Photo: Cristiano Costa



The elusive reforms

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THE INTENSE EXPECTATIONS that await re-elected President Rousseff's announcement of her economic team stem from the desire of markets to know how the president plans to put the country on a path to sustainable growth. Former Secretary of Economic Affairs of the Ministry of Planning Raul Velloso has been skeptical about the president's initial statements, which were replete with ambiguous words like 'change' and 'dialogue.' A close observer of the government, Velloso—an economic consultant since he left his government post in 1991—is particularly concerned about Brazil's fiscal situation. Here he analyzes how Rousseff's first administration managed the economy, emphasizes the need for a credible estimate of the federal fiscal situation, and advocates changing fiscal policy from stimulating consumption to promoting fixed investment. "Everything indicates that the government thinks it can push the situation to its limit. But if the opposition is arming to fight its proposals, we will have daily clashes as in the election campaign," he said.

***The Brazilian Economy*—With the economy still stagnant, what do you think the second Rousseff administration priorities should be to restore the confidence business lost in 2014?**

Raul Velloso—A serious problem is the looming fiscal crisis, which was asleep waiting for the election outcome. Now the crisis must be confronted. First, we need a credible estimate of the government's fiscal situation. It is difficult to suggest things unless we believe that a change in policy is possible—something that I personally do not believe. If we look at what has happened with revenue and expenditure recently, we

see that the fiscal situation has deteriorated, and now the crisis is imminent. … The Lula administration was in a very comfortable fiscal situation, because from 2004 to 2008 both revenue and expenditure grew at the same high rates, which preserved the fiscal surplus inherited from the Cardoso administration and reduced the debt-to-GDP ratio. After 2009 revenues fell but spending kept growing at 9%. The Lula administration decided to continue the fiscal stimulus and let public spending grow, arguing that restraining it would accentuate the recession.

Could we have phased out the fiscal stimulus?

At that moment, perhaps the government should have explained what it would do. One alternative was for it to hold down expenditure and wait for revenues to recover after economic growth resumed. … The government ignored the issue and kept public spending growing. As a result, the budget surplus fell and markets began to get restless, but the government instead initiated a program of tax cuts that has been reducing revenues ever since. Eventually, public spending declined, but not because the government took concrete measures to control expenses. In the 12 months through August, public spending growth slowed to 7% because part of the spending is pegged to the minimum wage, and adjustments to it have slowed with GDP growth. Meanwhile, revenues, excluding extraordinary revenues, grew by only 1%. … I think President Rousseff first has to say what she will do to turn this situation around, [so we can see] whether the government will be able to change current economic policy.

How would you describe current economic policy?

Current policy is mainly based on three pillars. First is expanding consumption at any cost, especially more public spending on transfers and expansion of credit. Second is protecting industry to compensate for losses from wages rising above productivity and competition from imported goods. Last is tariff populism: the government wants the private sector to invest in infrastructure, despite low returns, and to charge the lowest imaginable tariffs.

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After the election, the president said she had been re-elected to make big changes and would seek to advance fiscal responsibility. Would that be a positive sign?

I do not see it that way. The fiscal irresponsibility that has been around for some years is the result of the current policy and the lack of GDP growth. Everything indicates that the government thinks it can push the situation to its limit. But … we will likely have a daily clash as in the election campaign: When the president suggests a change, the opposition will raise questions. Today we already see markets going wild. Soon the turmoil may reach inflation, interest rates, further economic slowdown, further worsening of the fiscal situation, and downgrading by international rating agencies. There are great expectations for policy changes. If there are none, the government will be bombarded.

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Does the recovery of investment depend on these changes?

In general, entrepreneurs wonder whether the current policy is sustainable, whether consumption growth is sustainable. Today the consensus is that it is not. This is already a barrier to higher investment. …

Moreover, the natural tendency of a policy to promote consumption is to make service prices rise relative to industrial prices, which attracts investments in services at the expense of the industrial sector. … In recent years service prices grew by 9% and industry prices by 2–3%. No wonder industry is shrinking. That's why the Rousseff administration began granting tax exemptions and other measures to support industry. Actually, the government is taking resources from the economy to give to industry, even though it is shrinking. … The government does not see that its goals are in conflict. It cannot at the same time achieve low tariffs and large-scale private investment. That just won't happen.

Some people argue that the Brazilian social contract endorsed in the 1988 Constitution promotes transfers to low-income households, reducing savings to finance investment and promote growth. Do you agree?

I have a different view: It's easy to say a social contract was made, but it has never actually been spelled out and approved by actors who are well informed about its implications. This policy, what they call the social contract and I call a public spending growth policy, was not well understood by anyone. A policy of public spending growth leads to economic stagnation and large tax increases. No one who was involved in the Constitutional Reform of 1988—and I was involved in it intensely—was able to evaluate at the time how it would affect economic growth and the tax burden. I do not know if the people who voted for the Constitution Reform would have done so if they knew the consequences. I have done a study with colleagues showing that public spending on pensions, social assistance, and personnel now accounts for 73% of total public expenditure—nearly the entire budget—and almost nobody realizes that. If we do not reform, our projections indicate that public spending will double by 2040 as a percentage of GDP. That would require an unimaginable tax hike.

But if public spending is determined by the Constitution, any president would have little room to cut spending without effective constitutional reform?

It is complicated because you have to create a political environment to make it possible to discuss these issues, show [what will happen] to society, and create the conditions to do the reforms. I do not know if a government that has just been re-elected with a small margin of votes would be able to do something. … Given the situation, the only way for the country to grow is to attract foreign savings. We have many dilemmas, and maybe that's the biggest. But we

cannot regard the social contract as immutable. … I believe we should approach the problem as follows: a constitutional change was made that seemed good at the time, it certainly had positive effects, but no one had carefully estimated the consequences and therefore we need to reopen the discussion.

What changes should be made to reduce the tax burden?

Currently the only thing that government officials are discussing in private is how to raise taxes to continue increasing public spending. The environment has become very unfavorable for the discussion of tax reform, because the government is pressing in the opposite direction. Workers' Party leaders often blame the opposition for blocking higher social spending … . In reality, recent governments like to address the fiscal problems by creating new taxes, which conflicts with the idea of tax reform. … When we discuss tax reform, changes are always subject to finding a way not to lose revenue, and then it is difficult to carry out reform.

The Brazilian social security system is criticized because of its high fiscal cost for a still young country. What changes should be done?

President Fernando Henrique Cardoso's reform was an attempt to get closer to the ideal social security system in which benefits are paid for with contributions. After that, social security reform virtually stopped. Today, we see instead a counter-reformation. In a recent study we found that implementing various reform proposals would prevent social security spending from growing by 2040. Instead of doubling as a percentage of GDP, it would remain constant. We have reform proposals. Only political will is lacking. If we start reforming [social security] now, we will not see the results until after 2040 because it takes time. … Another benefit introduced in the Constitution is the special pensions, whose approval was not vetoed. … The Courts are granting these pensions even though they are not yet regulated. All this increases public spending.

"The government wants the private sector to invest in infrastructure, despite low returns, and to charge the lowest imaginable tariffs."

Do you think Brazil can grow without abandoning social inclusion?

I think so, because important factors for social inclusion, however trivial it may be, are economic stability and economic growth. Without them, you end up generating an economic crisis that will eventually reduce the incomes of the poor. Today, the country is growing between zero and 1%. Inflation is already above the target ceiling. If we continue like this, all social inclusion achievements will eventually be lost—especially because the transfers are not necessarily going to the poorest. This is a discussion that is also absent from the debate. We only speak of the Family Grant program, but it is small compared to what I have called the big payroll. For example, to what extent do increases in the minimum wage help the poor? There are studies that indicate they do not.