BRAZIL'S FISCAL FRAMEWORK: CHALLENGES AND OPTIONS FOR REFORM

A. Introduction

1. Brazil was an early adopter of fiscal rules, and the fiscal framework has guided fiscal policies for two decades. The framework helped modernize public financial management and significantly contributed to fiscal sustainability and macroeconomic stability. At the same time, effectiveness has waned in recent periods, partly due to design problems, but also reflecting a weakening of legal provisions in the face of entrenched budget rigidities and the need to respond to shocks. Brazil’s fiscal framework has also grown more complex over time.

2. The new proposed fiscal rule aims at achieving fiscal consolidation by limiting expenditures to grow less than revenues over time. The rule addresses important political priorities and helps reduce fiscal uncertainty, while providing the opportunity to prepare reforms for a gradual improvement in the primary fiscal balance. Given the rule’s design, delivering on fiscal consolidation will require ambitious efforts to increase fiscal revenues over an extended period of time. Current plans envisage a combination of reversing pandemic-related tax cuts, mitigating tax litigation losses, and increasing direct tax collection, including through closing loopholes and reducing tax expenditures.

3. This paper discusses options to build on the new fiscal rule and enhance the fiscal framework. The new rule’s focus on revenues carries important implementation risks, and more ambitious consolidation is needed to achieve a firmly downward debt path. Building on Brazil’s and cross-country experience with fiscal frameworks, this Paper proposes options to build on the new fiscal rule and enhance the fiscal framework.

4. The paper is organized as follows. Section I discusses international experience with fiscal rules. Section II describes the evolution of Brazil’s fiscal framework. Section III provides an assessment of the new fiscal rule and outlines options to enhance the fiscal framework. The last section concludes.

B. International Experience

5. Countries around the world have increasingly adopted fiscal rules, often combining a debt anchor and an operational rule. Many advanced economies started adopting fiscal rules and fiscal councils to strengthen their frameworks in the early 1990s, also in the wake of the EU accession/Maastricht process, increasingly followed by emerging market and developing economies. Nowadays, countries with fiscal rules generally have more than one, with the most common combination being a debt ceiling or anchor supported by an operational rule, such as budget balance or expenditure rule (IMF, 2021). Overall, there exists a broad spectrum in the design of rules, even though most countries have clear numerical targets. In turn, the new European approach, for

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instance, focuses on debt stabilization rather than returning to a fixed numerical threshold once a country exceeds the existing debt target of 60 percent of GDP.

6. Debt rules are less common in Latin America even though more countries have adopted them recently. The region stands out for having very few debt rules in fiscal frameworks, including compared to emerging market peers. Peru was the only LA6 country with a debt rule up to 2022, when Chile and Colombia introduced debt rules to complement and guide their existing operational rules. The Colombian debt rule measures the distance to the debt target and then determines the spending ceiling accordingly. The Chilean debt ceiling states that the fiscal path should keep debt below the defined prudent threshold.

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2 LA6 countries include Argentina, Brazil, Chile, Colombia, Peru, and Mexico.
7. **Expenditure rules are more prevalent in emerging markets, particularly in Latin America.** Expenditure rules have been adopted in particular in the aftermath of the global financial crisis, and mainly by emerging markets. Among LA6 countries, expenditure rules are as frequent as budget balance rules. Across countries, caps on real expenditure growth are the most common, closely followed by caps on nominal spending growth. Exemptions to the ceiling include items not under government control, such as interest payments (e.g., Finland, France, and Japan) and cyclically sensitive items (e.g., Poland, Spain, and the United States). Some countries also exclude capital (e.g., Croatia, Ecuador, and Peru) and security spending (e.g., Israel and Peru), which is, however, not recommended.

8. **Empirical evidence suggests that different rules help enforce different aspects of budgetary discipline.**

- **Debt rules** have been more effective in helping revert to previous (or lower) debt levels after the economy experienced a shock (IMF, 2021).

- **Budget balance rules** are comparatively better at limiting forecast errors, i.e., the difference between official projections of budget balances and private forecasts (IMF 2021); or minimizing deviations between the limit set forth in the rule and IMF forecasts (Davoodi and others, 2022).

- **Expenditure rules**, designed as real or nominal caps, are found useful in reducing procyclical, in particular in emerging market economies. Event studies show that investment spending often falls following the implementation of an expenditure rule, in particular in emerging market economies. A well-designed medium-term budgetary framework (MTBF) can help mitigate risks for capital spending be crowded out to comply with expenditure ceilings in the short term (Cordes and others, 2015), notably in the presence of budget rigidities.

9. **Strong underlying institutions are needed to foster compliance.** Significant deviations from existing rules occurred in the aftermath of the pandemic, with nearly 80 percent of countries suspending or modifying their rules (Davoodi and others, 2022). Many governments, however, envisage a return to fiscal rules to strengthen credibility, offering an opportunity to revisit frameworks (IMF, 2022). An upgraded medium-term fiscal framework (MTFF) that combines more flexible rules and strengthened institutions could provide appropriate guidance to promote sound public finances (IMF, 2022). In this context, strong institutions are needed to forecast fiscal paths and risks, monitor the implementation of MTFFs, and enforce compliance with anchors.

10. **Cross-country experience helps distill several principles for the design of fiscal rules.** Rules should be simple, transparent, and flexible enough to respond to shocks, while providing operational guidance and accountability. A fiscal framework should also ensure long-term
sustainability and economic stabilization, and, when applicable, facilitate coordination across levels of government.

C. Brazil’s Fiscal Framework: Past and Present

11. Brazil was among the first emerging market economies to adopt fiscal rules, according to the IMF Fiscal Rules Database. A golden rule was introduced as part of the 1988 constitution. In the wake of the late-1990s fiscal crisis, the country passed a Fiscal Responsibility Law (FRL) in 2000, implementing primary balance targets as the main operational anchor in annual budgets. Following the crisis in the mid-2010s, a federal spending rule was enshrined in the constitution in 2016. Currently, a new fiscal rule is under consideration by Congress after the ceiling was revoked by a constitutional amendment in December 2022.

1988 Golden Rule

12. The 1988 golden rule was adopted to safeguard fiscal responsibility and public investment. By restricting new borrowing to finance capital expenditures, it aimed to limit (current) fiscal deficits and reduce public debt, while allowing flexibility to tackle large infrastructure investment needs. The rule applies to each level of government.

13. The definition of capital spending under the Brazilian golden rule is very broad and has allowed de facto current deficits, while investment declined. The design of the rule hinges on a definition of capital spending that extends beyond the traditional concept of investment in non-financial assets. New borrowing is bound by the sum of investments in non-financial as well as in financial assets, including debt amortization, government lending, equity purchases, and debt valuation changes due to exchange rate fluctuations. Historically, public financial investment in Brazil has been as large or even larger than investment in physical capital (Barros and others, 2018). Furthermore, financial revenues have been sizable due to the transfer of central bank profits to the treasury and the returns to government assets, notably loans and the large Treasury Single Account. Consequently, the level of current spending that can be sustained while in compliance with the
Brazilian golden rule is much higher than envisaged under a strict application of its principle. Indeed, current deficits have been positive in most years since the introduction of the golden rule, despite de jure compliance. The rule has also not been effective in containing the growth of public debt or fostering public investment.

2000 Fiscal Responsibility Law

14. The approval of the FRL in 2000 was a key milestone in the post-1990 efforts to preserve fiscal sustainability and improve public financial management in Brazil. Already foreseen in the 1988 constitution, the FRL (a complementary law) consolidated various norms intended to promote fiscal transparency, limit deficit biases, improve budget planning, and define control mechanisms at all levels of government.

15. The FRL established spending limits and institutionalized the setting of annual primary balance targets in the annual budget process. Personnel spending (including pensions) is capped

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3 The Brazilian golden rule can be waived through Congress authorization of ‘extraordinary credits’, applicable for urgent and unforeseen spending needs. Such waivers were applied from 2019 to 2022. In all remaining years, there was strict legal compliance with the rule.
at 50 (60) percent of net current revenue for the federal (subnational) government(s), with individual limits set for the executive, legislative, and judiciary branches. Spending is further constrained during pre-election periods. Furthermore, permanent spending mandates cannot be created without compensatory revenue increases or spending cuts. The mandatory primary balance target is to be set in the Budget Guidelines Law prior to each fiscal year, along with indicative targets for the two following years. Debt limits (including guarantees) were to be legislated for each level of government. So far these have only been defined for states and municipalities, respectively at 200 percent and 120 percent of net current revenues.

16. **To this day, the FRL remains the backbone of Brazil’s fiscal framework.** There is a longstanding legacy of transparent fiscal reporting that enables public accountability, a culture of rules-based fiscal management, and improved coordination across levels of government. For nearly a decade, the framework supported a steady decline in public debt, at the federal and subnational levels of government, albeit helped by favorable economic conditions. Such success also helped build its credibility.

17. **However, challenges have emerged over time, including due to the procyclical nature of rules, the lack of a medium-term anchor, and extensive budget rigidities.** The primary balance target is defined in nominal terms, with no consideration for the business cycle, while limits to the wage bill were fixed in percent of revenue. At the same time, mandatory spending provisions render it difficult to reduce or even stabilize spending in good times. Thus, public spending outpaced GDP for much of the first 15 years of the FRL, while the tax burden increased to meet primary balance targets. As economic conditions worsened, compliance with the targets increasingly relied on legislative amendments, non-recurrent revenues, and off-budget operations. The FRL institutionalized some pluriannual budget planning instruments (including for investment), but their use is limited and mostly indicative. Over time, the effectiveness of the FRL has weakened, with structural primary balances turning negative and nonfinancial public sector gross debt trending upward (IMF, 2017).

18. **At the subnational level, despite the initial success in driving debt reduction, compliance with FRL debt and spending limits was uneven.** This was due to differences in accounting standards and reporting, weak internal and external controls, legal uncertainty over the application of the FRL, and loosening administrative controls on borrowing (IMF, 2020). Subnational governments also faced mounting spending pressures arising from procyclical rules (limits and floors linked either to revenue or GDP) and revenue earmarking.

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4 Initially, the target was set in percent of GDP, rendering it even more pro-cyclical.

5 The scope of the primary balance target, initially set to include the non-financial public sector, was gradually narrowed to exclude large state-owned enterprises (SOEs) (Eletrobras, Petrobas), subnational governments, and some spending categories. Quasi-fiscal costs associated with on-lending through public banks and with price controls were not reflected in the fiscal accounts, and the share of end-year unpaid commitments increased from five in the budget of 2007 to 13 percent in 2014 (IMF, 2017), reaching nearly 4 percent of GDP.
2016 Federal Spending Ceiling

19. The constitutional federal spending ceiling was introduced in the wake of the 2015-16 fiscal crisis to address procyclicality and reverse the secular rise in the federal spending ratio. The rule limited federal primary spending growth to inflation for 20 years, with a possible revision after 10 years. It would therefore induce a reduction in spending ratios over time, and, to the extent that it could sustain primary surpluses, lead to a reduction in public debt. The ceiling had broad coverage with few exceptions. It was accompanied by institutional reforms to strengthen public financial management (e.g., better fiscal risks accounting, more transparent fiscal reporting) and the creation of the Independent Fiscal Institution, with a mandate to provide independent macro-fiscal projections, assess compliance with the fiscal rules, and analyze the budgetary implications of public policies.

20. The ceiling helped bring credibility to the fiscal framework and contributed to curbing spending growth and improving fiscal primary balances. Although the ceiling did not have a direct link to fiscal sustainability, its adoption signaled renewed commitment to fiscal responsibility under the promise of ensuing spending reforms and helped bring down sovereign risk premia. Its implementation was followed by the 2019 pension reform, which stabilized pension spending of the general pension regime (RGPS), albeit at a relatively high level. The government was also able to restrain civil servant wage increases to inflation.

21. Nevertheless, the bulk of the adjustment was achieved through a retrenchment of discretionary spending and frequent amendments that weakened effectiveness. Given

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6 Exceptions included constitutional transfers to subnational governments, capitalization of SOEs, and extraordinary credits. The latter can be authorized by Congress in the periods of public calamity, war, or after natural disasters.
difficulties in addressing budget rigidities and reprioritizing spending, complying with the spending ceiling required restraining much needed public investment, reaching levels below capital depreciation. The response to the pandemic shock led to a sizable increase in spending in 2020, but this was largely reversed by early 2021. In 2021-22, four constitutional amendments proved necessary to accommodate new spending mandates, including expanded social assistance, growing court ordered payments, health, and public investment. In addition to expanding the spending envelope, these amendments reinforced some of the rule’s provisions, but introduced considerable uncertainty over the conduct of public finances. The frequent amendments and the retrenchment of discretionary spending contributed to weaken the effectiveness of the 2016 federal ceiling.

2023 New Proposed Fiscal Rule on Federal Spending

22. The transition constitutional amendment was passed in late 2022 to replace the federal spending ceiling with a new spending rule in 2023. Replacing the constitutional spending ceiling with a rule that grants more room for new government spending priorities was largely expected. With the constitutional spending ceiling lifted in December 2022, the new rule was proposed to Congress as a complementary law in March and informed the preparation of the 2024 Budget Guidelines Law. With a few exceptions, FRL provisions would remain in place.

23. The new proposed rule restricts spending growth below revenue growth to guide fiscal consolidation. The authorities aim to improve the federal primary balance from a deficit of 0.5 percent in 2023 to a surplus of 1 percent of GDP in 2026. The primary balance targets are determined on a yearly basis in the Budget Guidelines Law, while the tolerance band around targets of +/- 0.25 percent of GDP is included in the new rule’s draft complementary law. Real federal spending is allowed to grow within a corridor, with a floor of 0.6 percent and a ceiling of 2.5 percent. The actual spending growth is contingent on the previous year’s (i) revenue collection and (ii) fiscal performance relative to the primary balance target.

• If the federal primary balance in year t is within the target band, real federal spending growth in t+2 equals real revenue growth in t+1 (mid-year) multiplied by a factor of 0.7

7 The 2020 fiscal response took the form of a time-bound package (the ‘War Budget’) implemented under the umbrella of a public calamity decree that allowed for treating the pandemic-related support as extraordinary credits which are outside the expenditure ceiling.

8 In March 2021, the so-called ‘Emergency’ constitutional amendment (PEC) allowed for a second round of pandemic-related fiscal support, while freezing public wages/hiring and introducing automatic spending cuts when mandatory spending surpassed 95 percent of total. In December 2021, another PEC changed the spending ceiling calculation formula and imposed a temporary subceiling on parts of government liabilities (judicial claims come due, so-called precatorios). A third PEC in mid-2022 exempted social benefit increases from the ceiling to respond to rising inflation and a cost-of-living crisis. The so-called transition PEC of December 2022 expanded the spending envelope to allow for the continuation of social benefits at the 2022 level (not budgeted in the 2023 Budget Guidelines Law), additional child allowances, as well as the expansion of selected health programs and public investments.

9 Debt limits for subnational governments and the requirement for new permanent spending mandates to be matched by compensatory (permanent) revenue increases would remain in place. The draft complementary law specifies new sanction mechanisms as well as a limit of 25 percent of total discretionary spending allowed for cuts to meet the primary balance target.
• If the federal primary balance in year \( t \) is outside the target band, real federal spending growth in \( t+2 \) equals real revenue growth in \( t+1 \) (mid-year) multiplied by a factor of 0.5.

The rule also introduces a floor on public investment of 0.6 percent of GDP. In case of overperformance relative to the primary balance target, investment spending can be increased up to 70 percent of the overperformance per year, limited to 0.25 percent of the previous year’s GDP. The remainder would be saved.

### D. Avenues to Enhance the Fiscal Framework

24. **Brazil’s fiscal framework supported responsible fiscal management but has become relatively complex.** The framework comprises a set of rules and norms that could be internally inconsistent (e.g., spending limits while mandatory spending continues to grow) or not connected to one another (e.g., golden rule versus spending limits). Moreover, past exceptions to the rules have increasingly hampered monitoring and accountability. Beyond numerical fiscal rules, the framework comprises a myriad of administrative controls and regulations that have evolved over time.

25. **Challenges to advance structural spending reforms, coupled with short-term planning and reduced flexibility, have limited the effectiveness of the fiscal framework.** When facing economic shocks or needing to address new spending priorities, amendments to existing rules – even if requiring constitutional majorities – have been common. In contrast, approving structural reforms to open fiscal space for key spending needs has proven much more challenging. The lack of a medium-term horizon in the framework facilitated a short-term bias and the postponement of such reforms.

26. **The new proposed fiscal rule addresses important priorities of the new government and offers opportunities for gradual fiscal consolidation over an extended horizon, but important challenges remain.**
- **No built-in debt reduction.** Under staff’s macroeconomic assumptions, a primary surplus of over 1 percent of GDP over the medium term is needed to stabilize gross NFPS debt, as unfavorable interest rate-growth differentials are expected to lead to a rising debt path in the near future. To put debt on a firmly declining path, staff estimates a total fiscal effort of around 4-4½ percent of GDP would be required over the medium to longer term. Such consolidation path would be feasible under the new rule if real federal spending growth remains at the floor of the corridor (see “Inflation+0.6” scenario\(^{10}\)), and a sustained increase in the revenue-to-GDP ratio of 2 percent of GDP is achieved (in line with staff’s baseline scenario on revenues). However, with real spending growth at the upper limit of the corridor of 2.5 percent, which would be allowed by the rule given the underlying strong revenue growth, NFPS gross debt would reach around 110 percent of GDP by 2028.

![Federal Primary Balance Paths](chart1.png)

![NFPS Gross Debt](chart2.png)

- **Consolidation through higher revenues.** Compliance with the primary balance target band until 2026 requires increases in revenue collection of around 2½ percent of GDP from the 2023 budget. This carries implementation risks, given slowing cyclical conditions and a high revenue ratio on a structural basis. Closing loopholes and eliminating tax expenditures would help mitigate the negative impact on GDP, but given the already high tax burden of around 35 percent of GDP, a further sizable expansion of the tax base could dampen economic growth (Alesina, Favero, and Giavazzi, 2019).

- **Procyclical bias.** By linking spending growth to the previous year’s revenue growth, the rule entails a procyclical bias. The bias is stronger during economic booms (i.e., real spending growth is higher in good times, even if capped at 2.5 percent) (Box 1).

- **Increased budget rigidities and complexity.** Floors on both real spending growth and investment add to already entrenched budget rigidities (see accompanying Selected Issues Paper). Moreover, several provisions of the new rule are potentially conflicting, such as the combination of spending floors, within-year correction mechanisms for spending when the

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\(^{10}\) See text charts, red solid line “Inflation +0.6”. Assuming an increase in the revenue ratio of 2 percent of GDP, as under staff’s baseline, spending growth would remain close to the floor and the spending ratio would decline by 1¾ of GDP by 2028 and 3 percent of GDP over the longer term. The authorities’ proposed primary balance target path, depicted in blue, is assumed to remain constant at 1 percent of GDP given the required re-definition of parameters in 2027.
primary balance target is at risk, and the limitation of expenditure cuts to 25 percent of discretionary spending, which could pose challenges in communication as well as compliance.

Box 1. The New Proposed Rule Under Alternative Growth and Revenue Scenarios

Following the new proposed fiscal rule, this box presents fiscal paths under three illustrative growth scenarios: (i) ‘recession’, corresponding to a decline in real GDP growth similar to the 2015-16 crisis; (ii) ‘slowdown’, with low but positive growth (around ½ percent in three consecutive years); and (iii) ‘boom’, akin to the GDP growth spurt before the global financial crisis. Revenue measures of 1 percent of GDP are assumed to be implemented in 2024, prior to the cyclical swings in each scenario. The scenarios assume no further measures in the subsequent years, deviating from current projections in staff’s baseline scenario to capture possible challenges in securing a sizable increase in tax revenues during challenging economic conditions in the recession and slowdown scenarios, and strong revenue growth in the boom scenario, which would alleviate the need for additional revenue measures to meet the primary target path.

The real spending path is very similar during slowdowns and recessions (guided by the spending floor), but trends strongly upwards in a boom (guided by the spending ceiling). In a slowdown and recession, the new fiscal rule would offer some increase in the spending envelope, thanks to the spending floor that allows real spending to grow more than real GDP. However, the resulting fiscal stance is somewhat contractionary (and pro-cyclical). Moreover, missing the primary balance target during the downturn implies that spending growth is lowest in the year(s) following the trough and accelerates in the economic recovery, without recovering fiscal buffers. During economic booms, real spending follows a strong upward path, with spending growth at the maximum of the corridor, turning the fiscal stance expansionary (and also pro-cyclical).

Debt increases in recessions, mainly due to declining GDP, but also in slowdowns with still positive economic growth, stabilizing over a long horizon. In such cases, staff would expect the authorities to take measures to prevent a sharp increase in debt and maintain debt sustainability. During boom times, debt ratios decline initially, thanks to the larger denominator effect and higher cyclical revenues, but high lagged spending growth allows debt to rise again in the outer years, absent a sustained increase in revenues.

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1 The scenarios consider a revenue elasticity of around 1.1 percent, in line with the literature.
2 The floor on real spending growth of 0.6 percent applies even when primary balances are not within the band, or revenues are declining.

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1 Spending would be corrected through bans on: new hiring, increases in public wages, new mandatory spending, or increases in assistance policies or tax benefits.
27. **There is scope to build on the proposed new fiscal rule and enhance the fiscal framework.** The rest of this section discusses options for: (i) Refining the New Fiscal Rule; (ii) Addressing Procyclicality; (iii) Securing Debt Sustainability Through a Fiscal Anchor; (iv) Hardening Subnational Budget Constraints; and (v) Empowering Fiscal Institutions and Strengthening Medium-term Fiscal Planning.

### Refining the New Fiscal Rule

28. **The new spending rule could be enhanced by refining the spending corridor.** The corridor could be calibrated to ensure consistency between spending paths and the primary balance targets, including for 2027 and beyond. Exercising discretion to remain below the ceiling of 2.5 percent real federal spending growth could be incentivized, in particular during good times. In turn, spending cuts must be possible to deal with shocks if needed. Differentiated rules on current and capital spending within the corridor could be harmonized to mitigate risks of misclassification and safeguard public investment. Continuing to transparently report on fiscal developments and projections within the fiscal year would further support consistency and transparency.

29. **Binding multi-year targets and transparent medium-term expenditure paths embedded in the rule would improve accountability and consistency.** As per FRL provisions, a primary balance target becomes binding for the upcoming fiscal year once determined in the Budget Guidelines Law. Making a multi-year target path more binding could help guide the budget process over a longer horizon and improve consistency. Medium-term budget forecasts, including five-year projections of expenditure components, would also help ensure consistency with targets over time.

### Addressing Procyclicality

30. **Linking federal spending growth to sustained increases in the structural revenue-to-GDP ratio could help address procyclicality within the new proposed rule.** Acknowledging
volatility in non-recurring revenues, the new spending rule excludes *other revenues* such as dividends, concessions, and royalties (mainly from commodities) from the revenue base used to derive spending growth. While this is welcome, *tax revenues* remain exposed to both economic and commodity cycles. Considering a structural definition of revenues (rather than revenue growth) as the base for spending growth could help strip off broader one-off revenues as well as cyclical fluctuations in tax collection.

31. **Mechanisms to smooth commodity cycles could further prevent translating transitory windfall gains into spending increases and promote additional savings when commodity prices are high.** In general, a comprehensive expenditure ceiling and a binding primary balance path would channel windfall gains into government savings, unless these gains are offset by lowering tax rates. Procyclicality from commodity windfalls could be addressed through computing and publishing cyclical and structural components of revenues, or non-commodity fiscal balances, to raise awareness. Guidelines on smoothing consumption of surprise proceeds over several years could ensure establishing a proper understanding of structural and cyclical movements before the proceeds are consumed.

32. **Introducing an economic escape clause would provide useful guidance for dealing with major economic shocks.** As successfully proven during the COVID-19 pandemic, the FRL’s provision on extraordinary credits is a valuable option for countercyclical crisis response, triggered by the declaration of a state of calamity. Institutionalizing this response would help define the beginning, the end, and the return path to ‘normal times’. An escape clause would contain a limited and clearly defined set of events triggering the operation of the clause, if possible, quantitatively defined, including severe economic downturns, large natural disasters, and states of emergency. The clause would have a designated activating authority and a pre-defined correction mechanism with timeline and procedures to return to a normal, non-crisis path.

### Securing Debt Sustainability Through a Fiscal Anchor

33. **In line with recent developments in the region, Brazil’s fiscal framework would benefit from a fiscal anchor that puts debt on a firm downward path within a medium-term perspective.** A public debt anchor – as foreseen by the FRL – would guide the calibration of primary balance targets and thus any fiscal adjustment needs. It could be derived from a Debt Sustainability Analysis (DSA), taking into account appropriate risk buffers. Alternatively, the anchor could be a fixed target over the medium term. While the former regularly adjusts to risks and financing conditions, the latter would be easier to communicate and could be periodically revisited. Overall, the more dependent the anchor on models and inputs, such as the DSA, the more important underlying institutions and their checks and balances, such as an MTFF and independent scrutiny from a fiscal council. A third possibility would be to anchor the framework on a multi-year primary balance path, building on the proposed rule, albeit with pre-announced, binding primary balance

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12 Corporate income taxes and social security contributions from the commodity sector amounted to around 1 ½ percent of GDP in 2022, about ½ percent above past averages.

13 E.g.: expected impact on growth or fiscal balances.
targets over medium term that underlie budget preparation and are synchronized with consolidation needs.

34. **The choice of an appropriate anchor is challenging given uncertainties around debt thresholds, but can be informed by various approaches.** Several considerations could be helpful:

- **Defining a maximum limit for times of stress.** A debt limit should reflect the level of debt where the risk of distress is too high. This limit could be derived in various ways.

  - A simple first step would be to analyze the **fiscal effort** needed to sustain a certain level of debt during time of stress. The highest (NFPS) primary balance achieved in Brazil was around 4 percent in the early 2000s, on the back of strong commodity revenues and supported by a much lower spending ratio. Brazil’s interest rate-growth differential at times of stress reached around 4-5 percent during the crises of 2002-04 and 2015-16. As a rule of thumb, dividing the highest historical primary balance (4 percent of GDP) by an interest-rate growth differential under stress of 4.5 percent would indicate the maximum debt level that could be sustained during crises times from a fiscal effort’s perspective. For Brazil, the limit would be around 90 percent of GDP for gross NFPS debt.

  - Looking at historical debt levels, notably before and during crisis episodes, can further inform judgement about the limit. Compared with recent debt ratios, Brazil’s gross NFPS debt has indeed reached similarly high levels before, yet only during times of stress.

  - A more sophisticated approach to determine a debt limit would be through the lens of a **DSA framework.** The IMF (SRDSF) threshold for debt at risk of distress, computed for Brazil, would be around 90 percent of GDP in 2022, holding everything else constant and considering (i) the width of the fan chart, (ii) the probability of debt not stabilizing, and (iii) terminal debt level adjusted for institutions. It is important to note that there are considerable mitigating factors in Brazil, including large cash buffers by the public sector, and an overwhelmingly domestic investor base.
• **Factoring in a buffer.** Depending on risk tolerance, a buffer between the debt limit and the anchor should be considered. This buffer could be calibrated to avoid crossing the debt limit with a 90 percent probability in the medium term, for instance, corresponding to around 15-25 percent of GDP depending on the time horizon.

![Gross NFPS Debt Anchor]

![Net GG Debt Anchor]

Source: Fund staff calculations.

• **Deriving the anchor.** Given the debt limit and buffer as derived above, a desirable longer term debt anchor for Brazil could be around 50-55 percent of GDP for net general government debt, or around 80 percent of GDP for NFPS gross debt, taking into account liquid cash buffers, which are broadly 10 percent of GDP.\(^\text{14}\) As an additional benchmark, both the EM median and the LA6 average debt levels hovered around 40-60 percent of GDP for gross NFPS debt since the early 2000s.

**Debt Averages**

**GG: Gross vs Net**

Sources: IMF staff estimates and projections.

\(^{14}\) For a discussion on the pros and cons of different debt metrics see accompanying Selected Issues Paper.
**Hardening Subnational Budget Constraints**

35. **Expenditure ceilings for states and municipalities would more fairly distribute the fiscal effort to reduce the overall debt burden.** Subnational governments’ mandatory spending has been growing as much as the central government’s up to 2016. While moderation has been achieved at the federal level and for some expenditure items also at the state level, municipalities’ spending is decoupling, notably on the wage bill. Existing subnational fiscal rules could be strengthened, including by addressing legal uncertainty over the application of the FRL, mainly attributed to courts granting temporary injunctions that prevent the enforcement of sanctions. Data quality, in particular for municipalities, could be further improved and accounting standards harmonized to facilitate monitoring (Medas, Perrelli, and Gonzales, 2020).

[Graphs showing Compensation of Employees and Civil Servant Pension Benefits]

**Empowering Fiscal Institutions and Strengthening Medium-term Fiscal Planning**

36. **Strong fiscal institutions are needed to provide an effective control mechanism.** The existing IFI could be leveraged to perform tasks more akin to an independent fiscal watch dog, with adequate resources and bolstered independence. The tasks could include: monitoring the activation and implementation of escape clauses; running the DSA as an input to fiscal management when applicable (with independent macro assumptions); performing reality checks on the feasibility and stability of budget plans; and presenting opinions on federal and subnational fiscal paths and rules. In addition, a good communication strategy is key, including the publication of a credible medium-term fiscal strategy to anchor expectations.

**E. Conclusion**

37. **Brazil was a pioneer in adopting fiscal rules and its fiscal framework has adapted to new challenges and policy priorities over time.** The fiscal framework supported responsible fiscal management, but it has become increasingly complex over time. Challenges to advance spending structural reforms, coupled with a short-term policy horizon and reduced flexibility, have undermined the effectiveness of the fiscal framework, and increased the need to amend it. While the new proposed rule addresses important political priorities and offers opportunities for gradual consolidation over an extended horizon, several challenges and implementation risks remain.
There is scope to shape a more comprehensive and integrated fiscal framework, leveraging specific advantages of rules. Further considerations to refine the proposed new fiscal rule include ensuring consistency of the spending rule and the primary balance targets, while making the latter more binding. The existing fiscal framework would also benefit from a strong fiscal anchor that puts debt on a firmly declining path, rebuilds buffers, and embeds a medium-term perspective. Further options to strengthen the framework include addressing the procyclical bias, coupled with institutionalizing the escape clause and considering a mechanism to smooth commodity revenues, and hardening budget constraints for subnational governments. Strengthening the MTFF and fiscal institutions would support the greater flexibility granted by the framework.
References


