

Brazil's Fiscal Responsibility Law and the Quality of Audit Institutions

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Brazil has made great improvements in its fiscal governance over the last 15 years. While these improvements have led to fiscal adjustments and positive economic outcomes, they have encouraged incumbent politicians in Brazil to make use of “creative accounting” in order to facilitate the government meeting its budget deficit ceiling. That is, the use of fiscal window-dressing as a response to fiscal constraints might undermine the sustainability of fiscal balance.

In 2000, Brazil implemented a hard-budget constraint legislation – the Fiscal Responsibility Law (FRL) – which was applicable to all levels of government regardless of their prior economic conditions. The FRL illustrates the kinds of policy outcomes that reflect the power of Brazil's executive to implement its policy preferences in the federal political game. In its relations with the state governments, a powerful president and a strong finance minister have managed to recentralize fiscal authority in the country, curbing state level fiscal autonomy. Brazil's executive branch was able to implement its preferences because of its institutional prerogatives and because there were gains-from-trade in federal-state relations. State governors developed an interest in reforms in the wake of the approval of the re-election amendment and in view of the compensation mechanisms involved in the reform process.

There is no question about the positive effect of the FRL with regard to the fiscal situations of Brazil's states, which have improved considerably since the enactment of the Fiscal Responsibility Law. Whereas all states faced a deficit prior to the law, the consolidated state accounts have systematically presented a surplus roughly equivalent to 4 percent of GDP after the law was enacted. A similar success story can be told regarding public debt. A succession of primary surpluses enabled the government to effectively reduce the GDP/debt ratio. Since 2002, when the GDP/debt ratio peaked at 55 percent, there has been a reduction in net debt as measured by percent of GDP, which is estimated to be below 36 percent in 2008.

The FRL mandated that state audit institutions (*Tribunais de Contas*), with the role of external control of public administration, must audit the enforcement of the law by imposing procedural rules (reporting transparency, etc). The *Tribunais de Contas* are ancillary bodies of the legislative branch at the state level and they enjoy a great level of functional, administrative and political autonomy. Their purpose is to examine the government accounts and their compliance with the principles of the public administration (public morality, impartiality, publicity and efficiency) as well as the specific legal requirements for hiring of personnel, concessions of pensions, procurement, intergovernmental transfers, competitive public bidding and fiscal responsibility. These institutions were significantly strengthened by a number of changes introduced in the Constitution of 1988.

Although the Audit Courts are not technically part of the judicial system, in practice they operate as quasi-independent judicial authorities. Not only do the board members enjoy tenure security, but they are also appointed until the official retirement age for public servants, currently 70 years-old (Speck 2000; 2002). Even though there is considerable homogeneity in the functioning of the *Tribunais de Contas*, some important differences in the institutional design remain. For instance, there is great variation with regard to organizational aspects in terms of the number of employees, infrastructure and equipment available as well as the number administrative units under their

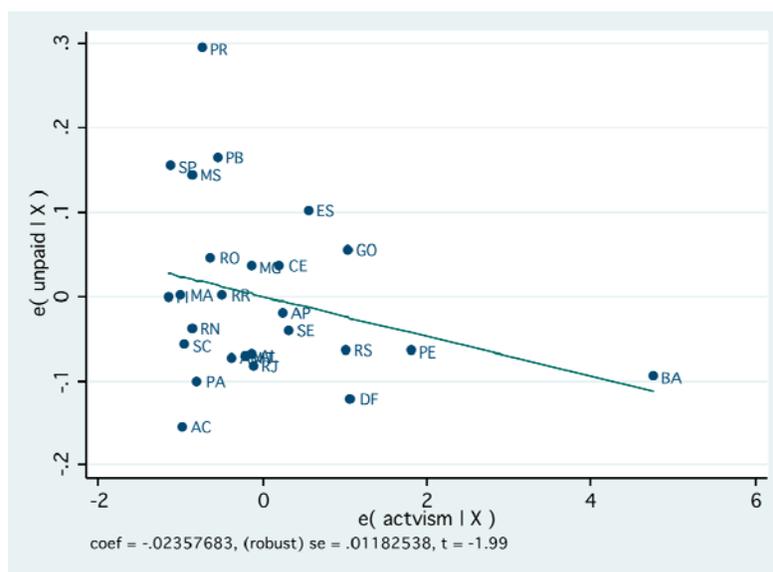
jurisdiction. There is also great variability concerning their activism (number of audit files per administrative unit) among audit institutions. An active *Tribunal de Contas* is one that does much more than the minimum required of one report per administrative unit and carries out audits as a result of the auditors' own self initiative or from third-party denunciations.

Melo, Pereira and Figueiredo (2009) have already demonstrated that a key factor behind a greater activism of state audit institutions in Brazil is the level of political uncertainty generated by the electoral competition among the state's elite groups. That is, the greater the risk of the elite in power losing the next election, the more autonomous the Audit Court. More specifically, they found that the turnover of political elites controlling state governments generates incentives for the strengthening of the autonomous audit institutions. In addition, the presence or lack of an independent senior auditor and/or public prosecutor in the Audit Board is another crucial aspect explaining the degree of activism of an audit institution in Brazil. That is, tribunals with independent auditors and prosecutors on their boards are more prone to action.

Despite the hard budget constraints imposed by the FRL, the Brazilian state governors retain some ability to undertake fiscal window-dressing in response to fiscal stress. Therefore, it is not a rare event to see Brazil's states experiencing yearly financial deficits as unpaid commitments (*restos a pagar*). These are the kind of expenses the payment of which are delayed to the subsequent fiscal year, whereby postponing their impact on the primary balance. If inadequately documented over the years, financial deficits can obscure the evolution of the state's underlying fiscal position.

Because the *Tribunais de Contas* are not immune to the influence of the legislature and state governor, there is evidence that the institutional quality of those audit institutions is associated with more creative accounting. More independent and active institutions constrain the use of creative accounting at the state level. As Figure 1 demonstrates, the more independent a *Tribunal de Contas* (measured by the presence of an independent senior auditor on its board), the smaller the incentives governors will have to rely on window dressing mechanisms (measured by unpaid commitments). In addition, political competition also matters for creative accounting. Specifically, there is evidence of the correlation between alternation of the elite in power (government turnover) and *restos a pagar*.

Figure 1: Activism of Courts of Account and Creative Account at Sub-national Level in Brazil (2000-2005)



Source: Melo, Pereira, and Souza (2009)

Therefore, the evidence of creative accounting in the states represents an indication that the influence of the *Tribunais de Contas* is binding and that there are costs for breaching the law. Second, the lack of institutional quality of the *Tribunais de Contas* is associated with more creative accounting. More independent and active institutions constrain the use of creative accounting at the state level. In sum, given that audit activism and political independence seem to refrain opportunistic fiscal behavior, enhancing the governance and the autonomy of sub-national audit institutions is key for the long-term sustainability of fiscal policy in Brazil. The Achilles' heel of the Fiscal Responsibility Law in Brazil might therefore be the quality of sub-national audit institutions.

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