

BRAZIL'S EMERGING FISCAL RISKS

Solange Monteiro, *Rio de Janeiro*

THE CHANGE IN THE RISK OUTLOOK for Brazil announced by international rating agency Standard & Poor's in early June has turned the spotlight on Brazil's fiscal policy problems. Despite 20 years of foreign debt restructuring and almost 15 years of the Fiscal Responsibility Law, both of which contributed to economic stability and the achievement of an international investment grade ranking, risk factors are now pointing to the need to rethink current fiscal policy.

In late April, economists of the Brazilian Institute of Economics (IBRE) and the International Monetary Fund (IMF) met at a seminar on "Brazil's Fiscal Risks in the Middle and Long Term" in Rio de Janeiro to discuss the threats to Brazil's public finances. Teresa Ter-Minassian, former director of the IMF Fiscal Affairs Department, criticized the proliferation of accounting gimmicks "such as transactions with the sovereign wealth fund, use of state-owned banks, and quasi-fiscal operations." The experts also discussed the difficulty of reforming Social Security, which is becoming more and more urgent because the population is rapidly aging. The Brazilian Institute of Geography and Statistics (IBGE) reports that pension-related spending for those over 65 today accounts for 12% of GDP and will reach 23% in 40 years.

There are also challenges that will emerge along with the revenues from future exploration of deep sea oil. The use of bonuses from the bidding for oil blocks to guarantee a primary budget surplus as well as the importance oil royalties have for some municipalities underscore the importance of defining, even before oil begins to flow, how oil revenues are to be managed in order to promote sustainable development.

Finance problems at every level

The experts stressed that public finances need to be improved not only at the federal level but also in states and municipalities. The combination of the control system to enforce contracts to refinance state debts (Law 9496 of 1997) and the limits on states' borrowing (Fiscal Responsibility Law of 2000) has led states to ensure primary budget surpluses over the past decade, contributing to Brazil's fiscal adjustment. Ter-Minassian noted, however, that the

laws have not resolved the country's problems, as illustrated by declining state budget surpluses in the past few years. Because of reduced tax revenues and increased spending, she pointed out, fiscal adjustment has been based primarily on cuts in fixed investments, which were less than 1% of GDP for most of the last decade, which increased Brazil's infrastructure deficit. The situation varies dramatically across the country: some states have low debt and others, mainly those with larger economies, have debt that exceeds 100% of net current revenue.

According to Ter-Minassian, one problem with the current situation is that the ceilings on the debt stock and new debt are very high. She also pointed out that "The Treasury has had substantial discretion to accept changes in [state] fiscal adjustment plans and authorize new borrowing since 2009," and argued that new borrowing should only be authorized after analysis of debt sustainability and the costs and benefits of each planned investment. To avoid future problems and ensure efficient use of new borrowing, both Ter-Minassian and IMF economist Marialuz Moreno-Badia advocate transparency and standardization in information and avoiding excessive use of subsidized credit, for example, from the National Bank for Economic and Social Development (BNDES). "Mexico is a good example," Moreno-Badia said. "There, when subnational governments demanded loans, they used to go to a federal bank for cash transfers, creating the expectation that the federal government would cover what states would not pay. That has ended."

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Market control of public debt

Fabio Giambiagi, BNDES economist, argued that ideally control of state and municipal debt should pass from the federal government to the financial markets, which would enhance the profile and composition of that debt while respecting budgetary constraints: "This is a promising avenue that has been explored by Rio Grande do Sul and Mato Grosso states, and the city of Rio de Janeiro. They refinanced part of their debt to the federal government at very favorable conditions, through external borrowing and extending debt maturities."

What is important, seminar participants agreed, is for states to refinance their debt sooner rather than later: "We do not want to wait for debt to mature in 15 years and then have a debt crisis," Ter-Minassian said. She also advised moderating foreign exchange risk to avoid a significant increase in state external debt, concluding, "It is also necessary to consider the actuarial deficits of state and municipality employee pension funds; there is a need for corrective measures, raising contributions and cutting benefits."