FISCAL POLICY
No more gimmicks

SPEND LESS THAN YOU COLLECT. This universal principle guarantees orderly accounting. In Brazil, however, since World War II, the rule has usually been disregarded. The results have been expansionist policies, disproportionate investment in state-owned businesses, and ever-growing public debt, checked only by very brief periods of fiscal austerity.

The changes that were set off by the crisis of 1998, whose icon is the Fiscal Responsibility Act of 2000, marked a new chapter in the spendthrift culture that had characterized Brazil until then. From this new fiscal framework followed an improved profile of debt issued with longer maturities and lower interest rates, and budget surplus targets that make fiscal adjustment part of the tripod of macroeconomic policy along with the floating exchange rate and inflation targets. "Thanks to the Fiscal Responsibility Law it was possible to establish a system of consistent primary budget surpluses," says Gabriel Leal de Barros, IBRE researcher in applied economics.



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But since 2009, when the government began to resort to accounting gimmicks to show budget surpluses, the 2000 fiscal framework has been eroding. "It was an expedient adopted in response to the international economic crisis in 2008, but since then these adjustments have continued," says de Barros. This year, low GDP growth and use of a series of tax incentives to stimulate the economy considerably reduced tax collections and the government turned again to creative accounting. De Barros explains that "From January to August, revenues grew only 1.8% in real terms, while public expenditure grew by 6.5% a year. The government will need extraordinary revenues to reach the budget surplus target of 3.1% of GDP." He warns that these accounting gimmicks make it very difficult to assess the impact of public sector demand on the economy.

And the medium-term outlook is not promising. For de Barros, there is no more space for tax exemptions, and the government should decide what its fiscal policy goal is: "Today, it has several: meet the primary budget surplus, pay interest on debt, support monetary policy to fight inflation, increase investment in infrastructure . . . these goals are incompatible with our current policy

of expansion of public spending and compulsory expenditures." That is not even considering the spending on large infrastructure projects related to the World Cup and Olympics, as well as the impact of tax exemptions on industrial policy. "The policy to cut electricity costs alone will increase public spending by R$4.5 billion for the coming year."

Given current conditions, the government will not be able to cut expenditures until 2015 when the current policy of keeping minimum wages above inflation expires. Since pension benefits are currently linked to the minimum wage, that policy automatically increases public spending. Ceasing to index pension benefits to the minimum wage valuation would open up a huge space to cut spending. The minimum wage is already at international levels, and social policies other than raising the minimum wage could address income inequality, such as enhancing the Family Grant program for poor families and investing in education and health.

Meanwhile, de Barros argues that the government must reevaluate its accounting practices and their consequences for the credibility of fiscal policy. "Having a transparent nominal budget target (including all expenses and interest payments) for the public sector is the next step. . . . Communication with markets needs to be clear, and this implies not promising that there will be budget surpluses no matter what the cost."

THE TAX WAR BETWEEN THE STATES

If on one hand the future of Brazilian public accounts depends on returning to the previous spirit of fiscal discipline, on the other the country also needs to eliminate a problem no less serious: the regional imbalances that have intensified the tax war between the states.

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Economist Fernando Rezende, professor, FGV Brazilian School of Public Administration, points out that the tax war originated because the federal government's policies to mitigate regional inequalities were ineffective. "At the time of the 1988 Constitution, states and municipalities demanded greater autonomy, which resulted in an increase in the State Participation Fund [FPE]," he says. The FPE receives a portion of the taxes on income and industrial products to make available to less developed states. However, the 1998 crisis and the need to ensure federal budget surpluses reduced the revenues available to the FPE, which diminished its importance

as a tool to promote economic balance between states. "The federal government has preserved the division of the pie that it had before 1988, with only some increase of municipal participation, and the conflict has worsened," he says. As poor states and municipalities depend more substantially on conditional transfers, their budget autonomy has been severely constrained. As a result, states have pursued a policy of attracting industrial activities by reducing VAT taxes, which has generated more conflict.

Although investors have identified the tax war as a factor in legal uncertainty, Rezende is optimistic about the possibility of change, particularly because many current legislators seem willing to discuss the matter. A special committee of the Senate has made suggestions for new rules for the FPE and ways to mitigate the tax war, including calculating the debt of the states and distribution of oil royalties. If successful, Rezende believes, the FPE reform could prepare the ground for the tax reform that is central to fiscal consolidation. This would be a huge step toward a more efficient tax system.

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