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The roots of Brazil's fiscal problems

Fernando Rezende

Professor in the Brazilian School of Public and Business Administration of Getulio Vargas Foundation

Solange Monteiro, Claudio Conceição, and Vilma da Conceição Pinto

THE WORSENING OF BRAZIL'S FISCAL SITUATION in 2015, which contributed to the deterioration in the perception of Brazil risk and the loss of its international investment grade rating last December, cannot be mitigated with short-term emergency measures alone because it is the result of a structural problem, says Fernando Rezende, an expert in fiscal and tax issues, professor at the Brazilian School of Public and Business Administration (Ebape) of the Getulio Vargas Foundation, and former head of the Institute for Applied Economic Research (IPEA). Rezende points out that the lack of meaningful discussions on tax, budget, and federal issues led to adoption of expedients that have only worsened Brazil's fiscal problems. He traces the history of Brazil's fiscal policy since the 1988 Constitution and speaks to areas he considers critical to the restoration of sound public finances: "We need to discuss budget reform … to discuss not a new public budget law but rather the government role, because the budget can no longer accommodate the government's responsibilities."

How would you assess the fiscal debate in 2015?

It has been very limited, focused on whether the primary surplus target will be met. In a recent paper I sought to draw attention to the need to discuss not only fiscal savings, but also public spending policy and the public choices that weigh on the public budget. In Brazil we have created an Orwellian Newspeak budget: Expenditures are classified as mandatory or discretionary. That classification is not found in any public finance text. Mandatory spending has become

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synonymous with priority and discretionary with irrelevant. This should not be. We have an institutional crisis because here the main fiscal institution of any government, the budget, has not been relevant for many years.

And that can only get worse, because spending choices have never been discussed in Brazil. They have accumulated in an almost archaeological process layer upon layer. … The Eloi Chaves Act creating the pension scheme in 1923, the unification of pension institutes in the 1960s, and more recently earmarked spending for education and health—all these were done without discussing how the public budget would accommodate all these choices…. At every crisis, the situation becomes more unmanageable. Again and again, we have had difficulty in having a meaningful discussion of the problem, which has led to a series of expedients. Over at least 20 years, the government has become addicted to one-time extraordinary revenues. … It's a tough habit to quit. It is as if Brazil were behaving like the heir of a wealthy family, selling assets until the crisis is over.

Did the 1988 Constitution aggravate the public finance problem?

It was an important milestone because it substantially expanded the government's responsibilities. It created a series of new entitlements. The expansion of social entitlements was certainly important at that time. But in 1988 we did not discuss how the new responsibilities would be divided between federal, state, and municipal governments. The discussion dealt only with federal and state revenue sharing, not the sharing of responsibilities. Of course this has had consequences … It is no coincidence that although we spend good money on education, its quality and management are still poor.

There is another important issue. Article 6 of the Constitution lists a number of social entitlements, not just social security and health but also transportation, housing, security, and leisure. It created a special scheme and financial guarantees for social security spending, expanding services to workers in the formal labor market. The idea is good: Universal access to these services. But over time it has crowded out other important social entitlements. It is no coincidence that poor public sanitation is threatening the urban population with diseases that had been extinguished, and new ones are emerging.

Perhaps we have not thought about the impact of population expansion on social security benefits and other policies....

Correct. Not only have we not thought about population size, we have not thought about the concentration of the population in large cities, micro-regions, with no planning. … The private sector built low-income housing for the federal government program My House, My Life on the outskirts of cities where land is cheaper. But then the state and the munici-

pality cannot afford to bring water, sanitation, and transport to the new developments.

To compensate, the federal government began to encourage states and municipalities to borrow from the National Development Bank (BNDES) and other state-owned banks to finance urban and social investments. This stimulus to indebtedness was accompanied by a centralization of power. The ministries that were created to handle cities, tourism, integration, and sports today make "covenants" with states and municipalities, which are another way to transfer resources to them to finance activities that have no secured funds, in addition to the transfers earmarked for health and education. The federal government has been setting standards, regulating the actions of states and municipalities to the point that nowadays you have the antithesis of a federation. Top-down rules define how much and on what programs states and municipalities should invest. In 2005, I attended a conference in India where the motto was Unity in Diversity. In Brazil, we create uniformity in diversity. It is an inefficient policy because, among other things, the public managers in charge of providing services to the community do not know their cash flow. They know they will eventually have a budgetary credit, but not how much or when it will come.

This is one side of the issue: The federal government has encouraged states to contract debt. But there is another side, which is the pile-up of expenses—in budget jargon "outstanding commitments." Outstanding commitments were created in the 1964 budget law to manage expenses for which resources cannot be released in the same fiscal year—for example, a December electric bill payable in January. In recent years

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outstanding commitments have expanded till they total just over R$200 billion, roughly twice as much as total discretionary spending.

Has the recession aggravated the fiscal situation?

Today we are pushing the problem down the road in the expectation that when the economy recovers it will solve the fiscal problem. This is a misconception. At best, if the economy recovers, it will alleviate the fiscal problem; it will not solve it. We need urgently to address budget reform … to discuss not a new public budget law but the government role, because the public budget can no longer accommodate the government's responsibilities. Pension reform alone will not eliminate the fiscal problem. We have to discuss public services, which in turn has to do with the budget.

Take health services. According to the Constitution, health services should receive 30% of social security revenues. Today, however, health gets no more than 10%. … Health is seeking other sources of financing. This issue has never been the subject of

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political debate. One point I am trying to emphasize when discussing the government role is that social entitlements are large, but access to them is not universal. It is unequal.

Does this involve the question of the federal pact?

Yes. Talking to representatives of states, I try to show that the option of keeping interstate conflict centered on a dispute over ICMS [the state value-added tax on sales and services] is a mistake. ICMS has no future. It is declining for a very simple reason: its main tax base is eroding. Communications technology is undermining taxation of telecommunications. Fossil fuels are facing environmental pressure. The industry share in GDP has fallen to less than 10%. The tax base in consumption and imports is declining, so state tax revenues are also declining.

In 1988, when the issue of decentralization of power was dominant in the Constituent Assembly, the discussion was limited to how to distribute the revenues. … But over time, social security spending has overrun the federation. The first milestone of this was the crisis of 1998. Ten years after the 1988 Constitution, Brazil was broke, and suddenly the government had to produce a fiscal primary surplus of 3% of GDP. How did we raise the fiscal primary surplus? We did it by increasing contributions from companies and businesses. Each time we do this type of thing, we simply postpone resolution of the fiscal problem, which is fundamentally structural.

Would a multiyear budget change the budget debate?

Before discussing the instrument, we have to start discussing the roots of the fiscal problem: How choices were made, how they crowded the budget. If we want to increase funding for health, we have to contain the expansion of pension spending; if we want to expand cash transfer programs for poorer families, this will be at odds with spending on health and social security; if we want to address serious urban problems, we have to make room in the budget, not just expand debt.

Everyone thinks that the discussion is already broad. But I have been saying the opposite: the problems today are so large and so complex that the only way to conduct a political debate is to put all these issues on the table. To get budget space to accommodate everyone's wishes, the issues have to be exposed. What has been taking place in Europe since the 2008 crisis is a profound political discussion on public spending, based on expenditure review and analysis of each government program: the outcomes, the problems, who benefits. This is the way [to address structural fiscal problems]. I do not see any possibility of resolving [the fiscal problem] by just putting forward technical proposals.

Today, in addition to budget expenditures, we have expenses we cannot actually see,

such as subsidized credit and tax exemptions, deductions, and credits to particular groups or activities.

Behind any expense or law that grants advantages there is always an interest group. And those interests over the years have become very well organized politically. We need to show those who do not benefit from government generosity how to organize themselves to meet their interests. This will not be easy. It is up to us, who know the numbers, to show the way. … Representatives of the private sector see that they have no hope for decent tax reform. So if they cannot improve the quality of the tax system, they reason that it is better to reduce their tax obligations.

What is your assessment of the initiative to reform the monthly federal taxes on gross company revenue? Are those taxes consistent with Brazilian reality, where 70% of GDP is generated by the services sector?

I think not. The new digital economy is not physical; it is based on things to which it is difficult to assign a value. … It is different from the time when production of a good was primarily based on physical transactions. We need to discuss the 21st century tax system. VAT, for example, is the worst case because services are not taxed. The PIS and Cofins also present difficult problems of administration. It is no accident that the service sector is against this debate.

You have argued for a ceiling on gross federal debt. Do you think that could change the perception of risk?

I would say it is a positive step. But again we are not directing our attention to the origins and roots of the fiscal crisis. We are trying to apply emergency measures to a situation that

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is not an emergency. The economy's downturn has exposed the problem, it did not cause it. What worries me in the current debate is that we are still selling an illusion that the current difficulties are momentary. That if we make a correction now, in 2017 the economy will be growing again and we can forget.

Can you identify measures to cope with the fiscal crisis more broadly, as you propose?

The fiscal crisis is an institutional crisis. And now it hits an institution established in 2000 to ensure the stability of public finances and macroeconomic equilibrium: the Fiscal Responsibility Law. The decisions that have violated the Fiscal Responsibility Law manifest a lack of commitment to discuss the fiscal problem. I do not see a way out.

The government has accumulated commitments, chosen to sell assets to gain extra revenues, and increased its debt, but all these were not enough to prevent the fiscal situation from worsening. Now we have the "visit of the old lady," the CPMF (tax on financial transactions). I do not like the idea. But if it has

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to come, it should be combined necessarily with a review of public spending priorities.

Could we make some changes and move in the right direction? The key is to focus on the origin of the tax, budget, and federal problems that have accumulated: the decision taken in the 1988 Constitution to establish what I call tax duality. Taxes and contributions are regulated in separate chapters of the constitution. Article 195 instituted social contributions on wages, revenues, and profits. In the economic crisis of the late 1990s, to avoid the collapse of the Real Plan it was necessary to adopt a fiscal adjustment program that was based on generating larger primary surpluses of 3% of GDP. Higher social contributions and creation of the Emergency Social Fund was the solution found at that time to raise government revenues. Then the continuing growth of public spending demanded successive extensions of this instrument to meet fiscal targets. The addiction to social contributions no longer brings any relief. To quit the habit, we must address the origin of the fiscal problems and … unleash a process of change.

The key is to address the tax duality that has caused an extreme rigidity in budget spending, deterioration of the tax system, and growing imbalances in the federation. That means reviewing Article 195 to eliminate the artificial distinction between taxes and contributions. We must acknowledge the fact that contributions on wages are the sole funding source for social security—they have long ceased to finance other social programs—and incorporate all other contributions into the tax chapter of the Constitution. The main advantage of this change is that it will prompt a debate in society on how to finance the social security deficit. Once a decision is made on how much of total revenues will be directed to cover that deficit, the budget discussions will shift to prioritizing spending, which will contribute to the political debate on measures to balance the budget to address social priorities.

What would be the result?

Addressing the tax duality would create an opportunity to tackle the accumulation of outstanding commitments and the use of extraordinary revenues. In the case of outstanding commitments we should focus on reducing those for health and education. … You may have committed expenses from five years ago that were not made and may have become unnecessary. But these expenses cannot be canceled.

A step toward fiscal consolidation would be to introduce a rule that extraordinary revenues should only fund capital, investment, and extraordinary expenses, if any. They should not fund current spending—every time they do, we delay solving the fiscal problem.

Summing up, the three proposals are complementary: first, balance the allocation of revenues by spending priorities; second, search for greater efficiency and effectiveness of resources for priority areas; and third, limit the use of extraordinary revenues.