The great fiscal debate: Social programs versus the tax burden

IF FORECASTS FOR INFLATION and the economy were not particularly promising earlier this year, the first quarter has further clouded the outlook. Inflation refuses to yield despite fuel and other price controls. But inflation is not the only worry. The disorder in the electricity sector and the risks of rationing, the government's deteriorating fiscal situation, and the exhaustion of consumer-led growth make the economic outlook very difficult not only for this election year but for years to come.

Fiscal policy is the theme of this issue. Although gross public debt has held steady at 60% of GDP for the last 10 years, tough measures are necessary if Brazil is to keep public debt under control and still move to a sustainable growth path.

The main problem is this: The government spends a lot, and most of that spending is for social programs. So an effective fiscal adjustment will necessarily challenge entitlements that Brazilians see as indisputable rights. As Samuel Pessôa correctly points out, Brazil's 1988 constitution embodies the desire of Brazilian society to build a comprehensive welfare state of the type adopted by European countries. Ever since, that desire has been endorsed in every election and public opinion poll.

That desire also explains the rise in taxes over the last 20 years, and the resulting increase in the tax burden. Although a welfare state is a legitimate goal, society cannot indefinitely increase taxes without consequences for growth and productive investment. The tax burden stands at 36% of GDP, one of the highest among emerging countries. It has long been a drag on growth, to the point where it now raises a question of the viability of the commitment to a comprehensive welfare state.

Reconciling social spending and taxes is the great debate of fiscal adjustment. How much governments should spend on this or that—or whether to spend at all—depends on the collective choices of the people, which often are not consistent with the resources available. What policy makers need to do is find ways to give spenders an incentive to save. Setting global spending limits is one such incentive. Former Central Bank Governor Arminio Fraga has argued for a legal limit on public spending relative to GDP, so that government spending must always grow the same or less than nominal GDP. A formal spending limit would help reconcile social spending and taxes by forcing on spenders and vested interests awareness of the composition and quality of budget items, which would minimize inefficient across-the-board cuts in spending. Also, a limit would slow spending gradually, over an extended period of time, which arguably would help lessen opposition.

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Are global spending limits desirable? That depends. The greater the preference for equality, the more is spent on social programs and consequently the higher the tax burden and the less the economy grows. Ultimately, the legislature and the administration must come to terms with how much social spending is reasonable and to a common understanding on how much taxation is tolerable without choking growth. The future of Brazilian economic growth and the welfare of future generations depend on the outcome of the debate.