

BIG GOVERNMENT IN QUESTION

Liliana Lavoratti, from São Paulo

Brazil is helping lead the global recovery: dollars are pouring in, foreign direct investment has remained stable, and interest rates have declined. It is conservatively projected that, after a year of stagnation, GDP should grow by 5% in 2010 — better than many other economies. The most optimistic are betting on 7% growth and talking about a new "economic miracle."

But is the current positive scenario sustainable? The main concern is familiar: the size of the Brazilian government and its intervention in the economy. Consuming about 40% of GDP — tax revenues plus the nominal deficit — our government is much bigger than those of our international competitors and of many developed nations. Government grew to pay for much greater spending on civil servant salaries, income transfers, and administrative costs. But spending on infrastructure and human capital has plunged, pushing the total investment rate down.

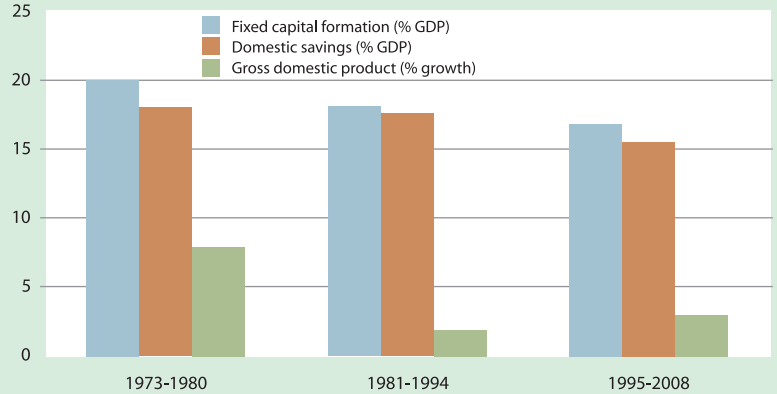
Resources

So there is an impasse: to sustain economic growth, the country needs to promote investment, say experts consulted by The Brazilian Economy. "To be able to grow by 5% a year, an investment-to-GDP ratio of 22% of GDP — against the current 17% — will be required," says Regis Bonelli, an economist at the Brazilian Economy Institute (IBRE) of the Fundação Getulio Vargas. Where would the necessary resources come from?

The private sector may very well seize the opportunities that available foreign resources open up. But in the public sector, investment of any size must be financed by the government's own resources (public savings) or through loans. "Public savings today represent only about 1.5% of GDP, an irrelevant figure," Bonelli says. To move forward, he argues, governments must cut primary current expenditure.

Economist Raul Velloso, an analyst in public finance, agrees: "If the ambition is to return to the rhythm of the 1960s and 1970s, when Brazil was the world's growth star ... the only way out is to increase the

Brazil: High domestic savings and investment were associated with higher GDP growth rates



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To compensate for its insignificant investment rate, Brazil needs vigorous technological progress and increased productivity, Raul Velloso says.

investment-to-GDP ratio." Between 1975 and 2003, the investment rate dropped from 26%of GDP to 16%; the 17% projected for 2009 is still far from ideal.

Standstill

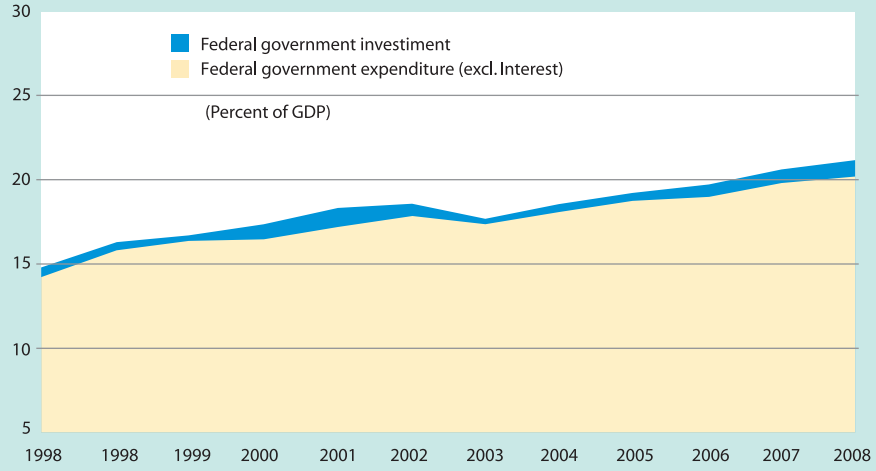
According to Velloso, to compensate for its low investment rate Brazil needs vigorous technological progress and increased productivity. Because investment and productivity go hand in hand, expanding capital stock will push up productivity. Thus one of the challenges awaiting the government elected in October 2010 is to sustainably increase investment for an extended period.

Former Finance and Planning Minister Antônio Delfim Netto says that the government cannot invest because it has allowed current expenditures to grab 40% of the nation's wealth to provide services of the worst quality. Correcting this type of distortion by cutting expenditures is not in our DNA, he thinks. The best situation would be for the economy to grow 6% a year, while the government grows 3%, so that within 10 to 20 years the government would again be a reasonable size. Then, he says, Brazil would no longer need tax revenues 10 times those of Sweden to provide services comparable to those offered in Ghana.

Social Security time-bomb

To control public expenditure, however, laws will be necessary that force civil servants to contribute more to

Brazil: Increasing public expenditure and meager public investment



Source: Central Bank of Brazil.

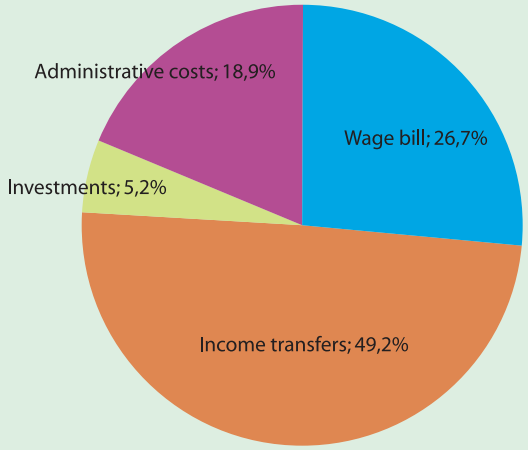
their own retirement. "Half the Social Security deficit is caused by the current civil servant pension system," says Delfim Netto. He believes the Social Security deficit "time-bomb" is the biggest obstacle to development. "Brazil will get old before it gets rich," he says. "By 2020 14% of the population will be over 65, twice today's number. There is no way this can be financed."

Bonelli points out another problem: the evolution of public investment. The government's average gross fixed capital formation (excluding state-controlled companies) declined from 4.5% of GDP in 1970 to 3%–3.5% in the early 1990s and to just 1.5% in 2003–05.

Meanwhile, since the early 1990s public expenditure has exploded, mainly due to the social benefits created by the 1988 Constitution. Velloso points out that primary spending by the federal government soared from 14% of GDP in 1997 to 18% last year. Salaries, social security benefits, bonuses and unemployment payments, subsidies and grants, other current expenditure, and investment together have quadrupled, from R$ 132 billion in 1997 to R$ 512 billion in 2008.

"We are confronted with a scandal of monumental proportions," Delfim Netto concludes. He points out that civil servant salaries are 100 times higher than salaries in the private sector, Executive branch pensions are 12 times higher and Legislative and Judicial branch salaries are 30 times higher.

Brazil: Composition of federal government expenditure



Source: Brazilian National Treasury.

Tax burden

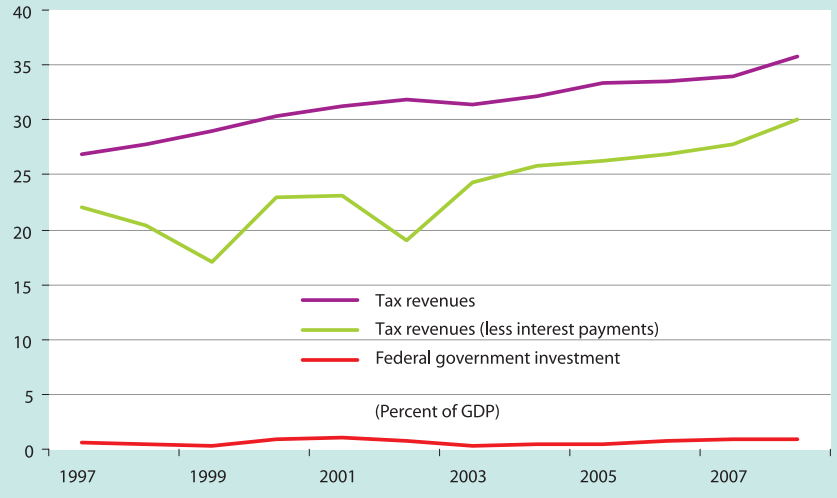
Naturally, taxes have shot up, from 27% of GDP in 1995 to 36% in 2008. This period coincided with the fiscal adjustment the Fernando Henrique Cardoso (FHC) administration introduced to offset external shocks and meet International Monetary Fund program targets. "Expenditures swelled to the point of forcing the contraction of fixed investment. Thus, reduced public investment was the negative consequence of the expansion of public expenditure combined with the need to generate a primary surplus in the government accounts," Bonelli explains.

Primary expenditure (excluding interest payments on public debt) increased by 3.7 percentage points of GDP from 1997 to 2008, while federal government investment increased by only half a percentage point, to 1% of GDP. Interest payments on public debt take up another 6% of GDP yearly.

Brakes to growth

"The starting point to untie that knot is contracting public expenditure," Bonelli says. "The current size of the government, with an expenditure composition that privileges current expenditure over investment, works like brakes applied to economic growth," he argues. Economist and IBRE researcher Samuel Pessôa agrees: "The tax burden imposed by the government inhibits productive activity." However, in his opinion, the government is correct when it claims there is no squandering of resources. "These policies should be

Brazil: Increasing tax burden and low public investment, 1995-2008



Source: Brazilian National Treasury

regarded as more or less adequate to fulfill medium- and long-term objectives. The major cause of the increase of the tax burden since the FHC administration is the expansion of income transfers."

Nor does Pessôa think the wage increases for the civil service are a waste: "The administration says that the impact of this increase will be absorbed in a few years' time; and civil service careers have been restructured to render the government more effective. This administration has credibility: it has cleaned house, reduced interest rates, and introduced adjustments to fiscal policy."

Whatever the merit of these policies, however, "GDP has grown between 10% and 15% less from 1994 to date because of the taxes and social contributions the economy must bear to finance the government," Pessôa said, based on a study he conducted with Bonelli and economist Armando Castellar Pinheiro. Brazil's tax burden should be about 24% of GDP to bring it in line with other emerging market countries with the same per capita income and at the same development stage.

The Constitution

Another problem relates to features intrinsic to the Brazilian federation. By forcing the federal government to assign half the tax revenues to the states and municipalities, the 1988 Constitution pushed the public sector to use social contributions to promote fiscal adjustment. Bonelli explains that "The astronomical level of expenditures that government leaders are forced to execute makes it difficult to introduce fiscal adjustment by cutting expenditure, so the solution is always the same: increase taxes."

Today, it is time, says Velloso, to start "reviewing the model of current expenditures, restructuring planning and execution procedures, and getting public-private partnerships [PPPs] and concessions up to full speed." The previous model of maximizing GDP growth has been replaced by a model to increase current expenditure, he says. Now, "it is essential to find room for public investment."

Politics

Private companies have adopted a different rationale from the government. They first assess whether the climate for expanding investment is favorable and then weigh obstacles imposed by the public sector. Government decisions are arbitrary and politically driven.

Despite privatization, the business community still feels that the government is too

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big, particularly considering state-controlled companies and deficient infrastructure in harbors, roads, airports, telecommunications, health, and education.

In recent years, the two critical influences on business decisions were the exchange rate and the interest rate. The international boom from 2003 to 2008 was the only period in Brazil's recent history when interest rates fell systematically — so investment increased. Risk also goes hand in hand with exchange and interest rates. During the boom all three variables fell simultaneously. The recovery of commodity prices mitigates the negative effects of the exchange rate for Brazilian industry and agriculture.

In Velloso's assessment: "Brazil will continue to be flooded with dollars because it is perceived as a country where consumers have a good financial situation, unlike the Americans, who are broke. The international reserves guarantee a certain degree of exchange rate stability." Thus, there is no reason to be concerned about the private sector. The problem is how to push up public investment, particularly in roads, harbors, and railways, which have been neglected for 30 years. Yet alternatives that could help fill this gap are not being contemplated: the administration has reduced its emphasis on PPPs and concessions.

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Raul Velloso

Minimum savings

Increasing domestic savings, as the Asians do, or using foreign savings have costs as well as benefits, Pessôa stresses. "It seems that Brazil has already made an option for low levels of savings," he says, so growth must depend on foreign savings. But to attract them, Brazil needs major institutional reforms, such as a predictable court system and respect for contracts, as well as sustaining its current sound economic policies.

However, this would make it harder to create large Brazilian companies funded by domestic capital. "You cannot be nationalist in this model. Furthermore, there will be less industrialization ... It appears that Brazil will specialize in export of primary goods. And there is no evidence that would be a bad thing," Pessôa stresses.

In Pessôa's opinion, until Finance Minister Antonio Palocci's administration, the policy was to keep the house in order so as to create the conditions to absorb foreign savings. That seems to have changed. "Proof of that is the decision to assign resources from the BNDES [the National Bank for Social and Economic

Development] to conduct industrial policy. This costs dearly," he says. "It is not a recommended industrial policy for a country that saves only 17% of GDP. "

Pessôa estimates that the annual fiscal costs of capital transfers by the administration to the BNDES (US$140 billion between 2008 and 2010) are about US$6 billion. Most of the capital has been transferred by issuing public bonds. The government pays the difference between the market interest rate paid and what it receives from the BNDES. Pessôa says, "If we had monumental savings like China and Japan, we might consider playing the game of promoting industrial policy. But we are far from that." He adds provocatively, "Why is lending US$6 billion to the private sector better than investing in education?"

Pessôa does not believe domestic savings will rise anytime soon. "The current political balance in Brazil generates the minimum level of internal savings. Society makes that option when it elects its lawmakers. Public policy approved in the National Congress always leads the population to save less," he points out. Recently, for instance, the Senate Constitutional and Justice Affairs Committee unanimously approved draft legislation that extinguishes the social security factor — one of the most important mechanisms in the reform the legislation introduced to delay pensions in the 1990s.

Social generosity

In a democracy, those who decide are the majority who elect legislators, who in turn let private salaries increase faster than productivity and guarantee a relatively generous social security system that reduces the savings of both companies and households. Pessôa says, "Most likely, the grandchildren of the current generations of Chinese will enjoy a better life than my own grandchildren. The Chinese have chosen to lead a harder life today and to leave a more promising future to their descendents. It is a question of choice."

According to Delfim Netto, one thing is certain: Development based on foreign savings never works. "It is useless to cite Australia as an example. ... It has 20 million inhabitants; we will reach 240 million shortly. We have to find jobs and pay decent salaries to 150 million people. We are a special case; our market is robust, our industry and agriculture are highly sophisticated, and they need a level playing field to continue competing," he stresses.

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Delfim Netto

Empowerment

Delfim Netto believes it is not so important to discuss whether the state is small or large, but rather what course it follows: "The Program for Growth Acceleration (PAC) and the acceleration of expenditures during the crisis are examples of empowering government. But it was not the acceleration of public expenditure alone that shortened the crisis. It was the conviction that President Lula managed to convey to the private sector that if the country did not consume, all jobs would be lost. And he succeeded."

Delfim Netto sees two other factors as having helped the recovery: the debt-to-GDP ratio declined to 38%, and foreign currency reserves increased to US$200 billion. Monetary policy, however slowly, worked in the right direction by lowering interest rates.

The market, with all its defects, is the most effective way to allocate an economy's resources. "The administration's role is to be the empowering government, to fire up the 'animal spirits' of the business community, and as far as possible to facilitate credit and create conditions for this mobilization to take place," Delfim Netto says, "because growth is simply innovation plus credit". He explains that "empowering governments, those where the government works to spur growth, such as the US — which has invested US$ 800 billion in research to replace fossil fuels with renewable energy sources — are successful."

There is really no issue of the minimum, maximum, or ideal government. What matters is a government capable of serving society. The former minister explains that in economic theory, there is one certainty: that the external current account deficit is equal to the difference between investment and internal savings. Therefore, he says, society has to choose between accelerated growth and more generous social policies. "The government does not need to invest where the private return rate stimulates private investment," Delfim Netto says. But "if savings are nonexistent, no government can mobilize them."