Investments	0.81	0.79	0.79
Transfers	2.97	3.90	3.56
Other Current Expenses	1.89	2.13	2.04
Others	0.61	0.60	0.60
Total	**19.11**	**21.55**	**20.66**

Source: Chamber of Representatives – Federal Government's Budgetary Execution.

Prepared by Ipea/Dirur/CFP.

2. It is undeniable that in the last two years the prospects of placing prefixed papers have been improving constantly, as demonstrated by the rising weight of these papers in the total federal bond debt. Another remarkable fact, as of 2003, is the reduction of the participation of foreign exchange bonds in the total federal bond debt in the market (including swaps), causing a reduction of the foreign exchange risk of the Brazilian public debt. What is not known is whether the change in course is sustainable, since there are reasons to believe that the reduction of the foreign exchange exposure of the Brazilian public debt has been determined by an abundance of dollars in the domestic and foreign markets, motivated, among others things, by a cycle of growth of world trade and of the prices of commodities that make up an important share of the Brazilian exportation portfolio.

Table 1 shows the evolution of the non-financial expenses of the Federal Government, in the 1995-2005 period. A significant growth of the total expenditure in percentage of the GDP is observed. The data also show that the period of effective fiscal adjustment (1999 onwards) presented an average annual expenditure above that of the 1995-1998 period, which was characterized by a relatively slack fiscal policy. This is one more indication that the Brazilian fiscal adjustment has concentrated on revenue increase, because both the primary surplus and the primary expenditures grow. Nevertheless, this is not a good sign, in view of the fact that a large share of these revenues corresponds to accrued contributions, i.e. "cascading" incidents, in each phase of the productive process, which distort the decisions of the agents and undermine the productivity and competitiveness of the economy as a whole.

Table 1 shows very clearly the contribution of the INSS social security benefits to the dynamics of the non-financial expenditures of the Federal Government along the last ten years. Whether the analysis is done on the basis of levels or on variation rates, the data seem to indicate that any attempt to restrict the growth of non-financial expenditures of the Federal Government will necessarily require a mechanism to control expenses with social security benefits.

With a view to analysing the effect of budgetary rigidity on the structure of public expenditure, the evolution of the rigid expenditures of the Federal Government's Budget in the 2006-2008 period is simulated.[3] The simulation mechanics follow the following guidelines: on the basis of the expected course of primary surplus of the Government (2.5% of GDP, compatible with the 4.25% of GDP relative to the consolidated public sector established as a target), the series of total non-financial expenditure is deducted, given the hypothesis that the non-financial revenue remains constant in relation to GDP throughout the projection period (based on the fact that it is no longer acceptable to increase the tax burden/GDP ratio). Then, the obligatory expenditures (personnel, social security, health and social assistance etc.) are projected, assuming that their behaviour will follow the model. In this scenario, the maintenance of recent trends for obligatory expenditures implies a reduction of the investment to GDP ratio.

Table 2 presents the results of the simulations and shows that, given the hypothesis adopted, there is a trend of relative reduction along time for public investments, given the fact that the expenses considered rigid grow more than

3. To obtain a detailed description of the Federal Government's public spending simulation model that provides the basis for the results of the exercise presented see Pinheiro (2006).

the non-rigid expenses, in general, and more than investments, in particular.[4] Soon, in a context of high tax burden and the need to maintain the primary surplus, in addition to the strong growth trend of rigid public expenses, public investments tend to undergo a reduction in their relative participations in total expenditure and in GDP.

TABLE 2
Brazil: simulation for investments and rigid expenditures of the Federal Government – basic scenario (2005-2008)
(R$ billions)

Year	Expenditure cap (a)[1]	Rigid expenditures (b)	Non-rigid expenditures (c)	Investments (d)[2]	(d)/(a) (%)	(d)/(GDP) (%)
2005*	418.3	293.6	101.4	23.2	5.5	1.2
2006	443.3	328.3	90.8	27.2	6.1	1.4
2007	469.9	370.4	73.4	22.0	4.7	1.0
2008	498.1	416.7	53.5	16.1	3.2	0.7

Prepared by Ipea/Dirur/CFP.
Notes: [1]Expenditure cap = total of non-financial expenditure of the Federal Government required to keep the primary surplus of the Federal Government at 2.6% of the GDP (compatible with 4.25% for the consolidated public sector), assuming that the non-financial revenue of the Federal Government remains constant in percentage of the GDP
[2]Includes financial inversions.
Obs. * Realized values.

In order to prevent the materialization of this somewhat sombre scenario, this article argues in favour of the need to create mechanisms to increase budgetary flexibility, particularly on the side of public spending. It is necessary to create mechanisms to restrict the growth of obligatory expenditures, in order to generate additional resource savings. These savings could be used to increase the primary surplus, in the cases where this is necessary, for example, due to a severe international financial crisis, or could be directly allocated to increased public investments. The basic idea of the rules for increased fiscal flexibility is to provide to the economic agents safe signals that the primary surplus can be raised quickly and significantly, strengthening the "fiscal shield" against internal or external shocks. It is reasonable to assume that the mere existence of rules to increase fiscal flexibility, duly regulated in Law, will have a favourable effect on the expectations of the market, and will thus help to lower interest rates and the debt even more quickly, even if these rules are not actually enforced.

4. The growth of investments in 2006 results from the hypothesis that the relative participation of investments in the total of non-rigid expenditures will return, in the 2006-2008 period, to its historical average (about 30%). In 2005, this participation was approximately 23%. This hypothesis is justified for 2006, because this is a general elections year and, as such, presents a typical pattern of increased investments.

The great challenge is the design of specific rules to increase fiscal flexibility – applicable, say, to certain segments of social expenditure – that simultaneously contemplate the goals of the social policies (social security, reduction of poverty, inequality and informality) and the economic stabilization and growth targets. The goal is to promote cuts or systematic reduction of those segments of expenditure that, by reasonable criteria, are considered inefficient, ineffective and/or unproductive.[5] This has nothing to do with conferring less importance to the effect of social expenditures as poverty, inequality and informality reduction instruments. Rather, it is about improving the evaluation of the social expenditures, introducing broader criteria, such as the effect of these expenditures on economic stabilization and growth. It is clear that a huge analytical effort must be undertaken, particularly by government agencies responsible for public policy design, evaluation and control.

In the centre of the Brazilian fiscal problem, there is a certain "choice of priorities" (materialized or institutionalised in the 1988 Constitution) determining a budget that is extremely rigid to social expenditure cuts and that causes serious restrictions to the increase of public investment in infrastructure and other important areas for economic development (examples: C&T, public security, Justice enforcement etc.). In face of this problem, one assumes that Brazilian society will hope for a State whose size and functions are compatible with the consolidation of macroeconomic stability – which entails fiscal responsibility and sustainability – and with the improvement of a social protection network that provides, efficiently and effectively, a minimum standard of welfare for the most vulnerable social segments. The position defended in this text is that, in the current circumstances, both principles – fiscal responsibility and universal social protection – are in conflict in Brazil. Fiscal rigidity and the historical drop of public investments are indicators or reflections of this conflict. It is impossible to maintain fiscal sustainability without increasing the flexibility of expenditure; it is impossible to increase the flexibility of expenditure without social costs. In turn, with the current public expenditure structure, it is impossible to increase social protection without undermining fiscal sustainability.

5. Systematic analysis of the efficiency of social public expenditure can reveal some segments that could be cut. For example: between 2001 and 2005, the evolution of the number of sick pay benefits increased from 574 thousand to 1.5 million, a fact generally attributed to increase of the number of frauds, resulting from a disastrous policy of outsourcing of INSS medical examinations. If this number had matched population growth in the period (which would be a reasonable expectation, if there had not been a failure in the management of the medical examinations), the resource saving with the payment of those benefits would have been of approximately R$ 14.6 billion, in accrued terms.

Therefore, Brazilian society needs to discuss thoroughly the State profile that it wants. For this, the dilemmas involved in the pursuit of the consolidation of macroeconomic stability, reduction of poverty and social inequality, and, finally, the pursuit of sustained growth, have to be addressed directly. The discussion around the rules to increase fiscal flexibility takes up these dilemmas only partially.