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Fiscal Straitjacket: The Politics of Macroeconomic Reform in Brazil, 1995–2002*

DAVID SAMUELS

Abstract. Brazil's President Fernando Henrique Cardoso will be remembered for his administration's accomplishments as well as the problems his government left unresolved. On the one hand, fiscal policy represents one of Cardoso's success stories: the *Plano Real* curbed inflation, established economic stability, and enabled the central government to rein in subnational governments' out-of-control spending patterns, which had been a key source of macroeconomic instability. However, the question remains whether Brazil can truly escape from the political and economic consequences of past fiscal profligacy. Despite many successes, Cardoso's own policies have created additional obstacles that future administrations will necessarily confront, in particular a dramatic increase in Brazil's internal debt. Observers of Brazil should count both sides of the accounting ledger when evaluating the Cardoso administration. Much has been gained, but the costs of those gains must be recognised and the impact of those gains on the range of policy choice available to future administrations understood. This article explores the factors that contributed to Brazil's macroeconomic difficulties prior to 1995, and then explores how the *Plano Real* provided the Cardoso administration with leverage to constrain the capacity of subnational actors to affect Brazil's economy. Subsequently, however, the paper describes how the Cardoso administration's policies have created Brazil's current 'fiscal straitjacket', and concludes by discussing how Cardoso's policies will constrain future administrations.

Introduction

Brazil's President Fernando Henrique Cardoso (1995–2002) will be remembered for his administration's substantial accomplishments as well as the problems his government left unresolved. Fiscal policy represents one of Cardoso's clearest success stories: the *Plano Real* curbed inflation, established economic stability, and enabled the central government to rein in subnational

David Samuels is Associate Professor in the Department of Political Science at the University of Minnesota.

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governments' out-of-control spending patterns, which had been a key source of macroeconomic instability. Tax revenue has also boomed faster than GDP growth, helping the government generate budget surpluses of about 3 per cent of GDP since 1999, quite a feat for any country, especially one with little history of government penny-pinching.

However, the question remains as to whether Brazil can truly escape from the political and economic consequences of the profligacy in its past. Despite successful economic stabilisation, the monetary, exchange rate, and fiscal policies that the Cardoso administration chose to pursue have created additional obstacles that future administrations will necessarily confront. At base, the Cardoso administration's greatest success has transferred the worst aspects of Brazil's fiscal crisis from the subnational to the national level – perhaps making the problem more manageable and preventing its recurrence at the subnational level, but not eliminating it. Thus while an optimist might conclude that Brazil's economy has gained stability and credibility because the central government established controls over subnational debt and expenditures and centralised subnational debts, a pessimist might conclude that the Cardoso administration has cleaned up one mess but created another for future administrations, and might also note that the administration's policies have actually *contributed* to Brazil's fiscal crisis.

Although some observers have concluded that the Cardoso administration 'put Brazil's fiscal house in order', debate has emerged about the extent to which this is the case. Brazil has not escaped from what appears to be a permanent 'fiscal crisis of the state'. The Cardoso administration transformed the nature of the beast, but it could not vanquish it. That is, not despite but *because* of the government's efforts to put Brazil's fiscal house in order, Brazil's internal debt has increased far faster than GDP growth under Cardoso's watch: from R$60.7 billion or 28.1 per cent of GDP in 1994 to R$633.2 billion or 56 per cent of GDP in 2001.[1]

Brazil faced an 'international' debt crisis in the early 1980s, and a 'subnational' debt crisis in the late 1980s and early 1990s. The debt problem continues to haunt successive administrations, but today perhaps it should be named the '*Real Plan* debt crisis'. That is, the very successes of the Plan explain the rapid accumulation of debt. Yet it is not so much the *level* but the *structure* of the debt that is potentially so problematic. First, much of Brazil's debt is relatively short-term, which leaves the country relatively more vulnerable to liquidity crises that could affect the government's ability to refinance the debt. Second, much of the debt is tied to the dollar, so if the

[1] Brasil, Ministério da Fazenda, Secretaria do Tesouro Nacional, 'Dívida Pública: Conceitos Básicos e Fatores Determinantes.' Download from www.tesouro.fazenda.gov.br, June 2002. The debt also increased dramatically in 2002, but consolidated figures were unavailable at the time of writing.

real depreciates the debt increases proportionally. From January 1999, when Brazil abandoned its attempt to keep the *real* at parity with the dollar, up to and including 2001, depreciation added R$72.8 billion to Brazil's debt (and billions more accumulated as the *real* depreciated in 2002). Third, another large portion of the debt is tied to Brazil's basic interest rate, which in November 2002 was about 20 per cent per year. Cardoso's economic team kept interest rates high to keep inflation in check, to keep the *real* from devaluing further, and to attract needed dollars into the country, yet another R$109.4 billion has been added to Brazil's debt simply as a result of these high interest rates since Cardoso came to office.[2]

In sum, although Brazil achieved budget surpluses in Cardoso's second term, this has not lowered (or even stabilised) Brazil's debt/GDP ratio. Brazil's government is caught in several vicious circles: it cannot improve economic growth without lowering interest rates and reforming Brazil's tax system, but it cannot cut interest rates without sparking fears of inflation, and it has few incentives to promote broad tax reform when such reforms are likely to result in reduced revenue. Moreover, it cannot address pressing needs without increasing government spending, but the need for budget surpluses precludes transferring spending to social programmes. These problems constrain Brazil within a 'fiscal straitjacket'.

Observers of Brazil should count both sides of the accounting ledger when evaluating the *Real* Plan. Much has been gained, but the costs of those gains must be recognised and the impact of those gains on the range of policy choice available to future administrations understood. In this paper I first explore the factors that contributed to Brazil's macroeconomic difficulties prior to 1995. I focus on how Brazil's federal institutions, which gained importance as the country redemocratised in the 1980s, constrained the central government's ability to achieve stability through the mid-1990s. I then explore how the *Real* Plan provided the Cardoso administration with leverage to constrain the capacity of subnational actors to affect Brazil's economy. Subsequently, however, I describe how this very success has created Brazil's 'fiscal straitjacket', and conclude by discussing the requirements for Brazil to free itself from these constraints.

Federalism and constraints upon the central government, 1985–94

During the 1980s in Brazil democratisation advanced concomitantly with the reinvigoration of federalism.[3] Economically, the 1980s was Brazil's

[2] *Ibid.*

[3] Celina Souza, 'Redemocratisation and Decentralisation in Brazil: The Strength of the Member States,' *Development and Change* vol. 27 (1996), pp. 529–55; Fernando Luiz Abrucio and David Samuels, 'A "nova" política dos governadores: política subnacional e transição

'lost decade' because of sluggish GDP growth and rampant inflation. Yet until the implementation of the *Real* Plan in 1994, successive stabilisation plans failed. One cannot understand these failures without understanding the impact of federalism on Brazil's economy.[4] Following redemocratisation in Brazil (as has also been the case in Argentina), federalism gave subnational actors and their representatives in the national legislature the capacity to constrain presidential reform initiatives.[5] These constraints offset the strong presidential powers enshrined in the 1988 constitution. In what follows I explain how federalism constrained reform by exploring the consequences of fiscal decentralisation, state-government debts, and state-owned banks.

Fiscal Decentralisation

The 1964–85 military regime centralised revenue, so it is perhaps no surprise that the process of democratisation in Brazil was associated with a process of fiscal decentralisation. From 1965 to 1980, the central government increased its share of final revenue allocation from 54.8 per cent to 68.2 per cent, while states' share declined from 35.1 per cent to 23.3 per cent, and municipalities' share from 10.1 per cent to 8.6 per cent.[6] Yet as democratisation advanced members of Congress worked to undo the military regime's policies and from 1980 to 1995 the central government's share fell back to 56.2 per cent while states' share increased to 27.5 per cent and municipalities' share boomed to 16.2 per cent.[7]

Fiscal decentralisation fulfilled the interests of newly-elected politicians at subnational levels, but it contributed to Brazil's worsening primary deficits, which grew as a percentage of GDP all through the 1980s and never reached balance until Cardoso took office.[8] This was because central government spending increased faster than revenue as a percentage of GDP during the 1980s: in addition to mandating fiscal decentralisation, the new constitution made reducing the number, salaries, and pensions of public-sector employees more difficult, and mandated increased spending in several other areas. After decentralisation the central government was left with diminished

democrática no Brasil,' *Lua Nova* 40/41 (1997), pp. 137–66; Fernando Luiz Abrucio, *Os barões da federação: o poder dos governadores no brasil pós-autoritário* (São Paulo, 1998).

4 Lourdes Sola, 'Estado, transformação econômica e democratisação no Brasil,' in Lourdes Sola (ed.), *Estado, mercado e democracia* (Rio de Janeiro, 1993), pp. 235–79.

5 Abrucio, *Os barões da federação.*

6 Ricardo Varsano, 'A evolução do sistema tributário brasileiro ao longo do século: anotações e reflexões para futuras reformas,' IPEA Texto para Discussão No. 405, Rio de Janeiro, 1996.

7 Brasil, Ministério da Fazenda, Secretaria da Receita Federal, 'Carga Tributária do Brasil – 2000 (tabelas).' Download from www.receita.fazenda.gov.br, June 2001.

8 World Bank, 'World Development Indicators' (CD-ROM), Washington, DC, 2001.

resources but growing demands from the general public.[9] Subnational governments continued to pressure the central government to provide services and resources, while presidents worked to rein in spending and transfer responsibilities to subnational governments.

The growing fiscal imbalance at the national level constrained the central government's ability to affect macroeconomic stabilisation, a fact recognised by the early 1990s.[10] Until 1994, however, no president successfully reined in spending or indebtedness. Presidents Sarney, Collor and Franco at times expressed a desire to rethink fiscal decentralisation, but none successfully reversed the process. The central government also considered, but did not seriously pursue, measures to push more public sector responsibilities onto state and local governments. In short, fiscal decentralisation made the central government's efforts to balance the budget more difficult, contributing to Brazil's macroeconomic difficulties in the late 1980s and early 1990s.

State debts

Despite fiscal decentralisation, subnational finances also deteriorated in the 1980s and began to contribute to Brazil's economic crisis. As democratisation gained momentum, newly elected governors (and mayors) sought to fulfil campaign promises and gain new supporters by increasing spending. For example, state and municipal government payroll expenditures increased 77 per cent as a percentage of GDP between 1985 and 1990.[11] By 1997 state governments had run up deficits that amounted to US$139 billion. Soft budget constraints encouraged this behaviour: no governor ever paid a price for deficit spending because the federal government repeatedly assumed state debts when governors would plead for help. In 1989 the federal government assumed states' debts to foreign banks, but failed to force state governments to comply with the conditions that would have avoided another debt crisis, so in 1993 the federal government assumed another US$28 billion in state debt. The central government repeatedly gave states generous repayment terms, including lengthy repayment periods and

9 Sola, 'Estado, transformação econômica e democratisação no Brasil'; Abrucio, *Os barões da federação*; Maria Hermínia Tavares de Almeida, 'Federalismo e políticas sociais,' *Revista Brasileira de Ciências Sociais* vol. 10, no. 28 (1995), pp. 88–108; Marta Arretche, *Estado federativo e políticas sociais: determinantes da descentralisação* (São Paulo, 2000).

10 See, for example, Antulio Bonfim and Anwar Shah, 'Macroeconomic Management and the Division of Powers in Brazil: Perspectives for the Nineties,' Policy, Research and External Affairs Working Paper, The World Bank, 1992; Rogério Werneck, 'Fiscal Federalism and Stabilisation Policy in Brazil,' *Texto para Discussão* 282, Departamento de Economia, Pontifícia Universidade Católica do Rio de Janeiro, 1992; Fernando Rezende, 'Federalismo fiscal no Brasil,' *Revista de Economia Política*, vol. 15, no. 3 (1995), pp. 5–17.

11 Werneck, 'Fiscal Federalism,' p. 10.

below-market interest rates. Even so, states postponed repaying their debts, effectively forcing the central government to assume the debts.[12]

States could transfer their debts to the central government because democratisation had given subnational political actors substantial political autonomy, and because Brazil's presidents often rely upon governors to drum up support in Congress to realise their policy goals.[13] Moreover, perversely, as long as inflation persisted, budget deficits at either level of government caused few immediate political problems because politicians could reduce real expenditures by delaying disbursements for salaries and government contracts long enough for inflation to have eroded their value – the so-called 'Tanzi effect'. But of course, mounting debts contributed to inflationary pressures, creating a vicious circle.

Although economists identified uncontrolled state spending as a key factor contributing to the central government's inability to bring about long-term stabilisation,[14] presidents from Sarney through Franco did not devote substantial political capital to forcing state governments to rein in spending and pay their debts. Instead, presidents often traded debt bailouts for governors' support for their legislative proposals. In sum, states' political autonomy, coupled with relatively weak presidents, obstructed a resolution of Brazil's fiscal problems and impeded the central government's ability to establish macroeconomic stability.

State-owned banks

Another critical factor contributing to subnational fiscal irresponsibility was the abuse of state government-owned banking institutions. As of 1993 25 of Brazil's 27 states (including the Federal District) owned at least one financial institution.[15] These banks contributed to state-government fiscal imbalance – and thus by extension to Brazil's economic situation – because governors used 'their' banks for political purposes, borrowing heavily to

[12] Fernando Luiz Abrucio and Valeriano Mendes Ferreira Costa, *Reforma do estado e contexto federativo brasileiro* (São Paulo, 1998).

[13] Fernando Luiz Abrucio, *Os barões da federação.*

[14] See World Bank, 'The Dilemma of Brazil's State Banking System: An Analysis and Suggestions for Reform,' Report Number 8247-BR, Country Operations Division, Brazil Department, Latin America and the Caribbean Region, 1990; Werneck, 'Fiscal Federalism'; Sérgio R. da Costa Werlang and Armínio Fraga Neto, 'Os bancos estaduais e o descontrole fiscal: alguns aspectos,' Working Paper No. 203, Escola de Pós-Graduação em Economia da Fundação Getúlio Vargas, 1992; Walter Novaes and Sérgio R. da Costa Werlang, 'Financial Integration and Public Financial Institutions,' Working Paper No. 225, Escola de Pós-Graduação em Economia da Fundação Getúlio Vargas, 1993; William Dillinger, 'Brazil's State Debt Crisis: Lessons Learned,' World Bank Departmental Working Paper 17430, 1997.

[15] Novaes and Werlang, 'Financial Integration and Public Financial Institutions,' p. 16.

cover their spending increases. However, given their short-term political horizons, governors would often then refuse to pay back the loans, ruining the state banks' financial health and contributing to Brazil's fiscal chaos. Between 1982 and 1993 Brazil's Central Bank had to intervene in 60 of the 87 state-government financial institutions because they were close to bankruptcy, and by 1990, 45.3 per cent of state bank loans were non-performing, compared to only 1.7 per cent of loans by private sector banks.[16] Although observers perceived that the political autonomy of state governors to use and abuse their state banks undermined presidential capacity to implement stabilisation policies, until 1995 the federal government regularly bailed out state banks in exchange for political support in Congress.

Summary

Abrucio has coined the term 'predatory federalism' to characterise the relationship between the federal government and the states between 1982 and 1994.[17] Subnational governments preyed on the central government's inability or unwillingness to control subnational finances. The costs of predatory federalism were alarming: state spending and state capacity to push the resulting debts onto the federal government contributed to the inability of successive presidents to tame the country's overall fiscal deficit and thus to curb inflation. Deficit spending at *both* the national and subnational levels were primary causes of macroeconomic instability prior to the *Real* Plan.

The origins and consequences of the Real *Plan*

Politicians paid little attention to economists' warnings until Fernando Henrique Cardoso assumed the Ministry of Finance in 1993. Cardoso's team was the first to take the relationship between inflation, macroeconomic stability and fiscal profligacy (at all levels of government) seriously, and thus the *Real* Plan aimed not simply to 'control' inflation (as previous plans had succeeded in doing, at least in the short term) but to bring fiscal balance to both national and subnational government accounts and thus keep inflation in check in the long term.

To control inflation in the short term, the *real* was tied to the US dollar. This overvalued the currency, causing an increase in imports and thus a current-account deficit. To finance this deficit, maintain the value of the

[16] Harry Makler, 'Bank Transformation and Privatization in Brazil: Financial Federalism and Some Lessons about Bank Privatization,' *The Quarterly Review of Economics and Finance*, vol. 40 (2000), p. 46.

[17] Fernando Luiz Abrucio, 'Jogos federativos: o modelo predatório brasileiro.' Unpublished manuscript, CEDEC, 1997.

currency, and thus keep inflation down over the long term, the government also sought to attract investment dollars. To do so, the *Real* Plan required high domestic interest rates. However, Brazil could only attract foreign investment, fulfil IMF obligations, and establish long-term credibility if it also reduced public debt. Thus, the plan required fiscal austerity at all levels of government.[18]

To generate surpluses at the national level, the economic team first created the 'social Emergency Fund' [Fundo Social de Emergência] (FSE), which disconnected 20 per cent of a large portion of central government revenue from constitutionally-mandated spending, in order to give the central government greater budgetary leeway. A constitutional amendment was required to enact the FSE because Brazil's 1988 constitution earmarked a high proportion of tax revenue. Constitutional amendments need a 60 per cent majority of all members of both houses of Brazil's Congress to pass, and thus Cardoso had to drum up congressional support for this core component of the *Real* Plan. At the same time (autumn 1993), the campaign for the October 1994 presidential elections had already begun. Because it would not be fully implemented until mid-1995, the *Real* Plan was therefore necessarily linked with a presidential candidate who would be committed to the Plan through the next administration.

Cardoso quickly became the obvious 'government' candidate, and the process of articulating congressional support for the FSE and for Cardoso's presidential candidacy are thus inseparable. The difficulties of getting the FSE through Congress led Cardoso, a leader of the centre-left PSDB party, to court the leaders of the PFL, a large centre-right party. Along with Cardoso and his PSDB, PFL leaders realised that if the Plan succeeded in stabilizing Brazil's economy it could generate tremendous electoral support for an alternative to the opposition Workers' Party (PT) candidate Lula, who led every poll by a substantial margin at that point.[19] Congress approved the FSE in February 1994. As the election neared and the *Real* Plan went into effect, inflation declined precipitously and Cardoso rapidly gained ground in the polls. He ultimately won convincingly, even avoiding a second-round runoff.

The obvious success of the *Real* Plan not only propelled Cardoso to victory but also gave him considerable popular and legislative support. In particular, the *Real* Plan provided Cardoso (in contrast to Brazil's other post-1985 presidents) with the leverage and the legitimacy to construct a larger and more cohesive governing coalition than earlier administrations

[18] Amaury de Souza, 'Cardoso and the Struggle for Reform in Brazil,' *Journal of Democracy* vol. 10, no. 3 (1999), p. 54.

[19] Gilberto Dimenstein and Josias de Souza, *A história real: trama de uma sucessão* (São Paulo, 1994), p. 130.

had enjoyed. Cardoso's legitimacy and broad coalition gave him political breathing room to enact important reforms that sought to establish long-term economic stability and lay the conditions for growth. In what follows I explore the way in which the *Real* Plan enabled Cardoso to gain leverage over subnational actors as well as the actions his government took to establish fiscal balance at the national level.

Gaining control over subnational spending resulted from the political consequences of the *Real* Plan.[20] By stopping inflation, the Plan eliminated the Tanzi effect. Governors could no longer reduce their bills via inflation, and some found themselves with payrolls of 80–90 per cent of revenues, little money to pay their debts, and even less money for their pet pork-barrel projects.[21] More importantly, the high interest rates caused states' interest payments on their debts to skyrocket, further exposing the fragility of subnational finances.[22]

In short, state governments found themselves in an untenable fiscal position for the first time since redemocratisation. This gave the central government considerable leverage to convince governors to change their behaviour and permit changes in the rules. Cardoso thus sought to tighten restrictions on subnational spending and indebtedness and to push state governments to sell or restructure their publicly-owned banks.[23] The Cardoso administration thus used the effects of the *Real* Plan to curtail the ability of subnational governments to interfere with Brazil's macroeconomic health. To parallel the previous section's analysis, below I explore the consequences of the *Real* Plan for state spending, state banks and the overall distribution of revenue across levels of government in Brazil.

State spending

Soon after the *Real* Plan came into effect in 1994 the financial situation of state governments deteriorated, leaving them more vulnerable to pressures from the federal government. Cardoso's team used this leverage to renegotiate state debts, obtain real commitments from states to repay their

20 Lourdes Sola, Christopher Garman and Moíses Marques, 'Central Banking, Democratic Governance and Political Authority: The Case of Brazil in a Regional Perspective,' Paper presented at the 17th Congress of the International Political Science Association, Seoul, 1997; Abrucio and Ferreira Costa, *Reforma do estado e contexto federativo brasileiro.*

21 William Dillinger and Steven B. Webb, 'Fiscal Management in Federal Democracies: Argentina and Brazil,' Policy Research Working Paper 2121, World Bank, 1999, p. 23.

22 José Roberto R. Afonso and Luiz de Mello, 'Brazil: An Evolving Federation,' paper presented at the IMF/FAD Seminar on Decentralisation, Washington DC, 2000, p. 16.

23 Christopher Garman, Christiane Kerches da Silva Leite and Moisés da Silva Marques, 'Impactos das relações Banco Central versus bancos estaduais no arranjo federativo pós-1994: análise à luz do caso BANESPA,' *Revista de Economia Política*, vol. 21, no. 1 (2000), pp. 40–61.

debts, and impose greater restrictions on future state spending and indebtedness. For example, the 'Camata Law', passed in 1995, stipulated that as of January 1999 states would have to limit their payroll expenditures to 60 per cent of net receipts or risk losing federal funds. Moreover, when the Cardoso administration agreed to refinance state debts in 1997–98, it required states to cease issuing bonds to cover their debts until their total debt was less than one year of tax revenue. In June 1998 the National Monetary Council also prohibited subnational governments from contracting new foreign debt.

The central government's new restrictions worked: when the state of Minas Gerais defaulted on its debts to the central government in early 1999, Cardoso blocked all federal transfers to that state and sequestered resources from state bank accounts to cover arrears on debt payments, reinforcing the central government's credibility. In May 2000 the government passed yet another law, the 'Fiscal Responsibility Law' [Lei de Responsabilidade Fiscal] (FRL), which sought to eliminate once and for all the perception that subnational governments enjoyed soft budget constraints. The FRL set strict debt limits for all levels of government and expressly prohibited the central government from refinancing future subnational debt. It also sought to increase 'fiscal transparency' by requiring all subnational governments to publish revenue and expenditure, and it outlined penalties for public officials who violate the law.[24] The FRL has contributed to the Cardoso administration's multi-pronged strategy to control subnational spending: although from 1994 to 1998 subnational governments ran primary deficits each year, from 1999 onwards subnational governments as a group have actually run budget surpluses.[25]

[24] Although it restricted subnational policy autonomy, governors tended to favour the FRL – the fact that it took only a year to get through Congress indicates the low degree of opposition. Governors did not object to the FRL because the central government had already resolved their debt issues by 1999 and because the law clarifies the conditions under which governors may dismiss employees and/or reduce public-sector employees' salaries. After the *Real* Plan was implemented and inflation was curbed, governors no longer wished to use the state government as an employment programme and have been far more reluctant to give pay raises because doing so leaves them without resources to invest in public works projects. For information on the FRL see Marcos Mendes, 'Lei de Responsabilidade Fiscal: análise e alternativas,' Instituto Fernand Braudel de Economia Mundial, São Paulo, 1999; Afonso and Mello, 'Brazil: An Evolving Federation'; Carlos E. G. Cavalcanti and Waldemir Luiz de Quadros, 'Economia do setor público,' *Indicadores DIESP* vol. 77 (March/April 2000), pp. 28–31; George Kopits, Juan Pablo Jiménez and Alvaro Manoel, 'Responsabilidad fiscal a nivel subnacional: Argentina y Brasil,' Presented at the XII Seminario Regional de Política Fiscal, CEPAL, Santiago de Chile, January 24–26, 2000.

[25] Increases in tax revenue at the state and municipal level helped (above and beyond increases in federal-government transfer payments), especially from the state value-added

State banks

As with state debts, the Cardoso administration asserted greater control over state banks. Beginning in late 1994 when it intervened in the state banks of Rio de Janeiro and São Paulo, the government indicated that it would not continue to bail out failed banks without exerting some leverage in return. Although Congress refused to accept Cardoso's initial proposal for resolving the state bank crisis and ultimately forced the government to pay a much higher price for a solution, the Cardoso administration eventually succeeded in intervening in and arranging for the privatisation of nearly all state banks, eliminating the possibility that the problem would re-emerge. In exchange for removing state banks from governors' control, the central government refinanced states' debts to their banks, and transferred them to the central government at favourable terms.[26] As a result of these changes, state governments can no longer use public-sector banking institutions as nearly bottomless pits of loans to cover deficit spending, and state banks can no longer undermine the Central Bank's control over national monetary policy.

Fiscal recentralisation?

The Cardoso administration's efforts in terms of macroeconomic policy were not limited to ending hyperinflation and reining in subnational profligacy. The government also strove to generate yearly budget surpluses, even though it faced criticism for not spending more money on needed social programmes or infrastructural development. To accomplish this, the administration sought to increase tax revenue, and also encouraged subnational governments to increase the efficiency of their tax systems in order to increase their own revenues. This effort proved successful: reversing the trend from 1980–95, central government revenue *increased* under Cardoso from 56.2 per cent to 59.9 per cent between 1995 and 2000 as a relative share of all government revenue, while states' share declined from 27.5 per cent to 25.1 per cent, and municipalities' share declined from 16.2 per cent to 15.0 per cent.[27] This development has led some to suggest that Cardoso's

tax. See Luis Nassif, 'Política macroeconômica e ajuste fiscal,' in Bolivar Lamounier and Rubens Figueiredo (eds.), *A era FHC: um balanço* (São Paulo, 2002), pp. 45–6.

[26] See Garman et al., 'Impactos das relações Banco Central versus bancos estaduais'.

[27] Brasil, Ministério da Fazenda, Secretaria da Receita Federal, 'Carga Tributária do Brasil – 2000 (texto).' Download from www.receita.fazenda.gov.br, June 2001; Brasil, Ministério da Fazenda, Secretaria da Receita Federal, 'Carga Tributária do Brasil – 2000 (tabelas).' Download from www.receita.fazenda.gov.br, June 2001.

administration has reversed fiscal decentralisation.[28] However, this tells us only about *relative* levels of revenue, not *absolute* levels. In fact, states and municipalities gained revenue in absolute terms during the 1990s, *only not as rapidly as the central government.* Revenue at all levels of government as a percentage of GDP increased from 25.2 per cent in 1991 to 34.2 per cent in 2001 (an all-time high).[29] During this period central government revenue as a portion of GDP increased by 37.4 per cent, states' portion by 19.2 per cent, and municipalities' by 25.6 per cent.[30]

A constitutional provision explains why the central government's revenue has increased faster than subnational governments', creating the impression of recentralisation. Central government revenue can come from 'taxes', 'contributions', or other assorted tariffs and fines.[31] Under the 1988 constitution if federal government *tax* revenue increases, so must transfers to subnational governments. Yet in contrast to tax revenue, the central government does not have to share revenue from contributions with subnational governments. The central government's relative share of revenue has increased because it has consciously sought to raise revenue from 'contributions' rather than from taxes. Contributions as a proportion of central government revenue increased from 27.2 per cent in 1990 to 46.7 per cent in 2001.[32] Thus the central government succeeded in increasing its relative share of revenue – and in meeting its targets for yearly budget surpluses – largely because it increased its revenue from 'contributions', not because it decreased transfers to municipal and state governments or because subnational governments' revenue declined in absolute terms.

In sum, these reforms allowed the Cardoso administration to regain control over subnational finances and eliminate many of the counterproductive political incentives that Brazil's federal institutions had produced.[33]

28 For example see Eduardo Kugelmas, 'A evolução recente do regime federativo no Brasil,' in Wilhelm Hofmeister and José Mário Brasiliense Carneiro (eds.), *Federalismo na Alemanha e no Brasil* (São Paulo, 2001).

29 Liliana Lavoratti, 'Arrecadação do ICMS bate recorde histórico,' *O Estado de São Paulo*, February 5 2002, p. B8.

30 Brasil, Ministério da Fazenda, Secretaria da Receita Federal, 'Carga Tributária do Brasil – 2000 (tabelas).'

31 An example of a 'contribution' is the CPMF, the 'Temporary Contribution on Financial Transactions,' charged on all financial operations.

32 Brasil, Ministério da Fazenda, Secretaria da Receita Federal. 'Arrecadação das Receitas Administradas pela SRF e Participação Percentual no PIB – (A Preços Correntes) – 1994 a 2001'. Download from www.receita.fazenda.gov.br, June 2002; Brasil, Ministério da Fazenda, Secretaria da Receita Federal, 'Participação percentual no PIB (1985–1999)'. Download from www.receita.fazenda.gov.br, June 2001.

33 Abrucio and Ferreira Costa, *Reforma do estado e contexto federativo brasileiro*; Afonso and Mello, 'Brazil: An Evolving Federation,' Alfred Montero, 'Competitive Federalism and Distributive Conflict in Democratic Brazil,' Paper presented at the Bildner Center Conference on Brazil, Columbia University, 2001.

Moreover, the Cardoso administration astutely employed available tools to increase government revenue. These reforms do not represent a true political recentralisation, but should be interpreted as the re-emergence of a coherent executive branch in Brazilian politics as a necessary counterweight to the institutions of Brazilian federalism, in contrast to the 1985–94 period, which can be characterised by the absence of such coherence.[34] This policy mix attacked the root problems of Brazil's earlier economic chaos and provided the basis for macroeconomic stability for nearly the entirety of Cardoso's two terms.

The costs of the Real *Plan*

Despite its successes, the Cardoso administration has paid a high price to 'clean house', and future administrations will continue to pay. In this section I detail the flip side of success and discuss the way in which Cardoso's policies have created a 'fiscal straitjacket' that constrains Brazil's economy and the possibilities for future political reforms.

The great logroll: the FSE for states' debts

The Cardoso administration successfully reined in the ability of subnational governments to interfere with national economic stability. However, to accomplish this goal the central government had to assume a disproportionate share of the costs. In return for governors' support of the FSE, which helped assure its passage in Congress, the central government agreed to purchase state debts and refinance state banks on a far larger scale than ever before. By early 2002, the federal government had assumed R$297.7 billion in subnational debts, equal to approximately 25 per cent of Brazil's GDP at the time.[35] Although states had to commit part of their revenue to paying their debts, the federal government assumed a large share of the costs because it offered states below-market interest rates and long repayment terms. The direct central government subsidy to states has been estimated at between US$32 and US$46 billion (in 1997 values).[36] This subsidy reduces subnational governments' debt levels while simultaneously increasing the

[34] David Samuels and Scott Mainwaring, 'Strong Federalism, Constraints on the Central Government, and Economic Reform in Brazil,' in Edward Gibson (ed.), *Representing Regions: Federalism and Territorial Politics in Latin America* (forthcoming, 2004).

[35] Brasil, Ministério da Fazenda, Secretaria do Tesouro Nacional, 'Dívida Pública: Conceitos Básicos e Fatores Determinantes'. Download from www.tesouro.fazenda.gov.br, June 2002.

[36] Francisco Rigolon and Fábio Giambiagi, 'Renegociação das dívidas estaduais: um novo regime fiscal ou a repetição de uma antiga história?' Unpublished manuscript, BNDES, 1998, p. 15.

Table 1. *National Debt* Growth in Brazil, 1995–2002*

Source of Debit or Credit	Amount (R$ billions)
Stock of debt in 1994	60.7
Refinancing State and Municipal Debts and State Banks	297.7
National Treasury Debt Emissions to Facilitate Rollovers	44.9
Impact of Exchange Rate Fluctuations	72.8
Impact of Nominal Interest Rates	109.4
Recognition of Unaccounted Debts (total)	128.2
■ *Bank of Brazil*	*25.5*
■ *PROEF (federal bank restructuring programme)*	*39.8*
■ *Federal Housing Mortgage Programme*	*14.6*
■ *Others*	*48.2*
Fiscal Incentives and Subsidies (total)	45.2
■ *Kandir Law (export industries tax exemption)*	*24.0*
■ *Agrarian Reform (landowner indemnifications)*	*5.4*
■ *Direct Export Subsidies*	*4.5*
■ *Others*	*11.3*
Privatisations (subtracted from debt)	(58.9)
Primary Budget Surpluses (subtracted from debt)	(76.1)
TOTAL (as of 12/31/01)	R$623.9

* *Dívida Mobiliária Federal*

Source: Brazil. Ministério da Fazenda. Secretaria do Tesouro Nacional. 'Dívida Pública: Conceitos Básicos e Fatores Determinantes'. Download from www.tesouro.fazenda.gov.br, June 2002.

central government's debt, thus constraining the central government's budget far into the future.

The overall cost of cleaning house

The effort to clean up subnational finances was only one aspect of fiscal policy under Cardoso. Overall, the administration's policies have contributed to raising Brazil's debt/GDP ratio from 28 per cent of GDP in 1994 to 56 per cent in 2001.[37] The total increase in debt has been R$563.2 billion. Table 1 details the sources of debt accumulation under Cardoso.

More than half the overall increase in Brazil's national debt in the period came from the restructuring and refinancing of subnational debts.[38] Some of the sources of debt are not directly linked to the *Real* Plan or its negotiations *per se*. For example, R$128.2 billion accumulated from the administration's recognition of debts that several federal banks and agencies had accumulated

[37] Brasil, Ministério da Fazenda, Secretaria do Tesouro Nacional, 'Dívida Pública: Conceitos Básicos e Fatores Determinantes'.

[38] The timing of the resolution of the state debt crisis was critical: the cost to the federal government escalated because the job was concluded after its own policy of high domestic interest rates had dramatically inflated the value of state debts. Unavoidable as this may have been, it certainly raised the cost for the central government.

but had obfuscated for years. Another R$45.2 billion accumulated due to federal government subsidies and tax exemptions such as the 'Kandir Law', which promotes the competitiveness of Brazilian exports by exempting them from the state-level value-added tax. This may help Brazilian exporters, but the law has cost the federal government considerably because state governments are reimbursed for their lost revenue.

Table 1 indicates that the administration *reduced* the debt by R$76.1 billion by running yearly budget surpluses from 1999, and by R$58.9 billion with receipts from privatisations.[39] These gains kept the debt from growing even larger, but one should put these sums in perspective: the 'gains' do not equal the increases in debt that came from the administration's own exchange and interest rate policies, which are responsible for R$182.2 billion in accumulated debt.

The government maintained high interest rates to stave off a fear of inflation and to attract foreign investors, thereby increasing the interest on the debt the government pays every year. Interest payments have increased every year since the implementation of the *Real* Plan. Currently Brazil devotes 8 per cent of its GDP to interest payments, nearly three times the average for other Latin American countries (2.6 per cent). It also devotes 20.5 per cent of all government expenditure to interest payments, twice the average for the rest of Latin America (10.9 per cent).[40] As for the impact of currency fluctuations, devaluation of the *real* pushed the debt level higher in Cardoso's second administration, after the government abandoned parity with the dollar in January 1999. Brazil's debt increases when the *real* loses value against the dollar because some of the debt must be paid in dollars, not *reais.*

Several other countries have similar debt/GDP ratios, but Brazil's debt level is *potentially* more problematic because 80 per cent of its debt is tied either to the value of the dollar or to domestic interest rates, and because the debt issues have relatively short maturity terms on average. These factors leave Brazil particularly vulnerable to international factors and to potential short-term financing problems.[41] This has created a vicious circle: to keep the *real* relatively stable, contain inflation and attract investment dollars the government had to keep interest rates high. This increases the debt, which

[39] Privatisations also helped reduce budgetary pressure at the state level (and helped re-elect several governors in 1998): states gained about US$34.7 billion from privatisations between 1996 and 2001 (Luis Nassif, 'Política macroeconômica e ajuste fiscal,' p. 51). However, as with privatisation at the national level, there are now few 'big-ticket' items left to sell off.

[40] International Monetary Fund, 'World Economic Outlook' (April) Chapter 2. Accessed at www.imf.org, June 2002.

[41] Paulo Nogueira Batista, 'O efeito FHC,' *Folha de São Paulo*, May 27 2002, p. B2.

decreases confidence in the *real*, which consequently reduces the attractiveness of investing dollars in Brazil. In turn this increases downward pressure on the *real*, which thus increases the level of debt.

In sum, increases in Brazil's debt/GDP ratio under Cardoso did not result from profligate spending but from the government's exchange and interest rate policies, and from the administration's efforts to clean up subnational and national finances. Ironically, although fiscal responsibility represents a core goal of the *Real* Plan, the government's own policies have caused this explosion of debt. In addition, as I will detail in the next sections, political obstacles impeded the government from realising even greater success in fiscal policy. In particular, pressures from subnational governments limited the extent to which the Cardoso administration could recentralise revenue, and the government's own goals precluded an effort to implement a broad fiscal reform that might have improved economic growth over the long term.

The limits of fiscal reform (1): no revenue losses for subnational governments

Although the *Real* Plan has focused attention on the increased capacity of Brazil's central government to articulate and implement its goals, the Cardoso administration did not simply *impose* the *Real* Plan or any of its elements on subnational governments. The plan involved extensive intergovernmental and executive-legislative negotiations. The administration did achieve the important goal of curtailing subnational governments' capacity to interfere with national macroeconomic management, but although Cardoso initially aimed to cut fiscal transfers to subnational governments, his administration did not do so. In addition to subsidising subnational governments' debts to win initial passage for the FSE, the Cardoso administration also had to agree that subnational governments would not receive any less in federal government transfers than they had received in 1993. Thus while the FSE 'freed' 20 per cent of government revenue from constitutional earmarking, it did not cut transfers to subnational governments by 20 per cent.

In December 1993 the Cardoso administration proposed that the FSE 'de-link' 15 per cent of all government revenue, *including revenue that the constitution orders be transferred to states and municipalities.* Governors, mayors, and members of the president's own legislative coalition opposed this, and pro-government parties blocked a vote on this proposal in January 1994. Consequently, the administration made three proposals: first, an income-tax rate increase; second, that 5.6 per cent of all revenue from personal income taxes and 100 per cent of all revenue from federal government employees' personal income tax no longer be included in the calculation of the amount to be transferred to states and municipalities (without the FSE, the constitution mandates that all income tax revenue be pooled and that states and municipalities receive approximately 45 per cent of the total); and third, to compensate for not simply 'freeing up' 15 per cent of all personal income tax revenue, the government proposed that the FSE 'free up' 20 per cent of the remainder of government revenue as opposed to only 15 per cent. Congress approved this proposal a month later and enacted the FSE.[42]

Yet this proposal did not *reduce* transfers to subnational government by 5.6 per cent: that figure was the estimated amount by which income-tax revenue would *increase* given the proposed tax rate increase. That is, with the tax increase states and municipalities would only *forgo* 5.6 per cent of their future share of the income tax, plus revenue from federal-employees' income tax. And even given these concessions, subnational governments actually received *more* revenue in real terms from federal government transfers after the implementation of the *Real* Plan. As noted above, tax revenue at all levels of government as a percentage of GDP increased dramatically during Cardoso's two terms. Personal income tax revenue in particular increased from 2.61 per cent to 4 per cent of GDP from 1994 to 2001,[43] due to the income tax rate increase as well as a government policy of allowing 'bracket creep' so that more Brazilians had to pay personal income taxes. As a result, constitutionally mandated federal transfers to subnational governments increased in real terms by 124 per cent from 1994 to 2001. During this same period, real GDP growth was only 18.2 per cent.[44]

Despite Cardoso's prestige and broad coalition, the administration could not simply impose its will in fiscal policy. Instead, it had to negotiate the *Real* Plan with Congress, and thus it had to concede to the interests of subnational actors, who energetically defend the fiscal interests of subnational governments in Congress. The particular nature of the FSE provided legislators with significant capacity to defend their interests, and reflects the degree to which the success of the *Real* Plan was a function of negotiations between the central and subnational governments. First, the *Real* Plan was unlike previous economic reform programmes in Brazil in a crucial way: by discarding the strategy of exclusively relying on presidential decrees and instead employing a mix of decrees and constitutional amendments, Cardoso

[42] João Ricardo Motta, 'A prorrogação do FEF,' *Correio Braziliense*, November 25 1997, p. 3; Pinheiro Landim, 'Relatório: proposta da emenda à constituição no. 85-A, de 1999'. Câmara dos Deputados, Comissão Especial Destinada a Proferir Parecer à PEC no. 85-A/1999, Brasília, 1999.

[43] Brasil, Ministério da Fazenda, Secretaria da Receita Federal, 'Arrecadação das receitas administradas pela SRF e participação percentual no PIB – (A Preços Correntes) – 1994 a 2001'.

[44] Brasil, Ministério da Fazenda. Secretaria do Tesouro Nacional, 'Fundo de Participação dos Estados 1991–2001'. Download from www.tesouro.fazenda.gov.br, June 2002; Brasil, Ministério da Fazenda. Secretaria do Tesouro Nacional, 'Fundo de Participação dos Municípios 1991–2001'. Download from www.tesouro.fazenda.gov.br., June 2002.

involved the legislature to a much greater degree in the process of economic stabilisation. Obtaining legislative support for a constitutional amendment in Brazil is difficult; presidents must negotiate and provide side-payments or concessions in order to win its passage.

Yet the peculiar nature of the constitutional amendment that created the FSE permitted even greater legislative involvement. When we observe approval of a constitutional amendment in a given country, we typically think that politicians have chosen to *permanently* alter a fundamental political arrangement. However, the constitutional amendment that enacted the FSE is different: it contains a 'sunset provision', and has already expired and been renewed three times (in 1995, 1997 and 1999) and it is set to expire again in December 2003. This helps explain why Congress initially accepted the FSE: it was not and is not a *permanent* reform of intergovernmental fiscal relations.

The sunset provision means that not only did the president have to negotiate the Fund's initial passage at substantial cost (the debt subsidies and the guarantee to maintain federal transfer levels), but that he must periodically return to the table to renegotiate passage of essentially the same bill. This has given states and municipalities repeated opportunities to obtain additional benefits in exchange for supporting renewal of the president's macroeconomic programme, and of course the president has therefore had to cede more than if the amendment had been permanent from the start. Each time that the 'sun set' on the FSE Cardoso had to offer incentives to members of Congress to renew it; these incentives have always involved additional funding for subnational governments. For example, by 2000 all the dispositions in the Fund that affected transfers of income tax revenue to subnational governments had been completely removed.[45]

Although future presidents have no guarantee that Congress will continue to extend the Fund indefinitely, the national debt will live on until it is paid off. The Cardoso administration never achieved its most preferred outcomes, permanently reversing fiscal decentralisation and permanently disconnecting revenues from constitutionally mandated transfers to subnational governments. Congress refused such a reversal, and has used the Fund's sunset provision to extract concessions that benefit states and municipalities. These concessions, along with the assumption of states' debts, illustrate how subnational interests have constrained the Cardoso administration's range of policy options even when it most demanded political autonomy. Likewise, future administrations will continue to depend on Congress to maintain macroeconomic stabilisation programmes.

[45] David Samuels, *Ambition, Federalism, and Legislative Politics in Brazil* (Cambridge and New York, 2003), pp. 186–8.

The limits of fiscal reform (2): the failure of tax reform

Cardoso's macroeconomic policies have not only had a direct fiscal cost. In addition, the administration's fiscal policy has precluded broader reforms in other areas, in particular of Brazil's tax system.[46] Tax reform can mean many things. In Brazil efforts have focused on improving the 'quality' of taxation, to reduce the so-called *Custo Brasil* or 'Brazil Cost' that make Brazilian products less competitive. Some of the specific objectives of fiscal reform include eliminating cumulative taxes, spreading the tax base more broadly, reducing the number of taxes, generating incentives to increase tax collection, eliminating state governments' incentives to grant tax exemptions to attract industrial investment, and changing the way that production and consumption are taxed.[47]

Across-the-board support for fiscal reform has been strong in Brazil since before the Cardoso administration came to power. Economists agree that fiscal reform would improve efficiency and attract investment.[48] As Minister of Finance, Cardoso stated that Brazil desperately needed fiscal reform; on the campaign trail, he affirmed that fiscal reform would be a priority for his administration; and in office he often repeated that statement.[49] Over sixty fiscal reform proposals circulated in Congress during the 1990s, indicating broad legislative interest.[50] Brazil's powerful business peak associations have also heavily lobbied both the executive and legislative branches for fiscal reform.[51] Cardoso even presented a fiscal reform proposal to Congress seven months after taking office.[52] However, even though it seems that ideas and interests coincide, in contrast to several other important reform proposals that eventually passed, broad fiscal reform failed to advance during Cardoso's two terms. A key reason for this inertia is the government's reluctance to alter a system that, even if onerous and inefficient, helped it meet its fiscal targets.

[46] The extent of administrative reform has also been limited by the administration's fiscal policies. See Sílvio Bressan, 'Reforma Administrativa,' in Bolivar Lamounier and Rubens Figueiredo (eds.), *A Era FHC: um balanço* (São Paulo, 2002), pp. 369–94.

[47] For details of tax and fiscal reform proposals, see José Roberto R. Afonso, Fernando Rezende and Ricardo Varsano, 'Reforma tributária no plano constitucional: uma proposta para o debate,' IPEA Texto para discussão No. 606, Rio de Janeiro, 1998; Edilberto Carlos Pontes Lima, 'Reforma tributária no Brasil: entre o ideal e o possível,' IPEA Texto para discussão No. 666, Rio de Janeiro, 1999.

[48] See Afonso and Mello, 'Brazil: An Evolving Federation'.

[49] *Veja*, January 31 2001, pp. 42–3.

[50] Sérgio de Azevedo and Marcus A. Melo, 'A política da reforma tributária: federalismo e mudança constitucional,' *Revista Brasileira de Ciências Sociais*, vol. 12 (1999), p. 81.

[51] See Confederação Nacional de Industria, *Agenda Legislativa da Indústria* (Brasília, 2000).

[52] Proposta de Emenda Constitucional No. 175.

Any fiscal reform, especially in a country with a complex system like Brazil's, involves a high degree of uncertainty about future revenue flows.[53] Consequently, although all actors may in principle favour reform, they also fear that economists' revenue projection models are wrong and that they will be the ones who lose revenue. Thus, despite repeatedly stating that fiscal reform was a high priority, Cardoso's highest priority was to maintain the *Real* Plan, which required fiscal conservatism. Because revenue was consistently increasing, the Cardoso administration instinctively favoured the status quo and never expended the political resources necessary to pass its own proposal.

In particular, constitutional rules set Cardoso's strategy against reform. Every reform proposal involved reduction or elimination of the so-called 'contributions' because of their alleged economic inefficiency.[54] However, the government needs the revenue from 'contributions' to generate budget surpluses. If contributions were eliminated or transformed into taxes, the government would confront a fundamental principle of Brazilian federalism set in the 1988 constitution: tax revenue must be shared with states and municipalities. Thus, the constitutional rules that allow the government to reap all revenue from 'contributions' but force sharing of tax revenue put Cardoso's government between a rock and a hard place regarding fiscal reform: contributions hurt Brazil's long-term economic growth but are essential for short-term economic stability. The Cardoso administration chose to side-step what from its perspective is the worst outcome of Brazil's revenue-distribution system, sharing of tax revenue, and to maintain what is from its perspective a less-worse system that permits it to meet its international obligations and maintain its macroeconomic programme. A desire to avoid the effects of federal revenue-sharing mechanisms forced this strategic choice.[55]

Brazil needs to overcome the perception that its institutions encourage economic inefficiency, in order to generate investment and increase the competitiveness of its products. Fiscal reform would help in this regard. However, despite the President's repeated statements, the work of well-intentioned members of Congress and heavy business lobbying, fiscal reform failed to advance far during the Cardoso administration. Indeed, broad fiscal

[53] William Ascher, 'Risk, Politics, and Tax Reform,' in Malcolm Gillis (ed.), *Tax Reform in Developing Countries* (Durham, NC, 1989).

[54] For example, the IMF considers the CPMF among the least efficient forms of taxation in the world. See *O Estado de São Paulo* 6/18/01, 'Fundo vê riscos na manutenção do CPMF,' p. B4.

[55] Subnational interests also vehemently opposed fiscal reform, and their influence contributed to the failure of broad reform proposals to advance. See Samuels, *Ambition, Federalism, and Legislative Politics in Brazil*, ch. 9.

reform appears less likely at the end of the Cardoso administration than it did at the beginning: the central government's increased reliance on 'contributions' makes it less interested in reform, and the elimination of other mechanisms of industrial policy (through privatisation of state-government banks and other agencies as well as the limitations on state debt levels) makes state governments more reluctant to relinquish their ability to manipulate state-level taxes, even though the power to grant tax exemptions as a tool to attract investment has cost state governments at least US$9 billion in lost revenue in the early 1990s.[56]

Summary

An exploration of the political negotiations for the approval and maintenance of the *Real* Plan reveals that the Cardoso administration has paid a high price for its limited success, and that its policy choices exacerbated Brazil's fiscal problem and precluded broader reforms in other areas. First, the government took on subnational government debts because it could not maintain the credibility of its entire stabilisation effort otherwise. Second, although they may have achieved other goals, the administration's exchange and interest rate policies also contributed to debt growth, ironically weakening the very principles of the *Real* Plan itself. Third, Cardoso could not implement the *Real* Plan without negotiating its core components with Congress, where representatives of subnational governments demanded compensation in return for relinquishing key components of the (counterproductive) autonomy they had gained during the transition to democracy. Fourth, the government negotiated its initial proposal for the FSE so that states and municipalities would not lose revenue (and in the event they ended up gaining revenue). The 'temporary' nature of key elements of stabilisation policy implies that future administrations will need to be as adroit in negotiating with Congress as Cardoso was in order to maintain macroeconomic stability. Finally, the administration's chosen path precluded needed reforms in other areas, in particular tax reform. These choices do not imply that Brazil is headed for an Argentina-style crisis, but their political and economic consequences must be appreciated. The growth of Brazil's debt imposes a heavy burden on the central government that will restrict the range of policy options available to future administrations to resolve emerging challenges.

Conclusion: Brazil's fiscal straitjacket

On the one hand, the Cardoso administration's focus on putting Brazil's 'fiscal house in order' has been a great success. The *Real* Plan corralled

[56] Abrucio, *Os barões da federação*, p. 233.

inflation and gave the central government the ability to generate budget surpluses, while the economic consequences of the Plan put subnational governments in a much weaker position, allowing the central government to negotiate tighter fiscal controls on state and municipal finances. Perhaps the most substantial advances have indeed been in fiscal discipline at the subnational level: the Cardoso administration has successfully resolved many of the problems that emerged from the 1985–94 period. In particular, the Fiscal Responsibility Law has established a series of mechanisms that control subnational debt and finances and impose penalties for future abuses.

The Cardoso administration also dramatically increased the capacity of the central government to generate tax revenue, to record levels. Tax rate increases, new taxes, enhanced administrative efficiency and slow but steady economic growth all helped increase central-government revenue. In addition, the administration sought to make Brazil's debt more manageable, despite its growth. Particularly during Cardoso's second administration, the Treasury and the Central Bank have made a strong effort to lengthen the terms of Brazil's debt issues, in order to decrease the day-to-day pressure on the government's accounts. In 1994 the median payoff period for internal debt issue was two months, but it was estimated by the end of 2002 that only 27 per cent of all debt will have a payoff of less than 12 months.[57]

Nevertheless, this effort has also revealed just how extensive Brazil's fiscal problems remain. Although Brazil's situation is not nearly as dire as Argentina's was before its economy collapsed in late 2001 (among other factors Brazil's currency floats, its debt is not entirely in dollars and tax revenues have been increasing as opposed to falling), Brazil's 'risk factor' remains stubbornly high because investors fear that the country's debt will eventually become unmanageable, and that therefore a future government (regardless of its partisan orientation) will be forced to renegotiate the debt (which is an implicit default of sorts). In sum, Cardoso's success on some fronts has necessarily created problems on others. Let us explore in more detail the limits of fiscal policy success under the Cardoso administration.

Brazil signed a major agreement with the IMF in October 1998. This agreement had two major fiscal policy goals: a budget surplus of greater than 3 per cent of GDP from 1999, and a reduction in Brazil's debt/GDP ratio from 50–53 per cent to 46.5 per cent by the end of 2001. The administration met the first goal, at a tremendous cost to society – it could have spent these budget surpluses on education, healthcare, housing, infrastructure development, or other needed programmes. Cardoso's fiscal policy also burdened

[57] Luis Nassif, 'Política macroeconômica e ajuste fiscal,' p. 67.

both taxpayers and industry – higher tax burdens deter investment and make Brazilian products less competitive. Yet future governments will have to maintain this policy just to keep the debt level stable.[58] If the government does not maintain budget surpluses, the debt level may rise, creating downward pressure on the *real* and thus upward pressure on prices and interest rates, perpetuating or even worsening the vicious circle of debt.

It is important to note that the Cardoso administration generated budget surpluses *without keeping yearly spending in check* – that is, it relied on tax revenue growth rather than budget cuts to generate surpluses. This highlights the distance between the rhetoric of 'fiscal austerity and responsibility' and 'fiscal reality' under Cardoso. Not only has the debt skyrocketed, but yearly government spending *in all areas* has increased dramatically: 6 per cent per year on average, while GDP growth has averaged only 2.4 per cent per year. Government non-financial spending climbed from 16.5 per cent of GDP in 1994 to an estimated 21.8 per cent in 2002.[59] Moreover, although expenditure on interest and debt amortisation increased fastest, spending in all areas, including personnel and investments, increased faster than GDP growth.[60]

The government has thus far been unable to keep spending in check; actually cutting spending will be extremely difficult. The FSE helped the government manipulate the *distribution* of revenue within the budget, but it could not help the government substantially reduce *absolute* spending levels. Doing so will be a tremendous challenge for future administrations, mainly because only a small portion of the budget can be cut from year to year. In 2001 approximately 75 per cent of the annual budget went to salaries, pensions, and direct payments to individuals that the president could not cut with his line-item veto.[61] This level of earmarking was approximately 51 per cent in 1987.[62] The increase in earmarked revenue has resulted partly from growth in the size of the bureaucracy (mostly in the 1980s) and from salary increases for public-sector employees: from 1995 to 2001, personnel expenditures in the executive branch alone rose 80.9 per cent.[63] Of the remaining 25 per cent of the budget, the constitution earmarks 40 per cent (or 10 per cent of the total budget) for healthcare. Thus the president cannot rely on his constitutionally-granted budget powers to achieve fiscal surpluses. Cuts will instead have to come through systematic reforms that

[58] *O Estado de São Paulo*, June 10 2002, p. B4.
[59] *O Estado de São Paulo*, April 14 2002, p. A4.
[60] Nassif, 'Política macroeconômica e ajuste fiscal,' p. 67.
[61] *O Estado de São Paulo*, June 10 2002, p. B4.
[62] Nassif, 'Política macroeconômica e ajuste fiscal,' p. 47.
[63] *O Estado de São Paulo*, May 18 2002, p. A2.

Cardoso either did not undertake or that were watered down when attempted, such as administrative reform or public sector pension reform.[64]

Another factor to consider regarding the yearly surpluses is that they have been accomplished on the basis of *temporary* revenue sources. These temporary taxes and/or temporary rate increases required arduous negotiation with Congress for their implementation, and they will require similarly difficult renegotiation if the government wants the flow of revenue to continue. Approximately R$10 billion in revenue will be lost at the end of 2003 unless the government convinces Congress to extend these temporary revenue sources.[65] In addition, as noted above, the constitutional amendment that allows the government to manipulate 20 per cent of what would otherwise be earmarked revenue (originally the FSE and now called the *Desvinculação da Receita da União* [De-linking of Federal Government Revenue] expires in December 2003. This amendment permits the government to manipulate approximately R$45 billion per year,[66] and without it the government will not be able to meet its surplus targets. In short, fiscal issues will be high on the political agenda during President Luis 'Lula' da Silva's administration.

Finally, a few skeletons remain in the closet. One observer estimates that government recognition of still-unaccounted debts could increase Brazil's debt by another 10 per cent of GDP.[67] Perhaps the greatest of the remaining 'skeletons' contributing to Brazil's fiscal problems is the growing public-sector pension system deficit. Although the system is fast becoming insolvent, pension reform is among those that advanced the least under Cardoso.[68] The national social security system ran a R$21.8 billion deficit in 2000 (whereas as recently as 1994 the system was not running a deficit), and state and municipal governments' pension systems added R$20.1 billion to the deficit that same year.[69]

The reforms undertaken during the Cardoso administration will not reduce this deficit but will only slow its growth.[70] The most intractable political problem is the excessive weight of retired bureaucrats, especially those at the higher end of the pension scale, who consume a disproportionate share

64 Marcus Melo, *O Jogo das regras: as reformas constitucionais no Brasil: instituições políticas e processo decisório* (Rio de Janeiro, 2001).

65 *O Estado de São Paulo*, June 8 2002, p. A3; *O Estado de São Paulo*, June 10 2002, p. B4. The 1 per cent surcharge on the CSLL (a 'contribution' on profits) and a 2.5 per cent surcharge on the IRR and IRPF (income taxes) are scheduled to be eliminated in December 2003, and the CPMF rate is scheduled to decline in January 2004.

66 *O Estado de São Paulo*, April 14 2002, p. A4.

67 Celso Pinto, 'O Brasil virou a "bola de vez",' *Folha de São Paulo* June 13 2002, p. A13.

68 Maria Inés Nassif, 'Previdência social,' in Bolivar Lamounier and Rubens Figueiredo (eds.), *A Era FHC: um balanço* (São Paulo, 2002), pp. 569–98.

69 *Ibid.*, p. 592.

70 *Ibid.*, pp. 591–7.

of pension disbursements. Pension payments grew faster than salaries for active personnel in the 1990s, from a ratio of salaries to pensions of approximately 2.5:1 in 1987 to approximately 1:1 in 1997.[71] Constitutionally, retired public sector bureaucrats are entitled to a pension that is equal to the salary they received when they retired, and they are also entitled to any raises that active personnel in their category subsequently obtain. Reforming these 'rights' requires legislative supermajorities as well as the will to confront Brazil's highly organised public sector unions and highly influential senior bureaucrats. This problem will only worsen over time, and it will particularly affect states and municipalities, which will find it increasingly hard to comply with the limits the Fiscal Responsibility Law sets on personnel spending (both active and retired).

Macroeconomic management, built on the *Real* Plan, represents the Cardoso administration's clearest success story. However, success is far from complete. The central government's gains came with a high cost, particular in terms of a much larger debt burden. The administration's exchange and interest rate policies also limited its flexibility in other areas, and have left Brazil vulnerable to international financial fluctuations. Finally, although future presidents may not have the legitimacy and/or capacity to negotiate such broad and cohesive coalitions as Cardoso did, fundamental elements of macroeconomic policy will depend on smooth executive-legislative negotiations. The challenges to Brazil's macroeconomic stability remain in the area of fiscal policy. Cardoso's policies consolidated these problems at the federal level, clarifying just how extensive the damage was, but they have not freed Brazil from the damage that past administrations wrought.

[71] *Ibid.*, p. 579.