PROJECT

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TÍTLE: Fiscal Reforms and Politics in Brazilian States

Introduction

During the last two decades, the history of Brazilian State was marked by a double transition: the re-democratization and the economics liberalization. Sallum Junior (1996:63) explains that the crisis of the authoritarian regime and the re-democratization were impulsed by the breakdown of the Brazilian Keynesian Model (called Estado Desenvolvimentista), which was triggered by external factors and became notorious since 1983. This breakdown distanced the political power from the society, collapsing the pattern of domination that had existed since 1930[1]. The crisis of the Brazilian state was in the cell of economic instability during the decades of 1980 and 1990 (when the inflation was high and there was economic stagnation), and its solving depended on deep institutional reforms that could change the real generator of the crisis: the fiscal deficits (Bresser Pereira, 1992).

While the re-democratization was speeded by the break of the state model, based on public massive investments, Brazil depended on the construction of a new model, that could be coherent to the international scene was emerging. By the end of the 1980 decade, the neo-liberalism, represented by the Washington

[1] Sallum Junior (1996:64-67) argues that two external factors were fundamental in order to start the Brazilian "crise da dívida": (i) the monetary contraction policy implemented by the North American govern specially after 1979 and during Reagan's govern, which promoted the increase of international interest rates and valorized dollar; and (ii) the second oil crisis, in 1979, result of Iran/Iraq War. The combination of those factors increased the Brazilian dependency of external capital, at the same time the cost of capital was very high. When the Mexican Crisis interrupted the voluntary capital flow to economies such as Brazil, the solution implemented was the internal debt, via money printing, instead of reducing the state's participation in the productive sector.

Consensus, became hegemonic and shows as an option to the construction of a new model through liberal reforms that could change the old state right in its soul. These reforms were widely used in the most of the capitalist countries since then.

The fiscal issue has major importance in the programs of liberal reforms. In Brazil, the need for reviewing the public finance (targeting the fiscal deficits) became the main strategy for developing macroeconomic conditions needed for maintain the monetary stability and for achieve sustainable economic development, specially after the 1990 decade international crises (México, 1995; Ásia, 1997; Rússia, 1998).

Those international crises exposed the macroeconomic fragility of developing countries (including Brazil), showing that they had to try very hard achieving primary surplus. But, even being able to achieve primary surplus of 3.5% of the GDP (in 2001), the Brazilian economy was still vulnerable. This situation forced the country understanding that a strong adjust would not be enough: it was necessary to improve wide reforms that could created the conditions for sustainable public financing.

The most precise translation for this understanding was the Fiscal Responsibility Act (FRA), promulgated on may 4th 2000, after a short legislative process. The high index of approbation (385 approval votes, 86 rejection votes and 4 abstentions) shows that public finance adjustment was a major issue in the political agenda at that time (Loureiro e Abrúcio, 2003; Asazu, 2003)[2].

Proposed by the Federal Government in 1999, the FRA "emerged as a response for the fiscal deficits of public sector, starting from a diagnostic that those deficits were caused by irresponsible governments" (Mora, 2002:65, my translation). But the FRA also must be seen as an institutional instrument for the public finance sustainability, resulted of a wide fiscal reforms process. This process of institutional changes is helping to build, in the last two decades, the public finance ordering in Brazil.

[2] Silva (2001) argues the FRA "was created to assure the sustainability of public finance". Achieving this objective is important because the strong relation between the fiscal condition of the public sector and the macroeconomic fundaments.

Public finance ordering should mean the promotion of the following: (i) planning; (ii) transparency; (iii) controlling of the public debt; (iv) accountability and (v) ending predatory practices in the Federation (non desirable economic help between Federal and sub-national governments). In other words, ordered public finance are tranparent, debt adjusted to the legal limits, planed budget, functional checks and balances instruments and no unexpected economic help between different governments (Federal, state and local). Ordered public finance allows the desirable credibility public sector needs in order to financing itself in long term and paying lower rates.

In federations, like Brazil, the role of local governments (specially the states governments) on the fiscal reforms is very important. The federal government must have the states support in order to implement them (the fiscal reforms) successfully. In other moments of the Brazilian history, as in the 1991-94 term, the governors of states were able to block fiscal issues came from federal government (Abrucio, 1998:201). The results of fiscal (and institutional) reforms on the states finance are essential to the success of the federal government macroeconomic policies[3].

The debt of the Brazilian states grow since 1994, specially because the high domestic interest rates. In 1996, the states economic crisis was highlighted in the nation's agenda. The diagnostic indicates that the pattern of financing the Brazilian states should be changed. So, between 1996 and 1997 the federal government launched a program for supporting the local governments fiscal and financial recovering (Programa de Apoio à Reestruturação Fiscal e Financeira). The states that agreed to the program had their debts negotiated by the federal government, what helped them to improve their capability to pay the interests (Mora, 2003:22).

The states ruled by the federal government coalition (PSDB and PFL) started to worry about fiscal issues in 1995[4]. Important states as São Paulo, Rio de Janeiro and Minas Gerais implemented reforms (they called administrative

[3] Before proposing the tributary and social security reforms, President Lula discussed these issues with the state governors because he understands the importance of their political support. See "Lula e Governadores levam hoje ao Congresso propostas de reformas" (OESP, 30/04/2003).

reforms, but they were not that deep) that targeted improving the public revenue and cutting public spending. Those states also sold several public companies (privatizations on electric energy sector, telecommunications and steel industries). In the national political agenda, the perception of the fiscal issue in the states reforms got stronger, which made the federal government strongly supporting the fiscal adjustment in those federated governments.

The federal government capability to promote fiscal reforms in the states, specially after 1994, was a result of federal power's increase. Because the Real Plan's success on controling the inflation, the federal government was able to implement some institutional reforms that change some federation rules (Loureiro & Abrucio, 2003:9). With more political power, the federal government was able to gradually induce the states to accept the federal fiscal logic.

The negotiations about the states debts (Federal Law 9496/97) were used by the federal government as an instrument to convince states implementing programs to obtain and maintain fiscal adjustment. Giambiagi and Rigolon (1998) explain that the Law 9496/97 "is a part of the fiscal adjustment program in the states, and it establishes targets to the states debt, the primary surplus, the spending on personnel, investments, revenues and privatizations efforts".

The states were compromised to several targets after the negotiation of their debts, but the privatization of the state banks was a highlight issue[5]. In the past, those banks were used to financing the states' budget deficit, and the extinction of the state banks represented the end of the governors' power to influence the monetary policy in the federation[6]. Again, because the political revenue obtained from the Real Plan success, the federal government was assuring its authority over the monetary policy.

[4] See "Azeredo anuncia fusão de secretarias. Governador quer cortar despesas, aumentar receitas e ampliar privatizações" (OESP, 27/12/1995).
[5] PROES was the federal policy that intended to end up with public state banks. See Sola, Garman & Marques (2002).
[6] Since the state public banks' directors were nominated by the governors, the states did not used to pay back the loans they got from their own banks. This practice gave to governors the power to create money. See Sola, Garman & Marques (2002).

This study is about all this problematic that involves deep political conflitcs about public finance. The objective of this research is analyzing the different strategies chosen by state governments to achieve fiscal adjustment (reducing public debt and promoting sustainability for the public finance). Even known fiscal adjustment is the most studied issue of fiscal reforms, no other study had proposed analyzing, through a political point of view, the fiscal adjustment in the Brazilian states. That's why the importance and the originality of this work.

The creation of new fiscal rules is a very important element to assure the success of fiscal reforms. But this study considers that more important is the institutional characteristics (or the political options) that restrict the executive authority and promote more debate on the process of formulating and implementing economic reforms (Stark & Bruszt, 1998). The existence of institutional constraints to the executive authority (or if the executive chooses to extend the debate before implementing a program) extends the political responsibility. In that way, "democracy offers some beneficial constrains that promote more efficacy, coherency and durability to economic reforms and to the State – Society relation" (Sola, Kugelmas & Whitehead, 2002:29, my translation).

Theoretical Arguments

This research considers the theory of institutionalism. Applied on the study of the fiscal issue, several works sustain the importance of the institutions on the determination of fiscal performance (Schick, 1993; Weaver & Rockman, 1993; Poterba & Hagen, 1999). The institutionalism argues that is a strong relation between fiscal rules and fiscal outcomes. This could be empirically confirmed in several countries where fiscal reforms were implemented.

Since the relation between fiscal rules and fiscal outcomes is consensual nowadays, the new studies highlight WHEN and HOW fiscal institutions matter. Alesina & Perotti (1996) studied the fiscal adjustments' composition, drawing a relation between types of adjustments and the level of success. They argue fiscal adjustments that promote cuts on wages, social spending and social security have greater chance to be successfully than fiscal adjustments that promote cuts on investments and raising of taxes. Their study showed the fiscal adjustments can be contractionists or expansionist, depending on its composition, what makes a lot of difference in terms of creating economic conditions to a sustainable public finance. The success of fiscal adjustments depends on its capability to lower, permanently, the public debt over the GNP.

Considering Alesina & Perotti's work, this research intends to investigate HOW the composition of the Brazilian states' fiscal adjustments is impacting over the states' debt and public finance. The intention is to contribute to the understanding that, even tough the institutions matter, the political dynamics during the fiscal adjustments formulation and implementation process also matter for the fiscal outcomes. Even the fiscal rules are the same for all Brazilian states, the fiscal adjustment formulation and implementation stage on each state can be based on different political strategies. In other words, the fiscal performance depends on fiscal institutions and on politics, on balanced level.

The political strategies used by each state govern can be observed by studying the composition of the fiscal adjustment. We can understand fiscal adjustment's composition by the different impacts this policy causes over governs' revenue and expenditure. For instance, primary surplus could be achieved raising taxes or cutting expenditures, and this choice would make the adjustment more or less permanent.

About the political dynamics, this study considers Stark & Bruszt's (1998) concept of accountability. They argue accountability happens when the executive's authority is restricted by political institutions (public and non-public), and it is forced to expand the debate during the policy formulation stage. With its choice restricted by the debate, governs tend to improve its evaluations and producing better policies.

Studying the coherence of public policies in east Europe, Stark & Bruzst sustain authority and responsibility are not contradictory; the key to the reforms' success is being able to produce an accountability expansion by institutionally restricting executive's authority. The democratic dimension present in this model explains the author's conclusion. "(...) the debate increases the policy makers' comprehension, bringing information that helps previewing economic, political and social consequences of their decisions" (Stark & Bruszt, 1998:27, my translation).

Among Brazilian states, the public debt evolution differs from state to state, even the fiscal rules been the same to all of them. A pure institutionalist approach could not be able to explain the impacts of fiscal reforms in Brazilian states. This research intends summing other fiscal outcomes' determinants: (i) HOW the governor and the policy makers decide implementing the fiscal adjustment policy; (ii) and WHY they chose a specific political strategy. The fiscal adjustment's politics will be studied in order to contribute to institutionalist theoretical approaches.

Research Problem

The institutional constraints, as the Fiscal Responsibility Act and the Federal Senate Resolutions, are the same for all Brazilian States. However, the fiscal performance of each state have been different. Information from the Secretary of Treasury shows states such as Alagoas, Goiás, Maranhão, Minas Gerais, Mato Grosso do Sul, Rio de Janeiro, Rio Grande do Sul and São Paulo exceed the limit (twice the liquid revenue) for public debt in the year of 2003. Among them, Minas Gerais and São Paulo did not had exceed this limit in 2000, when the Fiscal Responsibility Act was created. In other hand, the state of Mato Grosso, which had a debt of 2.5 times its revenue in 2000, adjusted its debt in 2001 and got to 2003 with a debt of 0.87 times its revenue. So, some states have increased their public debt, and others have not, in the context of the same fiscal institutions.

As I declared before, fiscal reforms intend putting public finance in order, promoting its credibility and sustainability. It is not only controlling fiscal performance (as primary results or the size of public debt) that matters. In democracy, there are many other objectives reforms intend to achieve, such as: planning, transparency, accountability and avoiding predatory practices among federation. However, there are few studies about fiscal reforms in Brazil, specially in the states. This research focused only one of the fiscal reforms' objectives, which is the fiscal adjustment (balanced budget, primary surplus and controlled public debt.

This focus is justified because the budget's adjustment and the public debt control are urgent objectives that are necessary to the Brazilian economic integration to the international market. The economic globalization demands to national economies controlling of some credibility indicators. Among those indicators, international investors pay a lot of attention on the public sector primary results and on debt versus GNP.

These information indicates fiscal reforms may end up on different results. From this observation, the empirical question for this research is:

> Why the Brazilian states have different fiscal performances after the Fiscal Responsibility Act? Specially, why some states' debt got higher, and others got lower, in the same period of time and under the same fiscal institutions?

Since the public debt is measured over Liquid Revenue, its reduction may be the result of the revenue improvement. That's why this research will monitoring the evolution of the states' economy, intending to compare states where the economic overall conditions were alike.

Research Hypothesis

The fiscal adjustment programs' success in achieving the desirable public debt control in Brazilian states depends on the political dynamics of each one. In other words, this research supposes that in order to be successful in democratic regime, fiscal reforms need politicians capable to implementing them considering the political context of each state. This capability depends on political ability to handle the reform with pragmatism instead of a hard and ideological oriented behavior[7].

The hypothesis of this research is:

State governs that exposes their decisions to a wide and public debate and to a political negotiation tend to implement adjustments close to type 1 (cutting on public wages and voluntary transfers, small increasing of indirect taxes) instead of adjustments close to type 2 (cutting on investments, maintenance of wages and transfers and notable taxes increasing, specially over families). This happens because the wide negotiation expands the accountability, and makes larger the necessary legitimacy to adjustments of type 1.

Complementing the hypothesis, type 1 adjustments tend to a higher probability of success, reducing (or stabilizing) public debt in a more permanent way, as sustain Alesina & Perotti (1996). Adjustments like that are, in a short term period, considered politically harder to implement because they promote cuts on sensitive budget areas. Those cuts are immediately noticed by electors, but in the median and long term period they are the only ones able to promote economic expansion.

Adjustments close to type 2 are politically easier to implement because they interfere in areas that are not immediately noticed by electors (such as public investments), but they produce contractionists effects over the economic activity. Those effects became harder to keep the debt sustainable, since GDP does not increase, or even get lower. In addition, public investments reduction can not be forever, and the increasing of taxes (also observed in adjustments type 2) reduces overall economic competitiveness, harm families' consumption and block private investments.

Methodology

This research has three related focuses: on one side, the composition of fiscal adjustment (economic dimension); and on the other, the political dynamics observed during the adjustment's implementation and the political elite profile (political dimension). The relation between the focuses happens because the composition of adjustment is a result of the following aspects: (i) political dynamics

[7] See Stark & Bruszt (1998:15).

during implementation, which may cause a higher or a lower level of accountability; and (ii) the political elite's options in expanding or not the debate about the fiscal adjustment for over the limits of institutional constraints to its authority. Investigating how politics "work out" fiscal adjustments, this study intends to answer the research question and identifying political determinants to success of fiscal reforms in alike institutional and economic condition.

About the economic dimension, this research intends to study the following fiscal adjustment composition's aspects: (i) public investments; (ii) voluntary transfers; (iii) public wages; (iv) social spending; (v) taxes revenue; (vi) ICMS revenue; (vii) IPVA revenue; (viii) direct taxes revenue; (ix) ITBI "causa mortis" and donation revenue; (x) privatization revenue.

In the other hand, about the political dimension this study intends to evaluate if the state executive govern considers internal and external actors' demands to take decisions about the fiscal adjustment strategies. At this point, it is important remembering that all states experiment the same institutional constraints to the executive authority. However, some state governs are able to create (or take advantage of) contexts where their decisions are less questioned. Also, executive authorities can purposely expand the debate about fiscal adjustment, including more actors in the fiscal adjustment implementation process.

Finally, about the third focus (still in political dimension), this research will consider as political elite those actors who take (or interfere) the decisions related to budget executing[8], which means the governor and the secretaries of finance and planning. The research will observe: (i) their network; (ii) their career history; and (iii) their political ideas. So, the state elite profile will help explaining the politician's options about accepting information from debates and political negociations, and projecting this learning on different adjustment compositions.

The study will focus on the period from 2000 to 2004, years that followed the creation of the Fiscal Responsibility Act. First, the research will describe the finance situation of each state, highlighting the public debt controlling aspect. Then,

[8] Since the majority of the public budget in Brazil does not obligate (but only authorizes) governors, its executing depends specially on the political elite preferences.

the fiscal adjustment's composition will be studied, from the analysis of state's revenues and spending, permitting the classification of each adjustment on type 1 (more probability of success) or type 2 (less probability of success).

After this first phase, the study will focus on the political dimension: politics in each state will be analyzed during the implementation process of fiscal adjustments. Also, the elite profile will be investigated. In order to run this phase, basically it will be used interviews with political actors and newspaper and magazines researches.

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