Ensuring fiscal credibility

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ALTHOUGH IN RECENT YEARS BRAZIL'S PUBLIC ACCOUNTS have become more transparent, that is not true of its fiscal policy indicators, particularly with regard to the federal primary budget balance, says Teresa Ter-Minassian, who in 30 years of service to the International Monetary Fund (IMF) directed its Fiscal Affairs Department for eight years. Currently an international economic consultant, she notes that with practices such as recording temporary revenues, excluding investments, and extensive use of accounting gimmicks related to transactions with public financial institutions, it becomes impossible to make out whether fiscal policy is expansionary or contractionary. Ter-Minassian spoke at the IMF-Getulio Vargas Foundation seminar on *Brazil's Fiscal Risks in the Middle and Long Term*, held April 25–26. Here she analyzes the fiscal risks to the Brazilian economy—including social security and the debt of states and municipalities—and how the IMF has performed with regard to the Euro crisis: "With no room for financing, austerity is almost inevitable."

***The Brazilian Economy*—Later this year the International Monetary Fund (IMF) is expected to launch a new Code of Fiscal Transparency for member countries. Do you think there has been a significant advance in fiscal responsibility globally?**

Teresa Ter-Minassian—The IMF has been quite effective in promoting greater fiscal transparency worldwide. Of course there are exceptions, and it was not equally effective in all countries. But good results were obtained by making governments aware of the need for transparency in public accounts and for improved fiscal and budget management. This was not just because of the IMF, but also because of other international organizations like the World Bank and the Organization for Economic Cooperation and Development (OECD) and non-governmental organizations like Transparency International. Some countries have also established fiscal "watchdogs," like the UK Office for Budget Responsibility. But the global crisis clearly demonstrated that many fiscal risks had not been sufficiently identified. So the IMF decided to draft a new version of the Code of Fiscal Transparency, which is still in gestation, and promote a new assessment of fiscal risks, whether macroeconomic shocks, natural disasters, or contingent liabilities, such as guarantees for the financial system. The new methodology has already been tested in Ireland and Costa Rica.

* In collaboration with economist Gabriel Leal de Barros, IBRE.

In what condition is Brazilian fiscal policy?
Brazil has made much progress toward transparency of public accounts; the availability of information is good. My concern is with the watering-down of fiscal policy objectives and goals, for instance, by redefining the public sector to exclude large state-owned companies like Petrobras and Eletrobras; ignoring some operations, such as the Growth Acceleration Program; tax exemptions; the use of state-owned banks and companies to conduct quasi-fiscal operations through directed and subsidized credit; anticipating dividend payments by state-owned banks, and finally, the government's proposal in the last Budget Law to not offset deviations by states and municipalities from the primary budget balance target. All this means the primary balance is no longer a trustworthy signaling of fiscal policy and whether it is expansionary or contractionary.

Brazil should relax its fiscal goals. That would be preferable to creating devices to reach a primary budget balance that is no longer needed. It would be much better to formally reduce the fiscal target and perhaps take the opportunity to start calculating a structural budget balance. It is essential that indicators of fiscal and budget policy are reliable, and the current primary budget balance no longer is.

Would adopting a structural primary budget balance rescue credibility?
Yes—in combination with initiatives such as expanding data coverage of the public sector and eliminating quasi-fiscal operations. It is preferable to use a budget balance adjusted for business cycles. Of course, this calculation is always subject to uncertainty. Personally, I would prefer calculating the structural result and using it to define the primary goal for the year. But I admit that is difficult because it is not clear at the moment how much of the growth slowdown in Brazil is due to structural factors and how much merely to cyclical factors. I believe the problem is more structural: supply factors are causing the fall in GDP growth.

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Has observance of Brazil's Fiscal Responsibility Law been relaxed?
The problems began before the current government. The Fiscal Responsibility Law is a law on budgetary procedures, a law on transparency, and a code of good public financial management. It does not establish many quantitative targets. Of the few that were fixed by the Senate, the borrowing limits for state and local governments are too high. In my view, the law needs to be supplemented. It leaves too much room for fiscal policy, though that is not necessarily negative, if there is careful monitoring and analysis of the sustainability and appropriateness of primary budget balance targets. I'm not a supporter of strict rules because they create incentives for accounting gimmicks. The important thing is to re-establish reliable indicators of fiscal policy goals and stance.

What are the consequences of using accounting gimmicks to achieve a primary budget balance surplus?
This practice is beginning to generate credibility problems, but for me, the key point is that it may become a disservice to govern-

ment itself, because it ends up not knowing whether it is carrying out an expansionary or a contractionary fiscal policy. The more uncertain the economic outlook, the more necessary are reliable indicators of the direction of monetary and fiscal policies.

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Do budget assumptions like 4.5% inflation and GDP growth of 4.5% significantly increase budget risk?

One of the most important roles of fiscal watchdogs is to comment on assumptions underlying the budget. In some cases, as in the UK, the assumptions the government should use are set beforehand by the Office for Budget Responsibility. I do not advocate that this model necessarily be applied to Brazil, but I think it would be good to have an independent agency with a mandate to comment on the quality of the assumptions underlying the budget, like the Congressional Budget Office in the United States.

You warned that debt levels remain high in the larger states. What risk does this carry?

With the current ceiling on debt service, the most indebted state governments will not be able to repay the federal government or refinance their debt in the next 15 years . . . The current ceiling of 16% of net revenue for contracting new debt each year is very high and clearly presents a problem. I would like to see more demanding quantitative rules for new debt and introduction of market discipline. For the latter to work, it is necessary to eliminate privileged channels of access to credit and Treasury guarantees because today the banks are not lending to state governments based on the situation and their solvency but based on the Treasury's guarantees. It is a soft budget constraint. Pressed to increase fixed investment very quickly, either because of infrastructure deficiencies or major sport events, the federal government is now allowing more room for major new debt without necessarily ensuring the quality of each investment.

A significant weight in government spending is the pension system. How to address this issue?

The seminar clearly showed that the Brazilian social welfare system is too generous from an international perspective, even compared with the welfare states in Europe, in terms of retirement age and adjustment of pension benefits. … At the same time, social security contributions are very high, which is a disincentive to private saving. It would be necessary, and I think there is consensus on this, that there be some short-term reforms of the public pension system. We're not talking about adopting a defined contribution system, which would involve very large structural changes, but about simply stemming the deterioration of social security finances. The main goal must be to review and reduce benefits, at least for future pensioners, since it is not possible to change the rights people have already acquired.

The government has granted tax exemptions to a few sectors of the economy, but without corresponding spending cuts. Is

there a risk of a fiscal problem ahead?

I would have preferred to see a general reduction of taxes on businesses and streamlining of the VAT. Very selective and specific exemptions to favor one or another sector further distort the Brazilian tax system, which is already so complex and difficult to administer. Replacing the payroll tax by the VAT would have the advantage of reducing taxes on exports and increasing it on imports—that strategy was much used in Europe in recent years. But here in Brazil, indirect taxation is already very heavy and distorted.

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Fiscal issues have been at the heart of the Euro crisis. Do you think IMF-imposed austerity is the best way to deal with the problem?

At least in the last year, the IMF has had a rather reasonable position in terms of the impact of fiscal policy and austerity. If you cannot afford to borrow, you have to do whatever it takes to adjust your deficit to your financing capacity. On the other hand, if you have access to some financing, you can use it to smooth out the short-term adjustment, provided it is accompanied by a credible medium-term adjustment. The problem is that the southern countries of the European Union, at present, do not have resources to finance their deficits. Of course this is a political decision as well because, in principle, the EU could increase the amount it loans to member countries. The IMF does not have this option, because it is not a European club. The IMF has to preserve its ability to operate in the future in other countries that may require financing. In fact, the IMF already has a very high exposure to European countries. At the same time, it cannot compel the European institutions to do more. This is the dilemma.

Are you optimistic about a solution in the medium term?

I think the political will to stay in the euro area is very strong in the southern European countries, but I see many problems with society accepting the required austerity. I think more could have been done in terms of structural reforms, especially in the labor market, to reduce the rigidity of these economies. But it takes time and usually has short-term fiscal and social costs. So with no room for financing, fiscal austerity is almost inevitable. In Italy, the debt stock is high, but the fiscal accounts are not bad: it has already managed to achieve a primary budget surplus. Greece and Portugal have carried out a powerful fiscal adjustment and their very high primary budget deficits are turning into a surplus. ... But I do not consider myself optimistic, and I'm worried.

The BRICS group is calling for reforms to redistribute quotas and increase their decision-making power within the IMF. Is Europe indeed over-represented today?

Absolutely. I am completely in favor of emerging countries having more weight in the IMF. Movement in this direction has begun, but we need to go further. I've always argued for more voice for emerging countries.