Brazil
Improving Fiscal Circumstances for Growth
(In Two Volumes) Volume I: Stylized Facts and Recommendations

March 2, 2007
Brazil Country Management Unit
Poverty Reduction and Economic Management Unit
Latin America and the Caribbean Region
CURRENCY EQUIVALENTS
Exchange Rate Effective January 31, 2007
Currency Unit = Brazilian Real
US$1.00 = R$2.12

GOVERNMENT FISCAL YEAR
January 1 – December 31

WEIGHTS AND MEASURES
Metric System

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<td>ANP</td>
<td>Agência Nacional do Petróleo</td>
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<td>BNDES</td>
<td>Banco Nacional de Desenvolvimento Econômico e Social</td>
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<td>CIDE</td>
<td>Contribuição de Intervenção no Domínio Econômico</td>
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<td>COFINS</td>
<td>Contribuição Para o Financiamento da Seguridade Social</td>
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<td>CPMF</td>
<td>Contribuição Provisória sobre Movimentação Financeira</td>
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<td>CSLL</td>
<td>Contribuição Social sobre o Lucro Líquido</td>
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<td>DRU</td>
<td>Desvinculação de Receitas da União</td>
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<td>GDP</td>
<td>Produto Interno Bruto</td>
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<td>FAT</td>
<td>Fundo de Amparo ao Trabalhador</td>
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<td>FNDCT</td>
<td>Fundo Nacional para o Desenvolvimento da Ciência e da Tecnologia</td>
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<td>FUNDEF</td>
<td>Fundo Nacional de Desenvolvimento e Manutenção da Educação Fundamental</td>
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<td>ICMS</td>
<td>Imposto sobre Comercialização de Mercadorias e Serviços</td>
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<td>INSS</td>
<td>Instituto Nacional de Seguridade Social</td>
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<td>IOF/IOF-Ouro</td>
<td>Imposto sobre Operações Financeiras</td>
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<td>IPI</td>
<td>Imposto sobre Produtos Industrializados</td>
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<td>IR</td>
<td>Imposto de Renda</td>
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<td>ITR</td>
<td>Imposto Territorial Rural</td>
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<td>LDO</td>
<td>Lei de Diretrizes Orçamentárias</td>
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<td>LOA</td>
<td>Lei Orçamentária Anual</td>
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<td>LOAS</td>
<td>Lei Orgânica da Assistência Social</td>
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<td>MMA</td>
<td>Ministério do Meio Ambiente</td>
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<td>OECD</td>
<td>Organização para Cooperação Econômica e Desenvolvimento</td>
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<td>PIS/PASEP</td>
<td>Programa de Integração Social / Programa de Formação do Patrimônio do Servidor Público</td>
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<td>PPA</td>
<td>Plano Plurianual</td>
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<td>PPP</td>
<td>Parcerias Público-Privadas</td>
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<td>RGPS</td>
<td>Regime Geral de Previdência Social</td>
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<td>RMV</td>
<td>Renda Mensal Vitalíca</td>
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<td>RPPS</td>
<td>Regime Próprio de Previdência – Servidores Público</td>
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<td>SUS</td>
<td>Sistema Único de Saúde</td>
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ACKNOWLEDGEMENTS

This volume (I) was written by Ethan Weisman, Lead Economist for Brazil, with Fernando Blanco, Economist. It was based on the detailed assessments contained in volume II of this report. Volume II was prepared by Yasuhiko Matsuda, Fernando Blanco and José Guilherme Reis with inputs from Santiago Hererra and Ethan Weisman. Background papers were commissioned to Silvia Valadares, Sol Garson, Claudio Frischtack, Gerhard Glomm (Department of Economics Indiana University) and Felix Rioja (Department of Economics Georgia State University). Anand Rajaram, Aymeric-Albin Meyer and Santiago Herrera were the peer reviewers for the study.
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1. EXECUTIVE SUMMARY

1.1 Why has Brazil not been able to grow faster for an extended period of time? Long-run real economic growth for Brazil seems stuck around 2-3 percent per year (2.4 for the period 1980-2004), in contrast with other middle-income countries (e.g. China (9.8%), India (5.8%), and Chile (5.1%)). Although Brazil experienced rapid annual average economic growth during the late 1960s and 1970s (8.5 percent), domestic and international events led to much weaker growth in the decades that followed.¹

1.2 Fiscal circumstances in Brazil are a key constraint to faster and more robust economic growth. In part, this is due to accumulated public sector deficits in earlier periods that are represented in Brazil's persistently high net public sector debt (currently about 50 percent of GDP). During the 1980s and mid-1990s high debt was associated with debt crises and hyperinflation. Several attempts to control inflation failed, until the 1994 Real Plan. Moreover, to inhibit the accumulation of debt, and to promote economic confidence in capital markets, two successive administrations have pursued primary fiscal surplus targets (4.25 percent of GDP in 2006). However, the quality of fiscal adjustment has been poor.

1.3 Legally mandated spending has increased rapidly, and without significant reform this type of spending is projected to become explosive. An important part of this mandatory spending is tied to the 1988 Constitution. Less than 20 percent of the budget is discretionary. Moreover, other policy decisions, such as minimum wage increases, have aggravated increased current spending. Rising minimum wages increase spending under mandatory programs, especially social security.

1.4 Given the fiscal target and constraints on current spending, the most important part of the fiscal adjustment in recent years has been the increase in tax revenue, reaching about 38 percent of GDP in 2005. High taxation provides disincentives to investment, and encourages tax evasion and informal sector growth, which in turn leads the authorities to search for additional tax revenue on a narrower set of formal activities. Thus, there is a vicious cycle of ever increasing mandated spending with increased taxation to meet the fiscal target. However, further tax increases would be difficult to implement and enforce.

1.5 Budget rigidity, especially revenue earmarking, restricts policy action to resolve the fiscal conundrum. Revenue earmarking is linked to transfers to sub-national governments, social sector spending, and specific taxes to cover the social security deficit. The federal government is required under the 1988 Constitution to share 47 percent of its tax revenue (personal and corporate income taxes, and taxes on industrial products) with lower levels of government. These transfers represent about 5 percent of GDP. Social sector spending is mandated as a share of current revenue.

1.6 Total public investment since 1998 has dropped by more than 2 percent of GDP.² Private investment has also been falling during this period. The drop in investment was caused by fiscal constraints and high interest rates (caused in turn by the high level of public debt and associated risks, weak regulatory environments, and public sector distortions in the domestic financial market).

² The central government dropped ¼ a percent of GDP, over ½ a percent of GDP from sub-national governments, and about 1 percent of GDP from public corporations.
Spending levels are high relative to the quality of public services, pointing to weaknesses in expenditure management. These weaknesses adversely affect public investment and spending on public services. Thus, increasing public investment alone will not accelerate economic growth; measures are also required to address expenditure management shortcomings.

**FIVE STYLIZED FACTS**

**A. Brazil's Spending is Large and Increasing**

Brazil has the largest public sector of any other middle income country. General government spending exceeds 40 percent of GDP and tax revenue was about 38 percent of GDP in 2005 (an increase of over 10 percentage points since the 1990s). This is comparable to sizeable welfare states in northern Europe, such as Finland. When combined with non-financial public corporations, the size of the public sector represents about half of the economy.

The bulk of public sector spending is devoted to primary current spending (roughly 33 percent of GDP) and is increasing. Social security schemes alone represent roughly 12½ percent of GDP. Sub-national government spending on social services also has been expanding; this spending devolved to state and municipal governments under the 1988 Constitution. Pressures to increase social security and social spending are mounting, due in part to the aging population.

Off balance sheet transactions also have contributed to increasing the size of the public sector. Contingent liabilities include pending judicial decisions. The discovery and recognition of liabilities not previously recorded (so called "skeletons") increased the stock of public debt substantially (with estimates ranging from 12-19 percentage points of GDP). The larger debt stock has increased debt servicing payments. Tax expenditures also contribute to fiscal pressures; the federal government tax expenditure was 2.5 percent of GDP in 2004.

**B. Social Security Spending Represents a Major Challenge**

Social security spending is mandated through the 1988 Constitution, which made the system generous and rigid. Pension spending covers: 1) social security for all public sector workers (RPPS); 2) social security for private sector workers (RGPS, the largest segment of the Brazilian pension system), and 3) a private complementary pension system. Brazil is an international outlier in almost every class of social security spending (old age, survivor, disability, and sick pay), due to extremely generous benefits. For example, survivor pension benefits represent 3.3 percent of GDP, which is over three times as large as OECD countries that have older populations and higher incomes.

Pension reforms have had limited impacts. The December 2003 reform reduced somewhat the RPPS pension deficit, in part due to increases in the average age of pensioners and slower growth in new pensioners. It also instituted contributions on retirement benefits, increased the minimum age for retirement, and equalized the benefits of public servants to the general RGPS system (but only for new entrants, so the effect has been delayed). On the other hand, administrative reforms to the RGPS system in 1998 had more limited impacts. They introduced changes in the formula (the fator previdenciario) to reduce incentives for early retirement, increased revenues (through recertification efforts) and reduced the number of sickness benefits (that took effect recently). However, both the average retirement age (54 for men and 51 for women) and average length of service remain low. RGPS expenditure and deficits continue to increase; so further parametric reforms are needed.

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3 Interest payments represented approximately 7 percent of GDP per annum during 1995-2004.
C. Effects of Public Investment and Consumption on Growth

1.13 The present level and composition of public spending are not conducive to long-term economic growth. Econometric analysis of per capita GDP growth over 1950-2000 shows:

- Public (and private) investment increases growth;
- Government subsidies increase private capital accumulation (and thus growth), but this effect dampens over time as debt accumulates.
- The tax burden reduces capital accumulation (and thus growth).
- Government consumption, social security, and social assistance transfers all reduce growth (the latter in the long run because more financing translates into higher taxes).

1.14 Over time, the composition of public spending has shifted to larger shares of government consumption, social security, and social assistance and away from public investment and targeted capital subsidies. Additional taxation needed to finance the enlarged public sector (along with inefficient expenditure composition) has dampened growth.

1.15 Simulations show that Brazil would benefit from higher public investment within a tight fiscal constraint (however, increasing taxation or borrowing to pay for such investment would limit long-run growth prospects). Given the low level of public investment, a reallocation from social security to spending on infrastructure would likely have sizeable growth effects. On the other hand, increasing public debt to finance transfers would decrease growth. Moreover, increasing public debt to finance education expenditure would increase growth in the short run, but the debt accumulation would slow growth in the long run.

D. The Budget is Inflexible

1.16 A major challenge is the excessive rigidity arising from legally mandated expenditure and extensive revenue earmarking. There are essentially three broad sources of budget rigidity: (i) earmarking of tax revenue, (the most important are Constitutionally mandated spending on social protection, health and education, and transfers to states and municipalities); (ii) social contributions, which are used to cover part of the social security deficit; and (iii) non-discretionary expenditure that includes legal or Constitutional obligations for interest payments, wages and salaries, entitlements (such as social security), and social assistance benefits.

1.17 So far government efforts in this realm have concentrated on an ad hoc measure to “de-earmark” federal revenue, called DRU (Desvinculação de Receitas da União). However, given simultaneous increases in certain non-discretionary expenditure items (most notably social security benefits), the DRU has had innocuous impacts on budget rigidity and overall spending.

E. The Budget is Not Well Linked to Planning and Execution of Public Expenditure

1.18 An expenditure management review highlighted institutional weaknesses in planning, budgeting, expenditure execution, and evaluation. In particular, there is a lack of congruence between expenditure allocations set in multi-year plans, annual budgets, and amounts of investment effectively executed. Since 1996, the government’s primary instrument for expenditure planning has been its Multi-year Plan (PPA, Plano Plurianual), which does not contain a medium-term fiscal framework. The Budgetary Guidelines Law (LDO) defines revenue, expenditure, and balances in a three-year rolling framework, but the LDO targets are not well linked to the PPA, nor do they integrate the impacts of policy decisions, such as increases in the
minimum wage. Moreover, Congress makes changes when the budget proposal gets finalized in the Annual Budget Law (LOA). In addition, a reversal of priorities results from reductions to the budget and restrictions on the release of funds (“contingenciamento”) during execution.

1.19  **As a result, the quality of spending is poor relative to the amount of spending.** For example, health indicators are well below the average for middle-high income countries, even though per capita health spending is above average. Moreover, the execution of spending is not well monitored and evaluated for outputs or results.

**FOUR RECOMMENDATIONS**

**A. Reduce the Size of the Public Sector (and Control Explosive Spending)**

1.20  **To address the fiscal conundrum nondiscretionary expenditures need to be controlled and the rising trend reversed.** Changes to legal mandates are required to restrain the growth of the public sector and to reduce its size. This will require legal changes to break the rigidity in social security and to add flexibility in social spending. Measures should focus on:

- reducing spending on the pension system;
- reducing certain subsidies, (e.g. credit through public financial entities);
- increasing revenue by selectively applying fees for services and eliminating tax expenditures;
- revitalizing the privatization process to add efficiency and limit quasi-fiscal deficits;
- taking into account the full fiscal impacts of further increases in the minimum wage, including impacts on social protection spending; (ideally, spending offsets should be contemplated for such increases); and
- improving the quality of spending through better targeting in social assistance programs, health, and education.

1.21  To make these adjustments more persuasive, a certain share of the fiscal saving should be directed to increase public investment.

**B. More Aggressively De-earmark Revenue in Combination with Reduced Mandatory Spending**

1.22  **Brazil should more aggressively pursue revenue de-earmarking, but not through DRU.** As a first step, all earmarked funding should be set in terms of reais in real terms (that is indexed to inflation) rather than as a share of revenue. Unused funds in a given year should be used for domestic debt reduction, or saved to fund additional infrastructure. De-earmarking should accompany reductions in mandatory spending.

**C. Improve Public Sector Management through Strengthening, Planning, Budgeting, Execution, and Evaluation**

1.23  **Reforms to improve the coherence of planning, budgeting, execution, and evaluation should be implemented across all levels of the public sector.** Efforts could focus on improving the budget cycle and developing a consistent medium-term macroeconomic framework consistent with the budget.

1.24  **The LDO is the most appropriate vehicle to develop a medium-term framework.** Even in the case of successful constitutional reforms to bring greater budget flexibility, there may not be sufficient information to determine where the budget should be cut, preserved, or increased.
in the absence of a medium-term framework. An institutionalized process of expenditure reviews for generating micro-level information about saving options would be a useful addition to Brazil’s planning and budget process.

1.25 To strengthen executing agencies, measures should improve financial management, increase flexibility regarding human resource management, and implement a solid set of monitoring and evaluation systems. Eventually, a medium-term framework and the monitoring and evaluation system could be developed in a harmonized manner to support results-based budgeting for the entire general government.

D. Increase Public (and Related Private) Sector Investment

1.26 Part of the fiscal saving should be directed to increase public investment, while keeping the overall tax burden and indebtedness under control. Systematic efforts also will be required to strengthen institutional capacities for planning, budgeting, and executing public investments. Improving infrastructure ministries’ capabilities to manage these limited resources efficiently and effectively could involve: (i) a medium-term infrastructure investment strategy; (ii) a set of performance indicators to monitor efficiency and effectiveness of the infrastructure portfolio as a whole, as well as by sub-sector; and (iii) an organizational reform, including adoption of a human resource policy to enhance the professional quality of the staff working in the infrastructure sector and to streamline the ministries’ business processes and organizational structures.

1.27 Given the fiscal constraints, the private sector will need to play a more active role. Public-private-partnerships; solid and reliable contracts (public and private); and public sector reforms that strengthen the regulatory environment are needed. Moreover, getting the size of the public sector under control and continuously working to reduce indebtedness would set enabling conditions for continued reductions in interest rates, leading to more private sector investment.
2. INTRODUCTION

2.1 The size and composition of public sector spending have served as a brake on robust economic growth in Brazil. Moreover, the present fiscal adjustment in Brazil is not sustainable in the long run, despite the improving macroeconomic conditions in recent years. Based on current trends and commitments embedded in the 1988 Constitution and other laws, Brazil’s fiscal spending is on an explosive path. Without corrective spending measures, further tax increases to maintain the primary fiscal target would choke off economic growth. No immediate crisis is envisaged; however, medium-term economic growth will continue at anemic rates as long as policies do not address the conundrum of high public sector debt, expansive and expanding public sector tax and spending policies, low investment, budget rigidities, and weak public sector management and institutional arrangements.

2.2 This document is part of a series of reports by the World Bank on Brazil’s potential to foment more robust economic growth and reduce poverty and inequality. This report does not attempt to directly address these outcomes. The main focus of this report is on the interrelated fiscal circumstances facing Brazil, with an emphasis on public sector spending.

2.3 The report is divided into two volumes. This first volume distills the essential stylized facts (that are described in detail in volume two) and focuses on key recommendations (discussed in detail in Chapter 5 of the second volume). These recommendations highlight not only areas where improvements could be achieved, but also suggest options on how to go about implementing such modifications, based in part on international experience. The second volume of the report contains: more detail on these stylized facts; a first attempt to compile data for the entire non-financial public sector; quantitative analysis of the fiscal impacts on growth using a dynamic general equilibrium model and a simulation based on that model; specific examples of key budget rigidities; and, as an example, a review of road transport spending with a view to strengthening the impacts of this infrastructure spending. Other related World Bank reports concentrate on social security, health, financial markets, infrastructure, poverty, and the issues surrounding the monitoring and evaluation of public sector services in general. Volume one of this report reflects some of the preliminary findings in these other reports.

2.4 The innovative contributions of this report are to: 1) put the information on Brazil’s fiscal circumstances (some of which is common knowledge to specialists) into a single report; 2) compile the profile of the entire non-financial public sector and the entire public sector for the first time (chapter 1 of volume 2); 3) provide empirical evidence on the overall economic growth impacts of the composition of public spending and simulate the growth impacts of possible expenditure reallocations (chapter 2 of volume 2); and 4) draw practical policy recommendations from this analysis. The report pulls together analysis that has been in progress over several years. While some of the data are not fully up-to-date, this reflects in part the difficulties to compile

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such coherent data and points to the need to strengthen publicly disseminated fiscal data.\footnote{The International Monetary Fund’s \textit{Government Finance Statistics Manual 2001} (http://www.imf.org/external/pubs/ft/gfs/manual/index.htm) and related reports on standards and codes on both fiscal and statistical practices provides useful guidance for such efforts.} This document aims to serve as a useful focal point in forthcoming debates on Brazil’s macroeconomic (and especially fiscal) policies and related structural reforms to promote enhanced economic growth and reductions in poverty and inequality.
3. CURRENT MACROECONOMIC CIRCUMSTANCES FACING BRAZIL

3.1 Even though Brazil experienced relatively rapid economic growth during the late 1960s and 1970s (at an annual average rate of 8.5 percent), domestic and international events led to much weaker growth in the decades that followed (for example, 3 percent per year during the 1980s). Moreover, since then, economic growth has been steady, but modest. Long-run real economic growth for Brazil seems to remain stuck around 2-3 percent real economic growth per year (2.4 for the period 1980-2004), while in contrast, many middle-income countries experienced more rapid and robust growth (for example, China (9.8%), India (5.8%), Turkey (4.1%), Chile (5.1%), Indonesia (5.4%), and Thailand (6.1%) during the period 1980-2004).

3.2 Why has Brazil not been able to grow faster for an extended period of time? The answer to this question may be long and complex (see also the World Bank Report (2002) - Brazil: The New Growth Agenda); however, there seems to be broad consensus that the fiscal position remains at the crux of this issue. In part, this is due to accumulated public sector deficits in previous periods that are represented in Brazil’s persistently high public sector debt (roughly 50 percent of GDP). The large debt stock means that the government must spend an important share of revenue collection each year on servicing this debt. The high debt burden initially caused severe economic turbulence through a series of debt crises and hyperinflation. Several attempts to control inflation failed, until the introduction of the Real Plan in 1994. Moreover, to inhibit the accumulation of even more debt, and to promote economic confidence in capital markets, recent governments spanning administrations with different political leadership have endorsed the pursuit of announced primary fiscal surplus targets (4.25 percent of GDP for 2006).6

3.3 Legally mandated and policy driven spending has increased rapidly and, without significant reform, this type of spending is projected to become explosive. An important part of this mandatory spending is tied to the 1988 Constitution (including specifically the social security scheme), as well as mandatory minimum levels of spending in social areas of education and health. As a result, less than 20 percent of the budget remains at the discretion of fiscal policy makers. Moreover, other policy decisions have aggravated increased current spending, especially real increases in the minimum wage. The rising minimum wage has impacts on levels of spending under the mandatory programs, especially social security and social assistance programs.

3.4 Given the fiscal target and constraints on current spending, the most important part of the fiscal adjustment in recent years has been the increase in tax revenue, reaching about 38 percent of GDP in 2005, an increase of around 10 percentage points since the 1990s. The high level of average taxation (which is unevenly distributed across tax payers) provides disincentives to investment, and encourages tax evasion and informal sector growth, which in turn leads the authorities to search for additional tax revenue (including through new or higher taxes) on a decreasing set of formal activities. This vicious cycle of taxation could be avoided if ample flexibility was available on spending, but as described in detail in this report, this is not the case.

3.5 Budget rigidity, especially revenue earmarking, restricts policy action to resolve the fiscal puzzle (see Annex 1). Revenue earmarking is linked to social sector spending, designed to protect this type of expenditure. In addition, transfers to sub-national governments are also based on earmarked revenue sharing mechanisms. The federal government is required under the 1988 Constitution to share a set percentage of its tax revenue (specifically, 47 percent of personal and corporate income taxes, and taxes on industrial products) with these lower levels of government. These and other transfers taken together represent about 5 percent of GDP. Thus, the federal

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6 The fiscal year is identical to the calendar year.
government has been induced to develop new tax mechanisms (on top of previous ones). This has contributed to a vicious cycle of spend and tax policies. In sum, about 80 percent of total federal tax revenue is earmarked, making the budget extremely rigid.

3.6 A small amount of fiscal adjustment has taken place through cuts to public investment. Central government investment has dropped to around ½ percent of GDP in recent years, from only 1 percent of GDP in 1998. Similarly, sub-national governments' investment has declined to 1.5 percent of GDP from 2.3 percent of GDP during this period, and public corporations' investment dropped to 1 percent of GDP from 2 percent of GDP during the same period. Thus, total public investment has dropped by more than 2 percent of GDP. Moreover, private investment has not picked up to compensate for this reduced public investment, and in fact has also been falling during this period. As a result, analysts note the sharp decline in total (public and private) investment since the late 1980s. This was driven in part by the drop in public sector investment and by the high interest rate environment (caused in turn by the high level of public debt and associated risks, weak regulatory environments, as well as public sector distortions in the domestic financial market).

3.7 Spending levels are disproportionate to the quality of results obtained, pointing to weaknesses in expenditure management (planning, budgeting, implementation, and evaluation). These institutional weaknesses adversely affect public investment, as well as spending on education and health. Therefore, increasing public investment spending alone will not accelerate economic growth; measures are also required to address expenditure management shortcomings. The report illustrates this point using the example of road transportation.

3.8 The policy response to these fiscal circumstances has resulted in a fiscal conundrum. Consistently achieving the headline fiscal targets, within a context of rigid and expanding current expenditure constraints, represents a fiscal conundrum. Recently the authorities have increased tax collection significantly and reduced public investment spending slightly to meet the fiscal target. However, this fiscal adjustment is of poor quality. High taxation has reduced the growth of formal sector activity, ceteris paribus, further narrowing the tax base. Spending rigidities channel resources to less than optimal allocations, including a shift away from infrastructure investment, further reducing economic growth. Moreover, this fiscal adjustment is not sustainable. With average taxation equivalent to about 38 percent of GDP, further tax increases would be difficult to implement and enforce.

3.9 Thus far the solution to the fiscal conundrum is one of the root causes for low economic growth, and therefore, it will not be possible for Brazil to grow its way out of this fiscal challenge. Higher growth cannot be attained without first addressing the spend-and-tax cycle. Given this context, focusing on public sector spending (its size, priorities, and qualities, as well as the budgetary and other institutional circumstances under which this spending takes place), is central to resolving the fiscal conundrum that may be the lead cause for slower than desired economic growth.
4. STYLIZED FACTS

THE PUBLIC SECTOR IS LARGE

4.1 Brazil has the largest public sector of any other middle income country (Figure 1). General government spending exceeds 40 percent of GDP and tax revenue was about 38 percent of GDP in 2005. This is comparable to sizeable welfare states in northern Europe, such as Finland. When combined with non-financial public corporations, the size of the public sector represents about half of the economy. Moreover, the high tax burden provides strong disincentives to private investment, formal sector employment, and economic growth.

4.2 Part of this spending is needed to cover debt service (that is, payments for deficits accumulated in previous periods). Interest payments on the debt represented approximately 7 percent of GDP per annum during 1995-2004.

Figure 3.1: Tax Revenue in percentage of GDP, 2002

4.3 The bulk of public sector spending is devoted to primary current spending (roughly 33 percent of GDP). The largest share of this spending is devoted to social security schemes (roughly 12.5 percent of GDP), which are generous and rigidly designed. Another important part of the increase in current spending is attributable to sub-national governments, because social sector spending has been devolved to state and municipal governments as mandated by the 1988 Constitution. In addition, administrative costs due to decentralization have been increasing rapidly. At the same time that federal funds were devolved to sub-national governments, the federal government has not been able to make equivalent cuts in its spending, resulting in an increase in the overall size of government.

4.4 Public enterprises remain important actors, despite privatizations in the 1990s. Gross revenue and expenditure by non-financial corporations reached more than 14 percent of GDP in the early 2000s. While quasi-fiscal operations may have been reduced due to these privatizations, rough estimates suggest that they may still be significant. This is particularly plausible when the effects of public financial corporations are taken into account. The public policy functions through these financial agents, especially the use of directed and subsidized credit operations are not negligible, but have yet to be studied thoroughly. Directed credit represents approximately one-third of Brazil’s total credit by the banking system.
4.5 Off balance sheet transactions also have contributed to increasing the size of the public sector. In addition to contingent liabilities, some of which are due to pending judicial decisions, the discovery and recognition of liabilities not previously recorded (so called skeletons) has increased the stock of public debt substantially (with estimates ranging from 12-19 percentage points of GDP). Only some of the skeletons were discovered during the process of privatizations. The larger debt stock has increased debt servicing payments, leading to a larger public sector.

SPENDING TRENDS ARE EXPLOSIVE

4.6 Public sector spending is increasing rapidly. General government spending, the largest component of the public sector increased spending to 43 percent of GDP in 2004 (from about 40 percent of GDP in 1995). Most of the increase in spending is attributed to social security and social assistance benefits, interest payments, and expense on goods and services.

4.7 Moreover, pressures for future spending increases are mounting even faster, due in part to the aging of the population and the corresponding need to increase social security and health expenditures, similar to the pattern observed in OECD countries. These pressures would tend to increase the size of the public sector. Uncontrolled, these spending trends could increase the size of the public sector to over 50 percent of GDP in a decade.

4.8 Social security, as mandated through the 1988 Constitution, reflects a generous and rigid system. The entire pension system covers: 1) the RPPS (Social Security System for Public Servants) for civil servants at all levels of government, 2) the RGPS (General System of Social Security) for private sector workers (the largest segment of the Brazilian pension system), and 3) the relatively new complementary pension system (a defined-contribution scheme, the third pillar). Fiscal cash flows are restricted to the RPPS and RGPS. Preliminary analysis shows that Brazil is an outlier in every class of expenditure (old age, survivor, disability, and sick pay), due to extremely generous benefits. The most obvious outlier concerns survivor pension benefits, which represent 3.3 percent of GDP (out of 12.5 percent of GDP for total Brazilian pension expenditure). This is over three times as large as OECD countries that have older populations and higher incomes, and even more disproportionate compared with non-OECD countries.

4.9 The December 2003 reform of the RPPS has had some impacts. It reduced pension expenditure (and the RPPS pension deficit), in part due to increases in the average age of pensioners and slower growth in new pensioners. The RPPS reform also instituted contributions on retirement benefits, increased the minimum age for retirement, and equalized the benefits of public servants to the general RGPS system (but only for new entrants, so the effect will be delayed).

4.10 On the other hand, reforms to the RGPS system have had limited impacts, and alone they will not be able to contain the growth in expenditure and deficits. They created the fator previdenciario to reduce incentives for early retirement, increased revenues (through recertification efforts) and reduced the number of sickness benefits (that only took effect recently). However RGPS expenditure and deficits have continued to increase. The average retirement age (54 for men and 51 for women) and the average length of service remain low. Further parametric reforms are needed.
4.11 The present level and composition of public spending are not conducive to long-term economic growth. The present composition of expenditure, with low investment and high government consumption consumption is inefficient for enhancing economic growth. Specifically, econometric analysis of per capita GDP growth over 1950-2000 finds:

- A positive effect on economic growth of (public and private) investment\(^7\) (and a positive correlation between the public and private capital stocks);
- A positive effect of government subsidies on private capital accumulation (and thereby on growth) due to the short-run fiscal impulse; however, this effect dampens over time due to debt accumulation;
- A negative effect on growth of government consumption (in the short and long run),
- A negative effect on growth of social security, and social assistance transfers (in the long run because of the greater financing need that translates into a higher tax burden).\(^8\)

4.12 Over time, the composition of public spending in Brazil has shifted to ever larger shares of government consumption and transfers for social security and social assistance, from a more growth-oriented mix of higher public investments and targeted capital subsidies. Additional taxation needed to finance the enlarged state (with a more inefficient expenditure composition) has dampened growth.

4.13 Simulated possible effects of expenditure reallocations further tested the hypothesis that the present expenditure composition does not stimulate growth. Using realistic parameters derived from existing empirical studies on the Brazilian economy, the simulation exercise confirms the commonly-held view that Brazil would benefit from higher public investment within a tight fiscal constraint (however, increasing taxation or borrowing to pay for such investment would limit long-run growth prospects). Especially given the current low level of public infrastructure investment, a reallocation from social security transfers to increase spending on economic infrastructure would likely have sizeable growth effects. On the other hand, increasing the public debt to finance transfers decreases growth substantially. Moreover running a public debt to finance education expenditure would increase growth in the short run, but the debt accumulation would slow growth in the long run. Also, spending on government consumption and transfers for social security and assistance dampen growth.\(^9\)

4.14 A smaller percentage of GDP is spent on public sector investment, (about 3 percent of GDP), broken down into roughly 0.5 percent of GDP by the federal government, 1.5 percent of GDP by sub-national governments, and 1 percent of GDP by public corporations.

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\(^7\) While such results are consistent with most theoretical models, empirical evidence establishing this relationship is rare.

\(^8\) The econometric analysis also shows a negative effect of the tax burden on capital accumulation and economic growth.

\(^9\) These simulations are based on a functional classification of expenditure. While the results contrast with the recent findings in World Bank (2005) "Poverty Reduction and Growth: Virtuous and Vicious Circles", specifically that reductions in inequality and poverty tend to have positive growth impacts, the simulation model did not explicitly take these impacts into account.
4.15 Increasing infrastructure investment is not the sole responsibility of the public sector; the private sector will need to play a larger role. Given fiscal constraints, the public sector will remain limited in the amount of infrastructure investment that it can finance directly.

4.16 Public sector policies to establish partnerships with the private sector have been initiated. In addition to the privatization program in previous years, examples include the Pilot Project for Infrastructure (PPI), public-private-partnerships (PPPs), and concessions and similar contracts. In particular, the PPI was designed to protect public infrastructure investment from budget cuts and to improve the expenditure management cycle. However, preliminary results from this exercise show that merely increasing public investment (for example in road transport) is not sufficient to overcome the institutional weaknesses embedded in the public sector expenditure management framework. Moreover, all of these incipient government programs will not be enough to meet the large infrastructure demands of the economy. Other public sector policies to address bottlenecks to private sector investment will be needed. At the same time, the high interest rate environment, due in part to the high level of public sector debt and other risk factors, impedes substantial increases in investment. Again, addressing the fiscal conundrum would contribute to reducing these risk factors and lower the interest rate environment for investment.

CERTAIN EXTRA-BUDGETARY SPENDING IS LARGE

4.17 The amount of public sector spending is affected by the operations of quasi-fiscal public corporations and tax expenditures. The activities of the entities outside the general government sector include non-financial and financial public enterprises (at all levels of government) whose operations result in the accumulation of public liabilities and assets that will affect the public sector's overall fiscal health in the long run. In addition, several policy objectives are being pursued through the utilization of tax expenditures by the public sector that represents about 3 percent of GDP.

4.18 Off-budget or quasi-fiscal activities have been extensively used by past governments in Brazil and generated large contingent liabilities which led to debt accumulation. Estimates of the contribution of contingent liabilities to debt accumulation are in the range of 12-19 percent of GDP.

4.19 Non-financial public corporations have played important roles in the country's development model. Through direct investment in key infrastructure and manufacturing sectors, non-financial public corporations made most of the public sector's total investment (above 70 percent) during the 1980s. Their role in the Brazilian economy remains important. For the three levels of government in 2001, non-financial public corporations' total revenue represented 14.7 percent of GDP and total expenditure represented 14.2 percent of GDP. However, a good share of this was associated with largely commercial activities.

4.20 Public financial corporations control a large part of the financial sector. As of December 2004, government-owned banks were responsible for 39 percent of the total lending of the financial system. The total revenue of public financial corporations represented 15.5 percent of GDP in 2001 for all levels of government.

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10 Also see the separate Bank report ("Brazil: Interest Rates and Intermediation Spreads", Report No 36628-BR).
4.21 The extensive presence of public banks does not necessarily mean that these banks engage in significant quasi-fiscal activities. Quasi-fiscal activities have impact on aggregate demand; it is a form of public policy and should be reported in the fiscal accounts. According to government statistics, one estimate of total implicit credits and financial subsidies by public banks (excluding the Central Bank) was 0.55 percent of GDP for 2004. This amount, roughly equal to 14 percent of the total revenues of public banks, should be considered de facto public expenditure in estimating total public spending in Brazil.

4.22 Tax expenditures are another way for governments to engage in extra-budgetary fiscal activities. Tax expenditures normally include exemptions from taxes, allowances deducted from gross income, tax credits deducted from tax liabilities, tax rate reductions, and tax deferrals. Total tax expenditures for the federal government reached 2.5 percent of GDP in 2004. Almost 60 percent of tax expenditures are related to economic affairs, with companies investing in the North and Northeast, agricultural firms, and micro-enterprises being the most important beneficiaries.

THE BUDGET IS INFLEXIBLE

4.23 A major challenge for expenditure reform in Brazil is the excessive and increasing degree of rigidity arising from the high share of constitutionally or legally mandated expenditure and extensive revenue earmarking (Annex 1). For example, in 2003 for the federal government, 80 percent of the revenue (20 percent of GDP) was earmarked for specific purposes and 90 percent of total primary expenditure (19.5 percent of GDP) was non-discretionary. Earmarked revenue is assigned to line ministries, which are not required to spend the entire amount. The remaining earmarked funds are effectively used to reduce the net borrowing requirement; however, these funds cannot be used to reduce debt liabilities. Non-discretionary expenditure is mandated to fully fund government programs. Thus the overlaps between revenue and expenditure rigidities are large, but do not match exactly. The actual degree of budget flexibility is less than the “free” portion of either the expenditure (10 percent in 2003) or the revenue (20 percent in 2003). For example, in 2002, the “free” portion of the budget was somewhere above 4.5 percent of revenue, but below 8.1 percent of expenditure. In 2004, combining revenue earmarking and mandatory expenditures, the “fully free” portion of the executed federal budget was just 2.2% of GDP (14 % of primary expenditures). Whatever the precise estimate for the actual “free” portion of the budget, it is clear that the government is quite limited in its ability to “freely” allocate funds within the budget process.

4.24 Social protection, including social security, is at the center of budget inflexibility. There are essentially three broad sources of budget rigidity in Brazil: (i) earmarking of tax revenue, (the most important of which are for constitutionally mandated spending on social protection and health, as well as transfers to states and municipalities); (ii) social contributions, which are completely used to cover part of the social security deficit; and (iii) non-discretionary expenditures that include legal or constitutional obligations of the government, specifically interest payments, wages and salaries, entitlements (such as social security), and social assistance benefits.

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11 The methodology used for this updated estimate is based on the government’s approach published by the Economic Policy Secretariat in 2000. While that methodology represents an opportunity cost of the government funds, it does not represent the total subsidy that would be the difference between the interest rates the bank could get in the market and the one charged in the operation. The latter estimate would be significantly larger.

12 For state governments, the available data indicates tax expenditures are around 0.5 percent of GDP.
4.25 More than half of total non-discretionary expenditure was associated with social security in 2004. The growth of non-discretionary expenditure is largely due to the growth of social security benefits payments, which grew from 10.5 percent of GDP in 1998 to 13 percent of GDP in 2003.13 The steady increase in the social security expenditures is related to both the expansion of population coverage – from 11.1 million in 1988 to 21.3 million in 2002 – and the increase in benefit levels, largely influenced by the successive upward adjustments of the minimum wage to which the minimum social security benefit is indexed. Although the reforms in the late 1990s slowed the rate of increase, the benefit level still remains quite generous by international comparison.

4.26 Health and education spending have devolved to sub-national governments from the federal government, creating significant budget rigidities for these sub-national governments. Total public sector spending on health and education has increased by only 0.6 percent of GDP between 1995 and 2004 (education remained at 4.2 percent of GDP and health rose from 4.4 percent of GDP to 5 percent of GDP during the period). There are legally mandated floors for spending on health. States and municipalities are required to spend on education 25 percent of the sum of constitutionally mandated transfers received from high levels of government (federal for states, and federal and state for municipalities) plus their own tax revenue.

4.27 A key policy question regarding budget rigidity is whether greater flexibility is attainable through reforms on the revenue side (i.e., “de-earmarking”) or of the expenditure side (removing expenditure mandates through Constitutional changes). So far government efforts in this realm have concentrated on an ad hoc measure to “de-earmark” federal revenue, called DRU (Desvinculação de Receitas da União). Formerly earmarked revenue has been directed to non-discretionary expenditure as much as possible. The effects of the DRU are partially offset by the mandated increases for certain non-discretionary expenditure items, most notably social security benefit payments (covering in part the social security deficit; R$17.2 billion in 2002) rather than to increase infrastructure investments. Thus, the DRU has had minor impacts on budget rigidity and an innocuous effect on overall spending.

THE BUDGET IS NOT WELL LINKED TO PLANNING AND EXECUTION OF PUBLIC EXPENDITURE

4.28 The review of expenditure management indicates institutional weaknesses in planning, budgeting, expenditure execution, and evaluation. In particular there is a lack of correspondence among investment expenditure allocations set in the multi-year plans and in annual budgets, when compared with the amount of investment expenditure effectively executed. These weaknesses are also evident in areas of current spending.

4.29 The government’s primary instrument for forward expenditure planning is its Multi-year Plan. Since 1996, the federal government has prepared multi-year plans, PPAs (Plano Plurianual) covering a four year period. The PPAs are instruments to strategically direct the allocation of federal resources to spending programs. The main innovation of the PPA was the intention to introduce a results-oriented management model, which would include detailed programs with defined objectives, performance indicators, and a clear intention to link planning and budgeting to ensure their implementation.

13 To a lesser extent, the increase was also due to the designation of federal health expenditure as mandatory under Constitutional Amendment no. 29 in 2000, which established a spending floor.
4.30 The budgetary framework for the medium-term is not well linked to planning. Despite considerable progress, the PPA does not contain a medium-term fiscal scenario to support the spending programs, especially for investment. In fact, programmed investment expenditure is not based on estimates of macroeconomic and fiscal variables that define resource availability. As a result, the indicative budget allocations contained in the multi-year investment plans are frequently unrealistic. The overall fiscal framework is contained in the Budgetary Guidelines Law (LDO), which defines fiscal revenue, expenditure, and balances in a rolling three-year framework. It contains annexes on social security, contingent liabilities, and revenue projections that are used to define the fiscal envelope. However, the LDO targets are not well linked to the PPA. Moreover, the LDO does not integrate the fiscal (and macroeconomic) impacts of policy decisions, such as increases in the minimum wage. Thus, the LDO does not provide a framework for strategic decision-making.

4.31 The inconsistency between planning and budgeting appears when the Executive submits its budget proposal to Congress. There is evidence that PPAs have not been used as the technical basis for actual budget allocations, whether in the government’s budget proposals or in the Annual Budget Laws (LOAs) approved by Congress. In fact, the strong adjustment effort that the federal government has been implementing since the late 1990s and the increasing expenditure rigidity that squeezed the fiscal space for investment reveals the disconnection between PPA and LOA allocations.

4.32 There is a lack of connection between annual budget allocations and expenditure execution. The tendency of the Congress to overestimate revenue has consequences for the budget allocation of expenditure. However, at the same time, the need to achieve announced fiscal targets puts downward pressure on actual expenditure execution. Moreover, inefficiencies include difficulties in procurement and contracting processes, and weakness in financial planning by sector agencies (such as the absence of reliable revenue flow estimates during the year and uncertainties about the completion of physical execution). These factors also explain large differences between budget allocations and expenditure execution, and contribute to lower than budgeted expenditure execution.

4.33 “Reversal of priorities” results from budget reductions and restrictions on the release of financial flows (“contingenciamento”) during the execution phase. The budgetary and financial constraints faced by sector agencies associated with achieving overall fiscal targets (in addition to spending inefficiencies) give the authorizing central Ministry an opportunity to justify changes in resource allocations set in the LOA. A ministry’s budget proposal is altered several times during the budget process: first in the intra-executive negotiations with the Ministry of Planning, then by Congress in the LOA approval process, and finally through the discretionary control of spending limits during budget execution. As a result, the priorities set in the PPA, (which are barely reflected during the budget approval process) are frequently ignored during the expenditure execution process.

4.34 The execution of spending is not well monitored and evaluated. While monitoring of cash flows follows formal norms and rules, the monitoring of physical capital remains weak. Evaluations are not systematically conducted and they focus primarily on cash spending, not on outcomes and results. Evaluations that are conducted do not feed into planning and budgetary processes that follow in future periods. Thus, budgets are not formulated with a view to outputs or results.
PUBLIC SPENDING IS NOT ACHIEVING THE DESIRED RESULTS

4.35 **The quality of spending is poor relative to spending levels.** A World Bank report on tracking health spending\(^{14}\) and the example of road transportation (see below) illustrate this point.

4.36 **Health indicators in Brazil are well below the average for middle-high income countries, even though per capita health spending is above average** (US$631 versus an average of US$585 for other middle-high income countries). Health expenditure in Brazil has grown consistently, putting severe pressure on already scarce public resources. International experience shows that the criteria and ways in which the resources are allocated, transferred from central authorities to provider units, and how they are used thereafter, significantly affect the impact that financial resources can have on health services and outcomes.

4.37 **Given the country’s federal structure and the decentralized nature of the health management system, the financial flows are extremely complex.** The Unified Health System (SUS) covers the entire Brazilian population and offers a complete range of services free of charge, although the quality of service provision varies widely across jurisdictions. Under this system, the federal government transfers resources for health activities to the states and municipalities in over 70 different ways.

4.38 **Health planning, budgeting and execution are disjoint.** The planning and budgeting processes in the SUS are fairly well structured and formal; however, complexity and bureaucratic formalism limit the usefulness of the SUS as an effective management tool. The execution of spending is complicated by numerous laws and norms covering purchasing and contracting processes, the management of human resources, and accounting requirements. The inflexibility of this legislation, designed to limit the misuse of public funds, also greatly limits the autonomy of local managers and thus their capacity to effectively manage resources. In addition, poor managerial capacity in local units, scarce information, and a misaligned incentive structure are other factors affecting the quality of health service provision under the SUS.

\[^{14}\text{See “Brazil: More Efficiency for Better Quality Resource Management in Brazil’s Unified Health System (SUS)” Report No 36601-BR.}\]
5. THE EXAMPLE OF ROAD TRANSPORTATION

5.1 Assuming existing budget rigidities can be diminished, more funds could become available for public investment, but this would not resolve the infrastructure bottleneck. Currently over 80 percent of total central government investment is dedicated to the transportation sector. The example in the report concentrates on road transportation because it represents the largest component of transportation investment. The lack of adequate road transport infrastructure is a critical bottleneck to sustained economic growth. The report shows inefficiencies in public spending on roads. A simple increase in budget allocation may not lead to immediate expansion in the formation of public capital. Weaknesses in planning, budgeting, and expenditure execution make production of infrastructure highly inefficient. In spite of their scarcity, expenditures in the transportation sub-sector are not well-planned and prioritized, and their execution suffers from delays and cost escalation. The extent and the quality of road infrastructure are insufficient to support the country’s economic activities (especially exports). Thus, greater public sector efficiency combined with increased public investments in roads and other transport infrastructure should enhance Brazil’s growth prospects.

5.2 Prioritization and resource allocations defined in the multi-year plans (PPAs) do not guide annual budget formulation even for critical sectors such as transportation. This is shown by the inconsistency between the allocations to the programs included in the PPAs for 2000-2003 and 2004-2007 and those set in the government’s annual budget proposals and the LOAs approved by Congress. This inconsistency has several roots including: (i) technical imperfections in medium-term revenue forecasting and program costing; (ii) particular vulnerability of the transport budget to Congressional amendments and discretionary management of expenditure execution by the Executive (e.g., so-called “contingenciamiento”, or partial freeze on spending authorizations); and (iii) frequent delays in physical execution of public works due to irregularity in resource flows, adverse weather (which tends to coincide with the time when the budgeted funds are released during the fiscal year), and sometimes detailed external oversight for fear of corruption.

5.3 The government introduced the PPI to improve the efficacy of public investment execution. The objective is to strengthen budget execution of selected infrastructure projects by protecting them from funding freezes and closely monitoring their execution by central economic agencies. The implementation experience of the PPI suggests that the lack of funding is far from the only, or perhaps not even the most important, constraint to efficient execution of the transport investment portfolio. The lack of institutional capacity for appraisal, implementation, and evaluation of public investment projects continues to be a major obstacle for the enhancement of the efficiency in public infrastructure projects.

5.4 Other government initiatives that aim to increase the amount of road transport infrastructure investment will still need to address weaknesses in expenditure management. Some of these initiatives include Public-Private Partnerships, decentralization of federal road projects to state governments, and results-based contracts and concessions. A deeper set of reforms would be needed, in conjunction with these initiatives to improve both the quantity and quality of infrastructure investment (in roads and other forms of assets).
6. RECOMMENDATIONS

6.1 In sum, the size and composition of the public sector, in the context of the Brazilian fiscal target, has led to a fiscal conundrum and lower than desired economic growth. The public sector is large and growing, due to legally mandated, as well as policy driven, increases in current spending (especially on social security and social assistance). Moreover, fiscal adjustment has aggravated the composition of spending away from public investment and has resulted in increased taxation. Budgetary rigidities explain, in large part, the size and composition of the public sector. To address the fiscal conundrum, this report recommends the following measures.

REDUCE THE SIZE OF THE PUBLIC SECTOR (AND CONTROL EXPLOSIVE SPENDING)

6.2 Changes to legal mandates are required not only to restrain the growth of the public sector, but to reduce its size. This will require Constitutional and other legal changes to break the rigidity in the social security scheme and to add flexibility in social sector spending. In short, nondiscretionary expenditures need to be controlled and their rising trend reversed.

6.3 Measures should focus on:

a. reducing current spending on the pension system (specific parametric recommendations especially for the RGPS are contained in a separate World Bank study);

b. reducing certain specific subsidies, especially on credit through public financial entities;

c. increasing revenue by selectively applying fees for services and eliminating tax expenditures;

d. revitalizing the privatization process to add efficiency and limit quasi-fiscal deficits;

e. improving the targeting of spending in social assistance programs and in health and education; this could provide some efficiencies thereby augmenting discretionary spending; and

f. taking into account the full fiscal impacts of further increases in the minimum wage, including indirect impacts on social protection spending. Ideally, spending offsets should be contemplated for such increases.

To make these adjustments more persuasive, a certain share of the fiscal saving should be directed to increase public investment (see below).

INCREASE PUBLIC (AND RELATED PRIVATE) SECTOR INVESTMENT

6.4 To enhance economic growth Brazil should increase its public investment by reallocating expenditure from other less productive areas, while keeping the overall tax burden and indebtedness under control. The econometric analysis and the simulation exercise in the report support this conclusion. Expenditure reallocations, however, are a difficult proposition from both political and technical points of view. The instruments at the government’s disposal, at least in the short run, are limited, especially due to existing budget rigidities. Nonetheless, over the long run Brazil must gain more effective control over growing current expenditure in order to arrest decades of fiscal expansion and to reallocate more resources to public investment.

6.5 Gradual increases in public sector investment spending would be desirable, but insufficient. Merely increasing the budget for public sector investment, given weakness in public...
expenditure management, would not lead to substantial creation of capital assets. Systematic efforts will be required to strengthen institutional capacities for planning, budgeting, and executing public investments. Such efforts could only be implemented over the medium term. A clear strategy for improving infrastructure ministries’ capabilities to manage these limited resources efficiently and effectively is lacking. Such a strategy could involve the following elements: (i) a medium-term infrastructure investment strategy; (ii) a set of performance indicators to monitor efficiency and effectiveness of the infrastructure portfolio as a whole, as well as by sector and sub-sector; and (iii) an organizational reform, including adoption of a human resource policy to enhance the professional quality of the staff working in the infrastructure sector and to streamline the ministries’ business processes and organizational structures, as necessary.

6.6 Given the constraints on the size of public sector investment, especially over the medium term, the private sector will need to play a more active role if economic growth is to become more robust. The World Bank infrastructure report highlights specific recommendations that could be implemented to promote more and better private sector participation in infrastructure investment. It notes that: public-private-partnerships are a useful — but not the only — mechanism to address the lack of infrastructure. It underscores the importance of designing solid and reliable contracts (public and private); and points to public sector reforms that would strengthen the regulatory environment to create more stable and reliable conditions for private sector investment. Moreover, getting the size of the public sector under control and continuously working to reduce indebtedness would set enabling conditions for continued reductions in interest rates, leading to more private sector investment.

MORE AGGRESSIVELY DE-EARMARK REVENUE IN COMBINATION WITH REDUCED MANDATORY SPENDING TO ALLOW A BETTER COMPOSITION OF PUBLIC SECTOR EXPENDITURE

6.7 Revenue earmarking contributes to budget rigidity that can complicate day-to-day management of budgets, and is ineffective in protecting funding for specific purposes, as shown by the evidence in Brazil and internationally. In this context, the federal de-earmarking mechanism (DRU) has beneficial, albeit limited, effects to add flexibility to the budget and contributes to achieving fiscal targets.

6.8 Brazil should pursue a more aggressive approach to implement revenue de-earmarking, but not mainly through the DRU. As a first step, all earmarked funding should be set in terms of reais. Linkages to revenue collection or any other form of indexation should be resisted. If this is not politically feasible, then earmarking could be set in terms of reais in real terms (constant prices), that is indexed to inflation. This should not prevent additional funds from being dedicated to priority areas over and above the earmarked amount that is budgeted. Moreover, earmarked funds that are not used in a given year should become available for domestic debt reduction in that year, or saved to fund additional infrastructure spending in the following year. In this way, over time, public resources would shift to where they are most needed and effective, while simultaneously encouraging further investment and a more sustainable fiscal path.

6.9 However, it is important to prevent additional de-earmarked revenues from being absorbed by rapidly rising non-discretionary expenditure. De-earmarking should be

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15 See “Brazil: How to Revitalize Infrastructure Investments in Brazil Public Policies for Better Private Participation” Report No 36624-BR.
accompanied by reductions in mandatory spending. Only under conditions of higher flexibility to allocate public spending would de-earmarking efficiently create fiscal space and lead to further public investment and debt reduction.

**IMPROVE PUBLIC SECTOR MANAGEMENT THROUGH STRENGTHENING PLANNING, BUDGETING, EXECUTION, AND EVALUATION TO ENHANCE THE QUALITY OF SPENDING**

6.10 **Reforms to improve the coherence of planning, budgeting, execution, and evaluation should be implemented across all levels of the public sector.** Specific efforts could focus on improving the budget cycle and developing a consistent medium-term macroeconomic framework within which the budget would be developed. Other actions could be directed to improve the quality of public spending within this framework.

6.11 **The LDO is the most appropriate vehicle to develop a medium-term framework.** This improvement in Brazil’s institutional arrangement for planning and budgeting might help the government to control the size and composition of expenditure over the medium term. The most common instrument that serves this purpose is a medium-term framework, combined with politically well supported budget rules to guarantee fiscal equilibrium and to control the growth in the size of government. A medium-term framework would keep government expenditure and revenue on target because it makes medium-term fiscal impacts of policy decisions explicit and makes this information available during the budget planning process.

6.12 **A medium-term framework could also facilitate reallocations of budget resources over time, provided that the structural causes of budget rigidity are lifted.** Without changing the expenditure composition in favor of investments in economic infrastructure, the budget’s contribution to long-term growth will remain limited. Even in the case of successful constitutional reforms to bring greater budget flexibility, however, it is not clear that there is sufficient information to determine precisely where the budget should be cut and where it should be preserved or increased in the absence of a medium-term framework. An institutionalized process of expenditure reviews for generating micro-level information about saving options would therefore be a useful addition to Brazil’s planning and budget process.

6.13 **To strengthen executing agencies, measures include improving financial management, increasing flexibility regarding human resource management, and implementing a solid set of monitoring and evaluation systems.** Capacity building and inter-agency exchanges would be useful to develop the skills required for financial management purposes. In addition, giving managers greater freedom to find and keep quality staff for the provision of public services would be desirable. There is a need for integration of financial execution and physical execution of projects. Eventually, a medium-term framework and the monitoring and evaluation system could be developed in a harmonized manner to support results-based budgeting for the entire general government.
ANNEX 1: BRAZIL’S FEDERAL BUDGET RIGIDITIES IN A NUTSHELL

Budget rigidity in Brazil arises from both sides of the federal budget. On the revenue side, constitutional or other legal revenue earmarking mechanisms guarantee that certain types of government revenue finance specific expenditure. On the expenditure side, there are expenditure items which are considered mandatory and include constitutional and other obligations of the government such as interest payments, personnel expenditures, social security benefits, and social assistance entitlements. There are some overlaps between the revenue and the expenditure rigidities: there is a portion of mandatory expenditure that is financed with earmarked revenue. The degree of budget rigidity is extremely high. In 2004, combining revenue earmarking and mandatory expenditures, the “fully free” portion of the executed federal budget was just 2.2% of GDP (14% of primary expenditures).

FEDERAL REVENUE EARMARKING MECHANISMS (2004)

Transfers to states and municipalities. There are two types of transfers from the federal government to subnational governments: 1) general transfers for equity and regional redistribution purposes, such as the Fundo de Participação dos Estados (FPE) for states and the Fundo de Participação dos Municípios (FPM) for municipalities; and 2) targeted transfers for specific types of spending (such as for education and health).

On general transfers, the 1988 Constitution established that 21.5 percent of both the income tax (IR - Imposto de Renda) and the industrial products tax (IPI - Imposto sobre Produtos Industrializados) would be transferred to states (as the FPE - Fundo de Participação dos Estados) and 22.5 percent each tax would be transferred to municipalities (as the FPM - Fundo de Participação dos Municípios). In addition, 3 percent of both taxes finance regional development funds (FCO - Fundo do Financiamento do Centro Oeste, FNE - Fundo do Financiamento do Nordeste and FNO - Fundo de Financiamento do Norte). In addition, 10 percent of the IPI is transferred to states to compensate states that export goods for the loss of revenue associated with the state value-added tax (ICMS) deductions. Also, 50 percent of the rural property tax (ITR - Imposto Territorial Rural) is transferred to municipalities. Moreover, about 90 percent of special levies on natural resource exploitation for water, electricity, and mineral resources are transferred to states and municipalities. Since 2004, 29 percent of the government established a tax on gasoline and oil derivatives (Contribuição de Intervenção no Domínio Econômico, CIDE) is transferred to states and municipalities (see below). Finally, the government distributes 100 percent of oil royalties to different units of government. Five percent of on-shore oil revenue is transferred to states and municipalities (100 percent), while 80 percent of off-shore oil revenue goes to these governments and the remaining 20 percent goes to the Navy “Above normal” on-shore oil revenue is transferred to states and municipalities (75 percent) and to the Fund for Technology and Science Development (FNDCT) (25 percent), while “above normal” off-shore oil revenue is shared as follows: 60 percent to states and municipalities; 15 percent to the Navy and 25 percent to the FNDCT. In addition, a special royalty from oil revenue is shared as follows: 50 percent to states and municipalities; 40 percent to the National Regulatory Oil Agency (ANP) and 10 percent to the Ministry of Environment (MMA).

Specific purpose transfers mainly aim at education. The federal Fund for the Development of Fundamental Education and Teacher Valorization (FUNDEF) is legally mandated to receive 18 percent of all tax revenue net of transfers to states and municipalities. Thus, 9.5 percent of the IR and 77 percent of the IPI is directed to the FUNDEF. Moreover, 18 percent of the financial operations tax (IOF) and 9 percent of the ITR is given to the FUNDEF. In addition, as another
earmarking mechanism for education expenditures, one third of the salário-educação contribution is earmarked to the National Development Educational Fund (FNDE) and the remainder is transferred to state education secretariats.\(^{16}\)

**Other targeted transfers.** In 2001, the government established a tax on gasoline and oil derivatives (Contribuição de Intervenção no Domínio Económico, CIDE). Since 2004, 29% of CIDE collection is transferred to states and municipalities, and the rest (71 percent) is directed to finance transport infrastructure investment, oil price subsidies, and environment projects related to oil exploration.

**Social contributions.** The 1988 Constitution created the “Social Security Budget” to finance expenditures for social security, social assistance, and health. This budget is financed by the following contributions: 100 percent of the social security contributions paid by private sector employees and employers to the Social Security General System (RGPS); 100 percent of the contributions of public servants to the Public Sector Social Security System (RPPS), 100 percent of the federal value added tax (COFINS - Contribuição Para o Financiamento da Seguridade Social), 100 percent of the tax on profits (CSLL - Contribuição Social sobre o Lucro Líquido, and 100 percent of the revenue from lotteries and other minor revenue sources. In addition, 100 percent of financial transactions tax (CPMF - Contribuição Provisória sobre Movimentação Financeira) is used to finance the Poverty Reduction Fund (25 percent), the Ministry of Health (50 percent) and to cover social security benefits (25%).

**Another value added tax.** (PIS-PASEP - Programa de Integração Social / Programa de Formação do Patrimônio do Servidor Público) is used to fund the FAT (Fundo de Amparo ao Trabalhador), unemployment insurance (Seguro Desemprego) and the salary bonus program (Abono Salarial) (60 percent of the PIS/PASEP), as well as to fund the BNDES (Banco Nacional de Desenvolvimento Económico e Social) (40 percent of the PIS/PASEP) which uses these funds to finance economic development projects, often lending the funds at below market rates.

**Other revenue collected by federal agencies.** Revenues collected directly by different agencies and entities are 100 earmarked to expenditures of the collecting agency or entity (e.g. environmental licenses to IBAMA (the Brazilian Environment Agency), judiciary charges to the Justice Branch, etc).

**De-earmarking mechanisms - FSE/FEF/DRU.** With the aim of decreasing the level of earmarking of the federal budget, in 1994 the government created a mechanism (called the Social Emergency Fund (FSE)) to “de-earmarked” 20 percent of earmarked taxes and contributions.\(^{17}\)

Initially the fund had two implications: 1) an increase in federal government resources due to a corresponding decrease in transfers to states and municipalities, and 2) increased flexibility of the federal budget. In 2000, when the mechanism was renamed the De-earmarking of Federal Government's Revenues DRU (Desvinculação de Receitas da União), the new regulation excluded intergovernmental transfers (or general revenue sharing) from the eligible funds under the de-earmarking process. In the event, the DRU has not had much impact, because mandatory expenditures limited the flexibility the DRU was supposed to provide (see below).

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\(^{16}\) FUNDEF is actually funded by all three levels of government through the allocation of resources according to a specific formula.

\(^{17}\) The 1994 FSE (Fundo de Social de Emergência) was renamed in 1996 to the FEF (Fundo de Estabilização Fiscal) and to the DRU (Desvinculação de Receitas da União) in 2000. In 2003, the DRU was extended to end-2007 Discussions are continuing on the possibility to raise the DRU above 20 percent.
Table A.1: Federal Revenue Earmarking (2004)

<table>
<thead>
<tr>
<th>Tax and other Revenue</th>
<th>% of 2004 Revenue</th>
<th>Earmarking</th>
</tr>
</thead>
<tbody>
<tr>
<td>Imposto de Renda (IR)</td>
<td>26.6</td>
<td>21.5% to states; 22.5% to municipalities; 3% to Fundo do Financiamento do Centro Oeste (FCO), Fundo do Financiamento do Nordeste (FNE), Fundo de Financiamento do Norte (FNO); and 9.5 to Fundo Nacional de Desenvolvimento e Manutenção da Educação Fundamental (FUNDEF)*</td>
</tr>
<tr>
<td>Contributions to the General Social Security System (RGPS)</td>
<td>22.7</td>
<td>100% to National Institute of Social Security System (INSS)</td>
</tr>
<tr>
<td>Contribuição Para o Financiamento da Seguridade Social (COFINS)</td>
<td>18.8</td>
<td>100% to Social Security and Social Assistance System</td>
</tr>
<tr>
<td>Imposto sobre Produtos Industrializados (IPI)</td>
<td>5.5</td>
<td>21.5% to states; 22.5% to municipalities; 10% to exporter states; 3% to FCO, FNE, FNO; and 7.7 FUNDEF</td>
</tr>
<tr>
<td>Contribuição Provisória sobre Movimentação Financeira (CPMF)</td>
<td>6.4</td>
<td>25% to the Poverty Fund; 50% to the Health Ministry and 25% Social Security and Social Assistance System</td>
</tr>
<tr>
<td>Contribuição Social sobre o Lucro Líquido (CSLL)</td>
<td>4.7</td>
<td>100% to Social Security and Social Assistance System</td>
</tr>
<tr>
<td>– Imposto sobre Operações Financeiras (IOF/IOF-Ouro)</td>
<td>1.2</td>
<td>18% to FUNDEF; 30% states 70% municipalities</td>
</tr>
<tr>
<td>Programa de Integração Social / Programa de Formação do Patrimônio do Servidor Público (PIS/PASEP)</td>
<td>4.7</td>
<td>60% to Fundo de Amparo ao Trabalhador (FAT), unemployment insurance, and the Abono Salarial; 40% to Banco Nacional de Desenvolvimento Econômico e Social (BNDES)</td>
</tr>
<tr>
<td>Contributions of Public servants to the Public Sector Social Security System (RPPS)</td>
<td>1.8</td>
<td>100% to the Public Servant’s Social Security System</td>
</tr>
<tr>
<td>Contribuição de Intervenção no Domínio Econômico (CIDE)</td>
<td>1.9</td>
<td>71% to road transportation investments and environment programs related to oil exploration; 29% to states and municipalities</td>
</tr>
<tr>
<td>Salário Educação</td>
<td>1.2</td>
<td>33% to the FNDE; 66% to states education secretaries</td>
</tr>
<tr>
<td>Other (lotteries and others)</td>
<td>0.6</td>
<td>100% Social Security and Social Assistance System</td>
</tr>
<tr>
<td>Imposto Territorial Rural (ITR)</td>
<td>0.1</td>
<td>50% to municipalities; 9% to FUNDEF</td>
</tr>
<tr>
<td>Charges, licenses, etc</td>
<td>0.6</td>
<td>100% to the collecting agencies</td>
</tr>
<tr>
<td>Oil royalties</td>
<td>1</td>
<td>100 percent to: states and municipalities; National Fund for Technology and Science Development (FNDCT); National Oil Agency (ANP); Ministry of Environment (MMA); and to the Navy</td>
</tr>
<tr>
<td>Special levies on natural resource exploitation (water, electricity, mineral resources)</td>
<td>0.0</td>
<td>90% transfers to states and municipalities</td>
</tr>
</tbody>
</table>

* The earmarking mechanism for education establishes that 18% of the tax revenues net of transfers to states and municipalities should finance the FUNDEF
MANDATORY EXPENDITURES

The distinction between discretionary and non-discretionary expenditures is not obvious since some expenditure items may be discretionary in the short run but closer to non-discretionary in the medium or long run (for example, Bolsa Família is currently classified as discretionary, however, these benefits become acquired rights and over time permanent entitlements). In 2004, federal discretionary expenditure was only 14 percent of primary (non-interest) spending. The most important mandatory expenditure items are:

Public sector personnel expenditures and pensions. Since the late 1980s, there has been an increase in the share of social security pensions in total personnel expenditure from 26.8 percent in 1987 to 48 percent in 2004. From 1987 to 2004, expenditure on employees increased 74 percent in constant prices, while expenditure on pensioners rose 300 percent.

Private sector social security – RGPS. Private sector social security expenditure increased from 2.5 percent of GDP in 1988 to 8 percent of GDP in 2005. This increase was due to: (i) increases in the number of beneficiaries; and (ii) increases in benefit levels. The number of beneficiaries more than doubled from 11.1 million in 1988 to 23.9 million in 2005, a 115 percent increase. During this period, the population increased by 27 percent. The increase in coverage was due to both aging and the adoption of more generous benefits since 1988.

Constitutional requirement for a budget “floor” on health spending. Constitutional Amendment No. 29 of 2000 established a minimum amount of health expenditure for the federal government, to be increased each year in line with nominal GDP growth through 2004. This amount is subject to be revalued through a Complementary Law.

Unemployment Insurance. The 1988 Constitution created an unemployment insurance program and the salary bonus program, Abono Salarial (with benefits linked to the minimum wage). Both are financed by the PISPASEP. Beneficiaries are formal sector workers with a monthly income equal or less than 2 minimum wages; the benefit is 1 minimum wage.

Other mandatory expenditures. Other mandatory expenditures comprise about 10 percent of total mandatory expenditures. Of these, the Organic Law of Social Assistance (LOAS-Lei Orgânica da Assistência Social), the lifetime monthly income program (RMV - Renda Mensal Vitalícia) and the unemployment insurance program are the most important. The LOAS and the RMV are federal government social assistance programs. LOAS, approved in 1993, regulated the constitutional mandate for aged and disabled people with family income lower than one minimum wage. The benefit is equal to one minimum wage and beneficiaries do not need to have made contributions to be eligible. The RMV existed before the LOAS with the same objective, and the LOAS program is supposed to progressively replace the RMV. The amount of both programs has steadily increased over time, from 0.27 percent of GDP in 1995 to 0.5 percent of GDP in 2004. Another mandatory expenditure was established in the Lei Kandir (LC87/1996), which requires mandatory compensation to states for the loss in revenues derived from the deductions they give on ICMS (state VAT) for exports.