Structural challenge

Brazil's acute fiscal crisis call for changes to make public spending predictable, transparent, and sustainable in the long run.



Solange Monteiro

WITH THE POLITICAL DEADLOCK exacerbated by proceedings to impeach the president, Brazil needs urgently to find a way to halt the fiscal deterioration: public debt is unsustainable because of large central government deficits, states have severe cash flow problems, state-owned companies are also deeply indebted, and state-owned banks are highly exposed to risk. And there is no end in sight to the economic downturn.

Many of the problems were identified long ago, but the policies adopted have not resolved them. The result is one of the most serious fiscal crises in Brazilian history.

In 2013 in a joint seminar cosponsored by the International Monetary Fund (IMF) and the Getulio Vargas Foundation (FGV),

concerns were raised about the proliferation of accounting gimmicks the government was using on the public accounts to artificially meet its fiscal targets. Three years later, at a follow-up seminar in April, it was clear not much has changed. "There is no doubt that to resume growth, the country will have to reverse this fiscal situation; the indicators suggest that the growth crisis will be severe," said Teresa Ter-Minassian, former IMF department director and current consultant. In its latest *World Economic Outlook*, the IMF estimates that in 2021 Brazil's per capita GDP will be lower than in 2011, making this a new lost decade.

Beyond accounting gimmicks and fiscal easing, there is another long overlooked factor: "It is no secret that some of Brazil's ailments today comes from a long tradition of fiscal policy that is inconsistent with reality," Carlos Ivan Simonsen Leal, president of FGV, commented. Leal attributed this to an immature budget process that overestimates revenues and inflates expenses. Since 1988, he said, there have been

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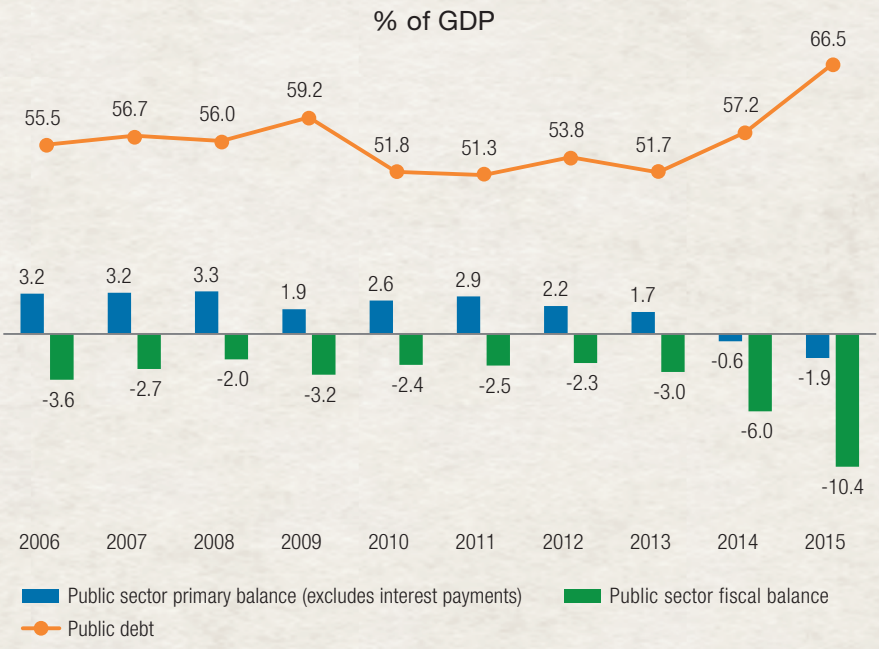
Brazil's fiscal deficit and public debt have increased sharply since 2013.



Source: Central Bank of Brazil.

"It is no secret that some of Brazil's ailments today comes from a long tradition of fiscal policy that is inconsistent with reality."

Carlos Ivan Simonsen Leal

just two improvements in public financial management: spending caps and the Fiscal Responsibility Law.

With the fiscal balance focused on the short term, there is little room to invest in infrastructure, innovation, and other factors to make the Brazilian economy more competitive. The result is less growth, which then reduces tax revenues. Jorge Arbache, chief economic advisor to the Ministry of Planning, pointed out the high volatility of Brazilian economic growth, second only to sub-Saharan Africa, adding that "Tax collections tend to deteriorate more in bad years than improve during the good years," which explains Brazil's "permanent situation of fiscal risks.," he says.

Given Brazil's serious structural fiscal problems and the severe recession, Manoel Pires, Ministry of Finance secretary of economic policy, argued for changing the policy focus from one-off fiscal adjustment to broader reforms "that would mitigate recessionary effects and steer the country to a more sustainable path." Mario Falcão Pessoa, division chief in the IMF Fiscal Affairs Department, said that policies to ensure fiscal discipline have become a public good in the world—"something nonpartisan which must be observed by all governments, but heightens the challenge of building political consensus for permanent public policy."

However, Brazil's rigid budgeted spending is preventing immediate fiscal adjustment—usually cuts are limited to investments—and leads to higher public spending. As the country's population ages, mandatory social spending goes up accordingly. From 1991 to 2015, social spending accounted for 75% of the growth in primary expenditure of the central government and this year accounts for 80%. With growth in GDP per capita modest, low productivity, and rapid growth of the elderly-to-active worker ratio, health expenditures, pension and welfare benefits will increase. "Much of this imbalance has to do with the rules of public spending, which we criticize but end up supporting, and every day the fiscal situation gets worse," said consultant Mansueto Almeida. "For example, according to current legislation, the central government needs to spend 13% of its net current revenue on health, but Congress raised the minimum to 19% recently, with almost unanimous support." A government that spends so much on social programs normally cannot carry out active policies.

Potential fiscal risks

In addition to the worrisome trend in social spending, there are unpredictable fiscal risks related to contingent liabilities that Brazil has accumulated involving state-owned banks and companies. Almeida pointed out that from 2007

to 2014, Treasury loans to state-owned banks shot up from 0.5% to 10% of GDP, noting that "In seven years, the Treasury borrowed money to lend to state-owned banks, increasing public debt by 9.5 percentage points of GDP." The Treasury borrows at market interest rates and lends at subsidized lower interest rates, generating a huge subsidy. According to Fabiana Rodopoulos, general coordinator of economic studies of the National Treasury, in January 2016 the estimated implicit subsidies in Treasury contracts with the National Development Bank (BNDES) alone reached R$182 billion.

Moreover, Almeida pointed out, in the last four years the state-owned savings bank, Caixa Economica Federal (CEF), increased its share in the commercial credit market from 6% to 12%. "Any bank in the world that increases its market share in a recessionary economy will see its loan portfolio suffer," he says. Almeida estimated that the bank's losses in the next few years could add up to R$1 billion.

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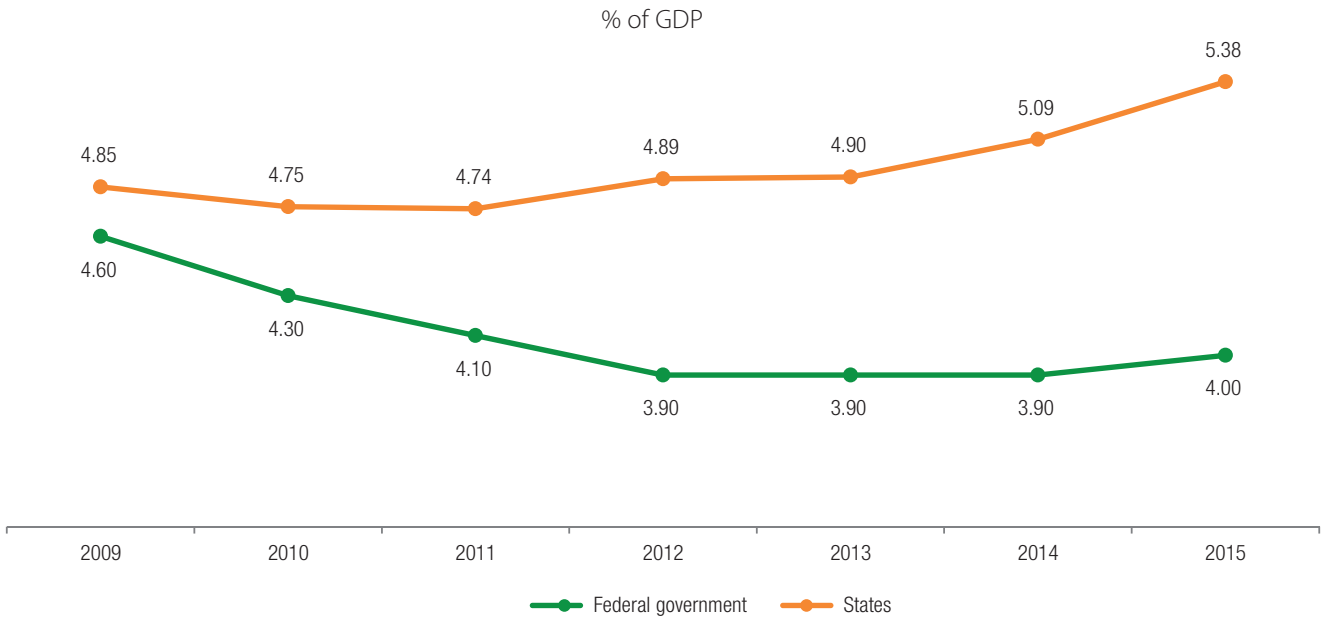
Another problem for state-owned banks is their involvement with nonfinancial state-owned

Public spending in wages and welfare benefits have expanded rapidly



Source: Ministry of Finance.

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enterprises. Oil company Petrobras alone owes them R$90 billion. Almeida said that "Every day the market speculates whether bank claims will be transformed into equity in Petrobras or whether the government will have to capitalize Petrobras by issuing new public debt." He explains that changes in legislation since 2008 have allowed state-owned banks to increase their exposure in the oil, gas, energy and mining and authorize the government to use its equity in state-owned companies to capitalize the CEF and BNDES.

"Any government has the right to grant subsidies to companies and industries as long as it is done transparently," Almeida said. "But the government expanded public debt by R$500 billion to give grants and only now, for the first time in eight years, has it published a report detailing the cost … . We should have done this from the beginning, because when you do not know the cost, the tendency is to overdo it."

Another contingent liability clouding Brazil's fiscal outlook is the cash flow crisis in the states. "Public finances in the 27 states have different degrees of deterioration, but the trend is unambiguously the same for all," said Ana Carla Abrão, Finance Secretary of Goiás state. In Rio de Janeiro state, the fiscal deficit has already reached 2.3% of GDP. In Goiás, Abrão said, the main cause of the mismatch between spending and revenues was personnel expenses: "In Goiás, personnel expenses increased on average by 12.8% a year for the last six years. This means a real increase of 6% in spending that is not linked to productivity gains." The state has 6.6 million inhabitants and



"The federal government has also contributed to the states' fiscal crisis by allowing states to borrow more."

Marcos Mendes

Photo: Luciana Vermell

150,000 public employees, whose salaries use up 76% of the taxes collected.

Ter-Minassian, the IMF consultant, noted that often federal government decisions directly affect state cash flows. Lower federally controlled prices also reduce revenues from state taxes on services, and the federal government mandates for public employee salaries also apply to state and municipal workers, said Marcos Mendes, legislative consultant to the Senate. He also pointed out that the federal government has exacerbated state fiscal crises by allowing states to borrow more even if they did not meet previous conditions for contracting new debt.

In recent months, state governments have resorted to a number of artifices to avoid servicing their debt to the federal government, even appealing to the Supreme Court to change how interest payments are calculated, which could cut their debt by R$400 billion. Mendes believes, however, that default on state debt obligations to the federal government would provide at best only temporary relief; it does not address the structural causes of the state and municipal fiscal crisis.

To mitigate fiscal risks, the 2017 federal budget introduced a risk assessment. "We found that if projected revenue does not materialize because of unforeseen changes in the macroeconomic outlook, the deficit could increase up to R$87.7 billion in 2017," said Arbache. The new budget law will also review non-macroeconomic risks, such as increases in welfare benefits and the need to

Neutralizing contingent liabilities

One IMF recommendation for countries to keep their current accounts in balance is to resist the temptation to underestimate the fiscal risks of contingent liabilities. For the period 1990–2015, the IMF was able to calculate the gross fiscal cost of 174 episodes of contingent liability problems. The highest incidence, with the greatest fiscal impact, was in the financial sector: in 82 episodes governments had to recapitalize banks; the average cost was 9.7% of GDP, though during the 1997 crisis it reached 56.8% in Indonesia. Among emerging countries, the highest incidence was also in the financial sector (about 50 cases, costing on average 10% of GDP), followed by natural disasters and problems in state-owned companies, each costing about 2% of GDP.



Photo: Luciana Vermell

"The weight of these sources of additional cost can be significant. And once they are better known, the next challenge is to manage them," said Gilbert Terrier, deputy director, IMF Fiscal Affairs Department. To do this, the IMF suggests four steps:

- Systematize the identification of risks, their probability, and their likely magnitude.
- Find ways to reduce the possibility that they will occur.
- Study how to use public policies and market instruments to reduce the exposure of the country.
- Finally, create fiscal space to absorb any remaining risks, by, e.g., creating a provisional budget and specific funds.

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capitalize state-owned banks. The next step of this work, Arbache said, is to produce a regular risk assessment report dealing with specific issues. "For the first issue we will look at how the minimum wage affects municipal finances," he said. He also saw the need for a comprehensive risk assessment of state and municipal debt and pension fund liabilities, capitalization of state-owned companies, and default risks in programs such as My House My Life and the Student Finance Fund: "To manage fiscal risk, we need to better identify and monitor these items, promote medium- and long-term planning, build up institutions, and continuously review policies and programs."

Efficiency and transparency

Otavio Ladeira, Treasury Secretary, spoke of the agency's efforts to make public accounts more transparent in order to "reveal to the public the consequences of each policy." He cited progress in the publication of Treasury documents and in Brazil's progress on convergence to International Public Sector Accounting Standards by 2021. Weder Oliveira, Deputy Minister of the Court of Audit, underscored the importance of initiatives to explain clearly to society the magnitude of the fiscal challenges the country is facing, stating, "Today we see technical capacity in the Treasury and will in the society. This situation is favorable for driving change."

Antonio Nucifora, World Bank chief economist for Brazil, supports fiscal reforms to ensure efficiency. He argued for fiscal planning based on medium-term budget and performance targets, starting with the fiscal policy. IMF's Pessoa agreed that medium-term fiscal planning encourages spending efficiency by encouraging fiscal discipline



Photo: Luciana Vermell

and strategic prioritization of expenditures. "Once a sustainable fiscal framework, [the overall revenue envelope and financing],is determined, the budget sets spending ceilings for each ministry, imposing discipline on public sector managers, … [and] leading to operational decision-making, where government institutions promote dialogue with society to identify medium- and long-term goals for the delivery of public goods and services," he explained.

Pessoa noted that countries at different stages of economic development, such as the United States, Colombia, and El Salvador, have already expanded their fiscal projections to as much as 10 years. A good example is Uruguay's five-year budget, he said: "With a multiyear budget, everyone in the economy can identify what is expected to happen in the coming years. There is an annual review of fiscal targets to calibrate the execution. But no one loses sight of the public spending trajectory." Experts also recommend appointment of independent fiscal councils to carry out studies of fiscal impacts and support preparation of the budget.

Manoel Pires, secretary of economic policy in the Ministry of Finance, cited IMF and OECD studies to support the view that currently the best alternative for Brazil is a broad reform that avoids measures that could deepen the recession and aims at long-term sustainability. "Building a long-term fiscal anchor could improve the perception of the risks of the Brazilian economy. With it, short-term fiscal instruments would become more effective for making fiscal adjustments," he said. Pires added that a reform that permanently reduces current public spending would make room for more investment in improving the quality of spending.

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Though these recommendations seem to deny the urgency related to Brazil's current fiscal crisis, experts agreed they are crucial if the country is to avoid future fiscal traps. Ter-Minassian summed up the essential policy agenda:

- Reduce the rigidity of public spending.
- Budget for the long term.
- Make public spending more efficient.
- Ensure that fiscal projections are reliable, including projections of contingent liability risks supported by independent councils.

"These measures will tend to reduce the procyclical bias of Brazilian fiscal policy," she said. Ter-Minassian acknowledged that in the short term Brazil's economic, political, and social problems will push demand for more public spending, "But I believe that the country has the fundamentals to deal with the current crisis."