

Fiscal squeeze

Investors, analysts, and economists who are concerned about the direction of fiscal policy are becoming ever more skeptical about the direction of Brazil's economy. Though all is not yet lost, if the country is to grow sustainably, the government must make a difficult choice between social programs and the tax burden.

Kalinka Iaquinto

LOW GROWTH, HIGH INFLATION, the recent downward revision of Brazil's credit rating by Standard & Poor's (S&P), a crisis in the electric power sector, control of fuel prices and public transportation fares—threats to the economy are everywhere. The only way out of the current predicament seems to be a robust and transparent fiscal adjustment. However, that can only be done by reducing social expenditure, which is politically contentious.

Analysts of a variety of persuasions agree that current fiscal policy is not working well, if at all. For 2014, the market expects that inflation will be close to 6.1%, up from 5.9% in 2013, and gross domestic product (GDP) will grow only 2%, compared to 2.3% in 2013. An external current account deficit of 3.5% of GDP and the primary surplus target of 1.9% will not do much for Brazil's solvency for the long term. Yet year after year the federal government has increased its spending.

CREATIVE PUBLIC ACCOUNTING

Last year the government managed to achieve a fiscal primary surplus of 1.9% of GDP, but not without criticism: It was accused of using "creative" accounting, such as extraordinary and nonrecurring revenues to meet the primary surplus target, mainly dividends paid through early redemption of government bonds held by state-owned enterprises, proceeds from concessions, and recovery of tax arrears.

Although Secretary of the Treasury Arno Augustin insists that Brazil follows International Monetary Fund standards for government accounting, Renato Fragelli, professor, Brazilian School of Economics and Finance of the Getulio Vargas Foundation (EPGE), says the market is not convinced, which is one reason the government must now pay higher interest on its borrowing. "When there is mutual trust between the government and the market," he explains, "it costs less to roll over the public debt." He points out that the real interest rate on national Treasury notes has almost doubled just since 2012 and considers the government's creative accounting to be partly responsible.

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Meanwhile, gross public debt has grown from 56.4% in 2006 to 57.2% last year. Gabriel Leal de Barros, Brazilian Institute of Economics (IBRE) researcher, thinks the large rollover of public debt this year will put heavy pressure on the federal budget: about a fourth of Brazil's public debt, some R$494 billion, matures in 2014. That will force the government to issue new bonds at higher interest rates, which, Barros points out, will heighten the budget deficit.

SHRINKING THE GOVERNMENT

"The mistrust of domestic and foreign markets has to do with two things: creative accounting and reduction of the fiscal primary surplus, and expansion of subsidized loans by the National Development (BNDES)," says economic consultant Raul Velloso. In three years BNDES has quadrupled its loan portfolio from 2% of GDP to about 8%, which "had a large impact on gross public debt."

Many urge reducing the BNDES share in financing the economy, and the government has announced that it will no longer subsidize such state-owned banks. That can help curb the growth of public debt, as BNDES loan interest rates were far below those the Treasury has been paying to get the money for the subsidies. "The interest rate differential and the large amount of resources [transferred to the BNDES] increase the cost of carrying out this policy. Ending it will reduce gross public debt fast," says IBRE's Barros.

IBRE consultant Nelson Barbosa adds, "The financial cost [of Treasury transfers to state-owned banks] is 0.7% of GDP. This cost is now expected to stabilize and fall. But the transition will take more than a decade."

Tax exemptions and benefits granted to various industries in recent years have cost Brazil over R$80 billion in lost revenues. Samuel Pessôa, also an IBRE consultant, believes the tax exemption policy was particularly clumsy; it generated a large loss of revenue without any cuts in public

spending being made. He explains that the failure of the policy was due to a misdiagnosis of the economic slowdown: "The premise was that the slowdown was cyclical. What we have learned over the years is that it was the result of a structural reduction of potential growth." He adds that rather than stimulating growth the misdiagnosis "only makes the situation worse because the fiscal stance deteriorates, increasing the country risk with little impact on growth."

FINE LINE

Is there a risk that Brazil will become insolvent because of its public debt? The answer is no. "We will always have government debt maturing. I do not see any risk. If there is any difficulty in rolling over debt, the Treasury will raise interest rates on public bonds," says IBRE's José Roberto Afonso. However, he is convinced that the maturing of so much public debt heightens the urgency for more attention to fiscal policy. Felipe Salto, an economist at Economic Trends Consulting, agrees about the lack of risk. Although in recent years the Brazilian economy has not grown vigorously, gross public debt has held steady, so that "even with the fiscal expansion, the risk of public debt insolvency is very low."

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Nelson Barbosa

But the consensus is that the government needs to show how it expects to hit its fiscal primary surplus target of 1.9% of GDP. In February, the government announced a budget cut of R$44 billion. "The announcement helps a little," Velloso says, "but if not achieved it will destroy the country's credibility." Although the market in general seemed indifferent to the announcement, it did not prevent S&P from reducing Brazil's credit rating from BBB to BBB-. "Everyone knows that cutting public expenditure, in most cases, is cutting wind," Velloso says. "The big question is whether the government will be able, as in previous years, to raise enough revenues to pay for its spending."

HIGH EXPECTATIONS

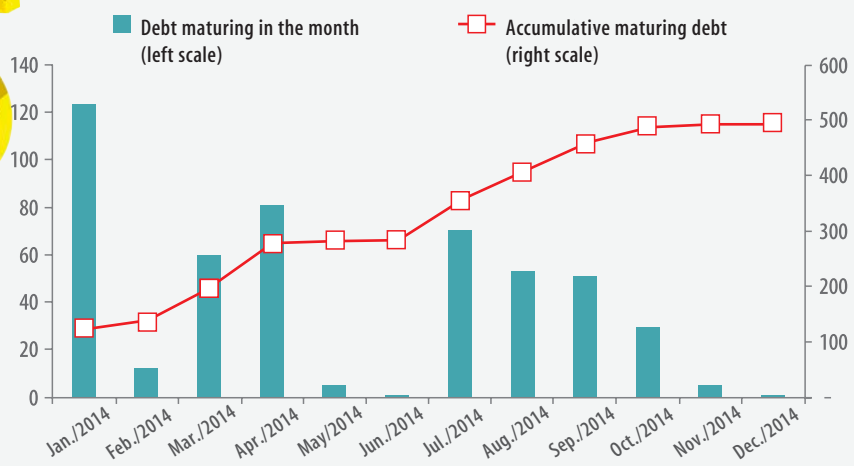
Most analysts agree that without changes in fiscal policy, the country will not achieve sustainable growth. Because of presidential elections this year, the market and analysts expect no major fiscal adjustment for Brazil until 2015. But what kind of adjustment should there be eventually? It is no longer possible to ignore the fact that the government spends a lot, and that most of the spending is social. This means that a fiscal adjustment will necessarily have to change entitlements that Brazilians see as indisputable rights, such as the minimum wage, social security, salary bonuses, and unemployment insurance. Will Brazilians accept changes to social spending?

Last year, a CNI/Ibope survey found that 91% of respondents consider the tax burden, at about 36% of GDP, to be very high. This seems to suggest there is no political space to raise taxes. At the same time, fiscal experts see no way to get more revenues to provide the social spending required by the constitution.



A significant share of Brazil's domestic debt will mature in 2014 and will need to be rolled over.

(Billions of reais)



Source: Public Debt Monthly Report, Central Bank of Brazil.

A CNI/Ibope survey this year has found that 58% of respondents consider health care to be Brazil's main problem, followed by combating violence and crime (31%) and improving education (28%). "Voters are in favor of higher spending in those areas, but when questioned about where the money comes from, they say from the fight against corruption. People think the government can greatly increase social spending without increasing taxes. That is not possible," says Mansueto Almeida, a specialist in public sector accounts.

IBRE's Pessôa agrees. He believes that even if the problems of corruption and mismanagement are successfully resolved, they will not generate enough resources to anchor fiscal and social policies in the medium and long term. "Social spending is supported by society and it explains the bulk of the tax increases in the last 20 years. Spending related to social programs is a consequence of the rules that were created. … All this legislation was passed by Congress, which was elected by the people," he notes.

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The current government follows the same social spending course as those of Presidents Fernando Henrique Cardoso and Lula. "What weighs heavily on the growth of public spending is income transfer programs," Almeida says. He explains that the economy is growing much more slowly today than under

Brazil's gross public debt is high compared to most other emerging countries.

(% of GDP)

	2009	2012	Change in percentage points
Emerging economies	**36.0**	**36.5**	**+0.5**
Ásia	**31.4**	**34.5**	**+2.9**
China	17.7	26.1	**+8.4**
India	72.5	66.7	**-5.8**
Europe	**29.5**	**25.9**	**-3.6**
Russia	11.0	12.5	**+2.5**
Turkey	46.1	36.2	**-10.1**
Latin America	**53.5**	**52.0**	**-1.5**
Brazil	57.4	58.7	**+1.3**
Mexico	43.9	43.5	**-0.4**

Sources: Central Bank of Brazil, and International Monetary Fund.

previous administrations. "We had an economy that was growing at the rate of 4% per year. So spending rose, but was partly offset by the growth of the economy. Now government spending continues to grow as much as before, but the economy is only growing at half the speed."

The policy that defines the rules for the minimum wage will be discussed next year and most experts argue for a new rule that takes into account labor productivity. In recent years, the minimum wage increased by 70% more than inflation. "The minimum wage law is exhausted," Pessôa says. "It cannot grow above inflation indefinitely. Instead of the minimum wage being indexed to inflation in the previous year and GDP growth in the previous two years, it should be fixed on the previous year's inflation and growth in GDP per capita of the previous two years." Treasury Secretary Augustin argues instead that "The policy has worked. Many people said it was not possible to have unemployment falling and a policy of

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raising the minimum wage. We have more than proven that it is possible."

One of the problems is that when the minimum wage goes up, it becomes the basis for increases in a number of social and welfare benefits like pensions. "Social security outlays account for about 11% of GDP and 60% of government spending. If we do nothing, social security outlays as a percentage of GDP will double by 2040," Velloso notes.

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Mansueto Almeida

But changes in social security are always difficult. Experts think many other points should also be evaluated—the retirement age, for example. "In a country whose tax burden is 36% of GDP, it is unacceptable that one-third of taxes are used to pay pensions," says EPGE's Fragelli.

The government has also presented a proposal to change how salary bonuses and unemployment benefits are calculated, but in an election year it will be very hard to get congress to vote on such matters. Salary bonuses, says IBRE's Barbosa, have soared, and "this is a program that can and should be

Central government social expenditures have increased substantially over the years.

(% of GDP)

Year	Personnel	Social Security	Subsidies	Administrative costs	Goods and services	Social programs	Investment	Total
1999	4.47	5.50	0.24	1.43	1.75	0.59	0.50	14.49
2000	4.57	5.58	0.31	1.27	1.76	0.59	0.66	14.73
2001	4.80	5.78	0.35	0.73	1.82	0.90	1.17	15.57
2002	4.81	5.96	0.16	1.05	1.83	0.96	0.95	15.72
2003	4.46	6.30	0.36	0.91	1.71	1.00	0.40	15.14
2004	4.31	6.48	0.29	0.98	1.71	1.21	0.62	15.59
2005	4.30	6.80	0.48	1.10	1.78	1.29	0.64	16.38
2006	4.45	6.99	0.40	1.14	1.70	1.56	0.72	16.96
2007	4.37	6.96	0.38	1.18	1.78	1.63	0.82	17.12
2008	4.31	6.58	0.20	1.01	1.75	1.64	0.93	16.42
2009	4.68	6.94	0.16	1.05	1.89	1.89	1.05	17.66
2010	4.42	6.76	0.25	1.06	1.96	1.84	1.15	17.43
2011	4.34	6.81	0.44	0.88	2.04	1.93	1.09	17.52
2012	4.24	7.21	0.55	0.86	2.22	2.15	1.10	18.32
2013	4.22	7.43	0.86	0.99	2.24	2.27	1.02	19.02
1999-2013	**-0.26**	**1.93**	**0.61**	**-0.44**	**0.49**	**1.68**	**0.52**	**4.53**

Source: Ministry of Finance of Brazil.

reformed so that other social spending can grow without pushing the tax burden up." But he warns, "This will involve a discussion with the unions, and they will demand something in return."

To escape the current low growth and income distribution model, EPGE's Fragelli calls for the country to increase its domestic savings, currently about 16% of GDP. How to generate more savings? He believes pension reform is the key: it will relieve the state from costly obligations, and require the private sector to save more because people will retire later. He noted that increasing savings takes at least 10 years. "If the country decides, democratically, to have low savings because people want to retire earlier, one implication is that Brazil will not have industry. Which sectors of the Brazilian economy will support the high tax burden to pay for all social benefits?" he asks, and concludes, "Only those in which the country has stupendous comparative advantages, such as commodities, will survive."

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