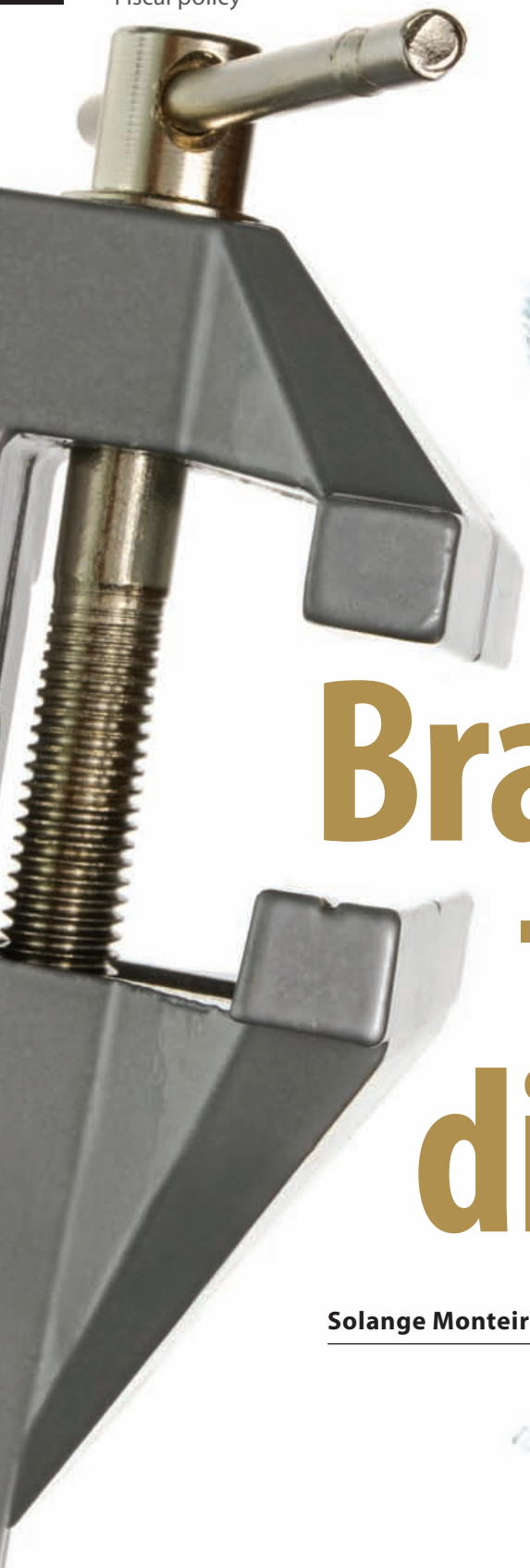


Brazil's fiscal dilemma

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In a break with the expansionist policies of former President Lula, President Rousseff ended her first year in office with expenditure cuts. However, without the record-high 2011 tax revenue and with spending pressure mounting, her administration will face hard choices in 2012.

When Dilma Rousseff became president in January 2011, the markets and society had mixed feelings about whether there would be continuity with the previous administration. In terms of fiscal policy, the previous two years had been markedly expansionist, with the Lula administration adopting countercyclical policies in 2009 to stimulate an economy confronting international crisis and questionably increasing public spending in the election year 2010. There was considerable uncertainty about the Rousseff government's ability to adjust the public budget.

Rousseff began by announcing a budget cut of R$50 billion, spent much political capital to keep the minimum wage adjustment (which involved no gain in real terms in 2011), and achieved a central government primary budget surplus for January through November of R$91 billion; the full-year target was R$92 billion. Political consultant Cristiano Noronha (see list of interviewees at the end of this article, p. 20) says, "The government has managed to create good expectations."

This took more than political skills alone. Tax revenues grew at twice the GDP growth rate: taxes collected in the first 11 months of 2011 totaled R$873 billion, 12% more than in the same period in 2010. "I would say this is big news," says economist Mansueto Almeida, although he points out that since 2009 Brazil has increased revenue more than it has cut spending. The positive combination of increased revenues and ability to meet the minimum wage goal — a key part of

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Photo: Velela/Wikipedia.

the government's social policy and the most sensitive point in the public budget — will not happen again. That is why some analysts believe that in 2012 Rousseff will have to demonstrate a consistent fiscal strategy that can meet demands for investment and increased social spending despite likely lower tax revenue. "Rousseff did not use 2011's extraordinary revenue to invest but instead opted to control spending, following a commitment of the Central Bank to cut interest rates," says consultant Raul Velloso. "There are many unknowns about how she will continue."

Compared to 2011 the budget outlook is unfavorable. "The GDP growth that we had in the second term of the Lula government, 4.5% a year, was a window of opportunity that is closed," says economist Samuel Pessoa. Certainly the current policy of adjusting the minimum wage in line with the previous year's inflation plus the GDP growth of the previous two years leaves little room for maneuver. Almeida believes that "This policy has a very high cost because you're giving increases in real terms, and simultaneously you have a natural increase in the number of social program beneficiaries, especially social security at 3.5% to 4% a year. The tendency of that spending is to grow." Meanwhile, increased infrastructure spending, especially related to the World Cup and the Olympics, will leave little room for cuts in investment in 2012. "There's no other way than reducing the primary budget surplus," says public finance specialist Gabriel Leal. "The government will find it hard to meet its target" for 2012. The Brazilian Institute of Economics (IBRE) estimates a surplus of 2.5% of GDP for 2012 compared with 3.2% in 2011.

To prepare the ground for 2012, last year the government worked to prevent Congress from approving measures that would require more public spending. Noronha

says that here the government was very effective, but he points out that the numerous confrontations weakened the governing coalition. "With this year's municipal elections, there is a greater risk of coalition breakdown," he says (see p. 21), and of course pressure for more spending. "The tendency to spend more in election years is part of the Brazilian political culture, but from the standpoint of fiscal policy it's a structural problem," says academic José Álvaro Moisés. Another consequence of such recklessness is the continuing rise in outstanding commitments, a major fiscal risk.

Even with the administration's efforts in Congress, Almeida predicts, despite government optimism, that public spending will hit new records by the end of Rousseff's term. He estimates that by 2014 there will be another R$104 billion in annual spending on investments and welfare and social benefits. That would mean a jump of 1.4 percentage points of GDP over the next three years. "In the Lula administration," he says, "these expenditures increased 1.2% of GDP in the first term and 1.1% in the second." He predicts that central government investment will rise from 1.3% of GDP in 2010 to 1.5% in 2012 — though in fact this is much more a hope than an estimate, given the pent-up demand for better infrastructure.

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SOCIAL MODEL

A question permeating the market is whether the administration has a formula to change the fiscal policy mix, which is growth in social spending, tax revenue growth to fund the spending, and very little room for more public investment. Because it takes time for the government to cut operational costs, investments will have to be cut in the meantime. Operations carry both administrative costs and costs for such social programs as subsidies to low-income housing and unemployment insurance, which have been growing steadily. "Since 1999, whenever Brazil tries to make a strong short-term fiscal adjustment, it ends up cutting public investment," says Almeida.

This is corroborated by a study from the Institute of Applied Economic Research (IPEA) on government primary expenditure (excluding interest payments) from 2001 to 2011. IPEA found that while direct expenditures for government consumption and fixed capital expenditures have been stable, transfers — the social safety net enshrined in the Constitu-

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Photo: Bruno Spada/MDS.

tion of 1988 to increase the purchasing power of the poorest — have expanded considerably.

For 2001–11 government primary spending as a share in GDP increased by about 2.7%; transfers to households accounted for just over 70%, education and health transfers for 29% and investment for just over 0.3%.

INFRASTRUCTURE AND THE INTEREST RATE

Given the social model of income transfers, Pessoa says, Brazil's subways, roads, and airports will continue to be congested: "To have better infrastructure we would need to save much more than we save, and saving little means there must be more social transfers. That's what society wants." For Almeida, a possible alternative would be for government to rely more on concessions to improve infrastructure: "It's a way to increase investment without pressuring fiscal spending . . . the private sector bears the cost of investment."

But Professor Francisco Lopreato argues that it is feasible to invest more without changing the model of current transfers. "Achievements such as the minimum wage policy and the Family Grant raised Brazil to the next level, and now there is no way back," he says. Meanwhile, he says, "This government is starting to accomplish something that neither Lula nor Fernando Henrique Cardoso did: the removal of indexation of public debt to the central bank benchmark interest rate. But that is taking place slowly."

With regard to public debt, high interest rates distort a relatively comfortable outlook. At 37% in November, Brazil's debt-to-GDP ratio compares well with many other countries. "In Japan, it exceeds 100%, [but] the important difference is that interest payments [in Japan] are equivalent to only 1% of GDP," Lopreato says. Almeida adds, "If we can reach international interest rate levels, it would mean

a major breakthrough, because currently interest payments on public debt are 5.4%." He cites another potential source of income: "Annual tax revenues from deep sea oil could reach 3.5% of GDP, when it has fully exploited its potential," he says.

To earn a fiscal windfall from a decline in interest rates, the need for saving more in the short term is clear, so the Rousseff administration must make tough decisions. "Holding off on adjusting public salaries is important," Pessoa says. "President Lula made all the adjustments to salaries — now it's time to tighten our belts." He also advocates a significant drop in funds transferred from the Treasury to the National Bank for Economic and Social Development (BNDES), even for private parties involved in public concessions. "We need to make concession contracts at higher rates. We will pay more, but it is a way to increase the country's savings," he says. "If you refuse to touch anything, inflation will return." However, Treasury Secretary Arno Augustin disagrees on one point: "With the work of BNDES, we left behind a long period of low investment." He points out that gross fixed capital was only 15% of GDP in 2003 but is now about 20%.

OPEN DEBATE

Leal points out that an alternative for restricting public spending is Complementary Law Project 549/09, which the House Committee on Constitution, Justice and Citizenship is considering. It would amend the Fiscal Responsibility Law to limit spending on federal government personnel and social charges to the amount paid in the previous year, adjusted for inflation plus 2.5% of real gain or by the rate of GDP growth, whichever is less. "Its approval would be a great commitment to fiscal balance in the medium and long term," Leal says. However, given the strained relations between the government and public employees over salary adjustments, the law is not likely to be approved this year.

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Almeida argues that the most important fiscal adjustments will only happen if the government takes advantage of today's good economy to involve society in the discussion, even if there is a cost in administration popularity. He believes that if the need for change is not explained, the president will not be able to convince the population — which favors policies that have immediate impact on

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Gabriel Leal

INTERVIEWEES

ARNO AUGUSTIN, Treasury Secretary.

MANSUETO ALMEIDA, economist, Institute of Applied Economic Research, Brasília.

LOPREATO FRANCISCO, professor of economics, University of Campinas.

GABRIEL LEAL, public finance analyst, Brazilian Institute of Economics of Getulio Vargas Foundation.

JOSÉ ÁLVARO MOISÉS, scientific director, Center for Public Policy Research of the State University of São Paulo.

CRISTIANO NORONHA, partner, Arko Advice political consulting.

SAMUEL PESSOA, consultant to the Brazilian Institute of Economics of Getulio Vargas Foundation.

RAUL VELLOSO, director, ARD Consulting Associates.

purchasing power — to think long-term, saying, "The president must make it clear that if we do not make any adjustment on the expenditure side, she will have to impose on society a higher tax burden." Among the changes experts support is a review of the policy of granting social benefits to eliminate inconsistencies that distort some social programs. Leal cites as an example current pension system rules: "Today Brazil spends 3% of GDP on pensions, while average spending in OECD countries is 1.5%." Economist Almeida argues for stricter criteria for granting unemployment insurance; currently disbursements are increasing even with the record growth of formal employment in Brazil.

One move that could open 2012 on the right foot would be approval of the Pension Fund of Federal Public Employees, the vote on which was postponed to February. With just over 3% of all social security beneficiaries, social security for public employees recorded a deficit of R$56 billion in 2011. Social Security Minister Garibaldi Alves Filho says that over the next five years 40% of federal employees will be able to retire. If only half actually do so, they would add 220,000 pensioners. Almeida says, "That would have a devastating effect on social security, since the current average pension is R$10,000 a year."

Such a change would be an important signal: "In 2011, Rousseff showed austerity in discretionary spending, but that is a relatively small part of total government spending," says Velloso. "Decisions of much greater impact, such as pension reform and long-term control of personnel spending, will reveal her true fiscal policy. Only at the end of 2012 will that become clear."