

A leaner government?

A proposed constitutional amendment to limit government spending renews the debate about the role of the Brazilian government in the economy, past and present.

Solange Monteiro

AMID POLITICAL, ECONOMIC, and social uncertainty, Finance Minister Henrique Meirelles announced a group of programs to halt the worrying deterioration of public finances and reverse the negative expectations in the market. The program should be set in motion once the Senate votes on the impeachment of ousted President Dilma Rousseff.

The first policy action would resume concessions and privatizations, with which the government hopes to add about R$30 billion to its cash flow next year. The second, and most controversial, is a constitutional amendment project (PEC) that would put a ceiling for 20 years on current federal government spending (excluding interest payments) and limit its growth to the previous year's inflation. The government hopes to approve the amendment late this year, to go into effect in 2017.

Samuel Pessôa, research associate, Brazilian Institute of Economics (IBRE), argues that a ceiling on current spending would be a way to deal with the social spending mandated in the 1988 Constitution, which is not consistent with the current need for fiscal tightening. As former Finance Minister Delfim Netto put it, "social spending does not fit the budget," especially since the demands of various interest groups have increased over the years. "The evidence is that we have too many distortions: free universities to children of wealthy families, National Development Bank–subsidized loans for businesses, and income tax exemption for patients regardless of their income, among many examples," Pessôa says. He believes that unless the social spending bomb is defused, the result will be higher inflation. If the demand for social spending keeps growing faster than tax revenues, the conflict will eventually be resolved by printing money to pay for the spending, which would create inflation. "Unless we do something in the next three years, in six years inflation will reach 40%. Inflation as a form of managing social spending conflict is barely better than civil war," he says.

For 25 years government spending has grown more than GDP: the annual expansion of primary public spending (which excludes interest and compulsory transfers), adjusted for inflation, was about 6% but real GDP growth was under 3.5%. In the 1990s, this imbalance was offset with higher taxes and debt. In 2000-2010, the performance of tax revenues was unique—they grew by nearly 7% a year. According to Pessôa, this was the result of a long process of formalization, which broadened the tax base, and of the commodities boom, which raised incomes. In 2011, the situation changed: tax revenues grew at the same pace as GDP, and four years of slow growth in tax revenue brought the primary budget from a 2.15% GDP surplus in 2010 to a 1.5% deficit.

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Marcos Mendes, head of the Ministry of Finance advisory office, estimates that tax exemptions and special tax regimes accounted for revenue losses of about 5 percentage points of GDP (from 17.2% of GDP in 2006 to an estimated 12.4% for 2017). "Economic players find ways to defend themselves from a tax system that has become dysfunctional," he says. "The tax system, which was designed to extract a large volume of resources to balance the budget, is very distorted and, for example, encourages companies to stay small, which depresses productivity." Mendes believes the Brazilian government today is a burden on the private economy either because it absorbs savings that could be channeled to private investment or because the government is

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less productive than the rest of the economy. Unless a sound tax reform raises productivity and economic growth resumes, he says, Brazil will be doomed to very low potential growth.

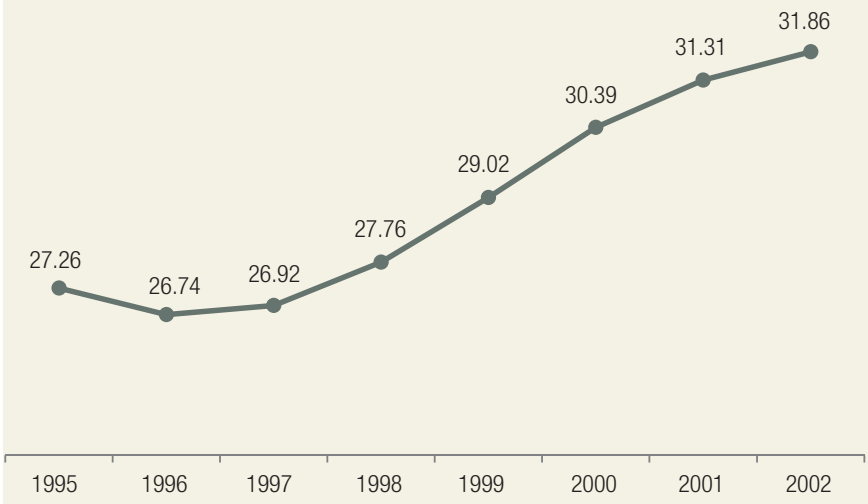
"In Brazil, where we have a very unequal society and institutions vulnerable to pressure groups, the combination of a primary budget balance target with a nominal spending growth ceiling would help to discipline demands of various interest groups, which unchecked ends up increasing public spending for everybody," Mendes concludes.

Necessary cuts

Marcos Lisboa, president of the Institute of Education and Research (Insper), says a reality check is needed. "If Brazil continues on this public spending path," he says, "debt will not stop growing, and the space to cut spending is very limited. Unless there is reform of social security and public employee pensions, and a review of the cost of public employees, it will not be possible to reduce public spending."

To cap current spending and ensure the solvency of the Brazilian government in the long run, the most important of the postponed reforms has to do with social security. Currently, social security benefits account for about 40% of primary public spending and have been growing above inflation, so that resources to cover them have to be taken from somewhere else. In April, IBRE organized a seminar where participants discussed the urgency of social

Brazil's tax burden has grown significantly
(% of GDP)



Source: RFB.

security reform and argued for changes, such as ending the generous pension rules for women and rural workers and ceasing to index pension benefits to the minimum wage (this rule is scheduled for review in 2019). "Because we have taken such a long time to undertake a comprehensive social security reform, we have to deal with a much greater liability," said Fernando Abrucio, professor, FGV São Paulo School of Business Administration (EAESP).

The Ministry's Mendes says the government's plan is to transition gradually to the new pension system. "There are issues of entitlements and equity. … So we are working with various options, and the reform is expected to have a significant fiscal effect by 2020," he says. At the IBRE fiscal reform seminar in July, Finance Minister Meirelles reiterated the need for transition rules that are not restricted to newcomers but also do not punish those nearing retirement.

The question is how the Meirelles team plans to narrow public spending by 2020. According to the estimates of IBRE researcher Vilma da Conceição Pinto, the government is not under immediate pressure; additional fiscal effort would not be necessary until 2019. "If the PEC's new ceiling on current spending comes into effect in 2017, it will start from a relatively high spending point," she says. If in 2016 current spending is R$1.26 trillion and inflation is 7%, the constitutional ceiling on current spending would be about 20.7% of GDP next year, compared to the 20.1% that is projected, which being below the proposed limit would allow R$37 billion as a margin of safety to meet the ceiling. For 2018, the ceiling and projected current spending would be the same. After this respite, however, the gap between the constitutional ceiling and projected current spending widens to a difference of 3 percentage points of GDP by 2022. Pinto points out that many factors can bring about a decline in expenses without the ceiling, but not enough to stabilize the public debt trajectory.

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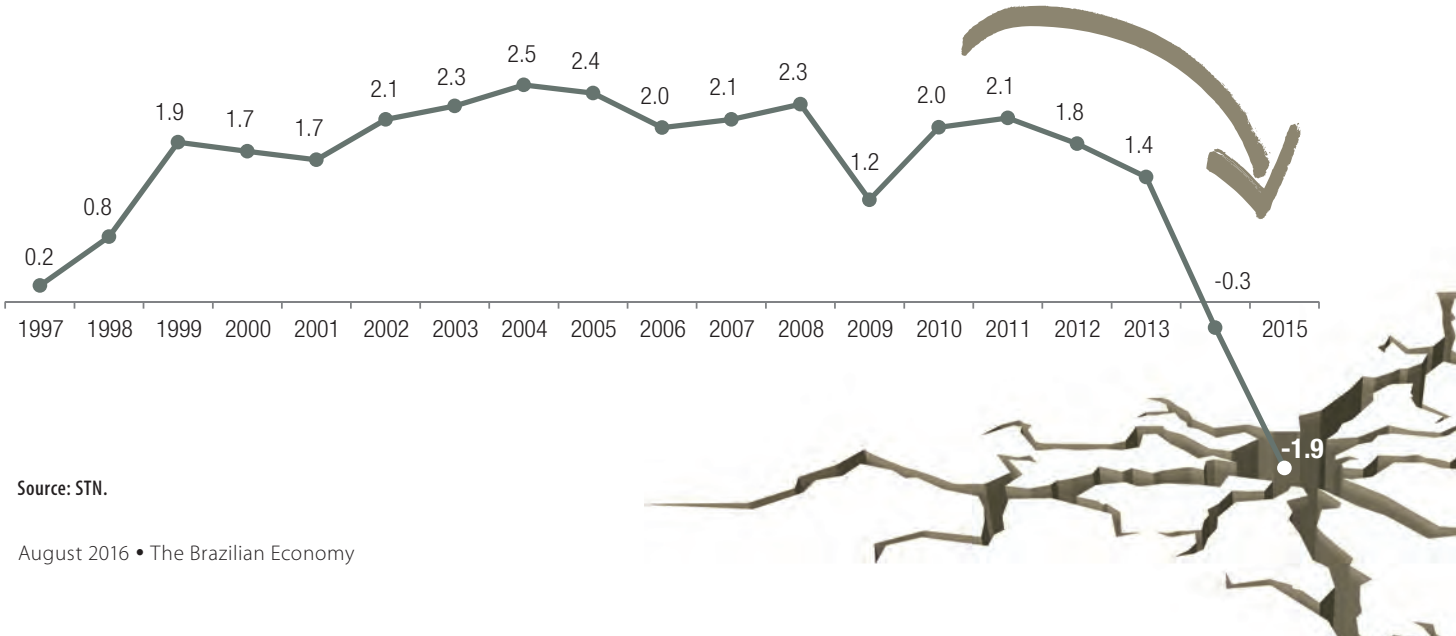
Rationalizing spending is also being considered. Mendes says that the economic team is reviewing social policies, including disability benefits, disability pensions, and unemployment benefits. "What we found is that, on the one hand, in recent years all of these programs have sought to cover as many people as possible whether or not they comply with the eligibility criteria; on the other hand, we have

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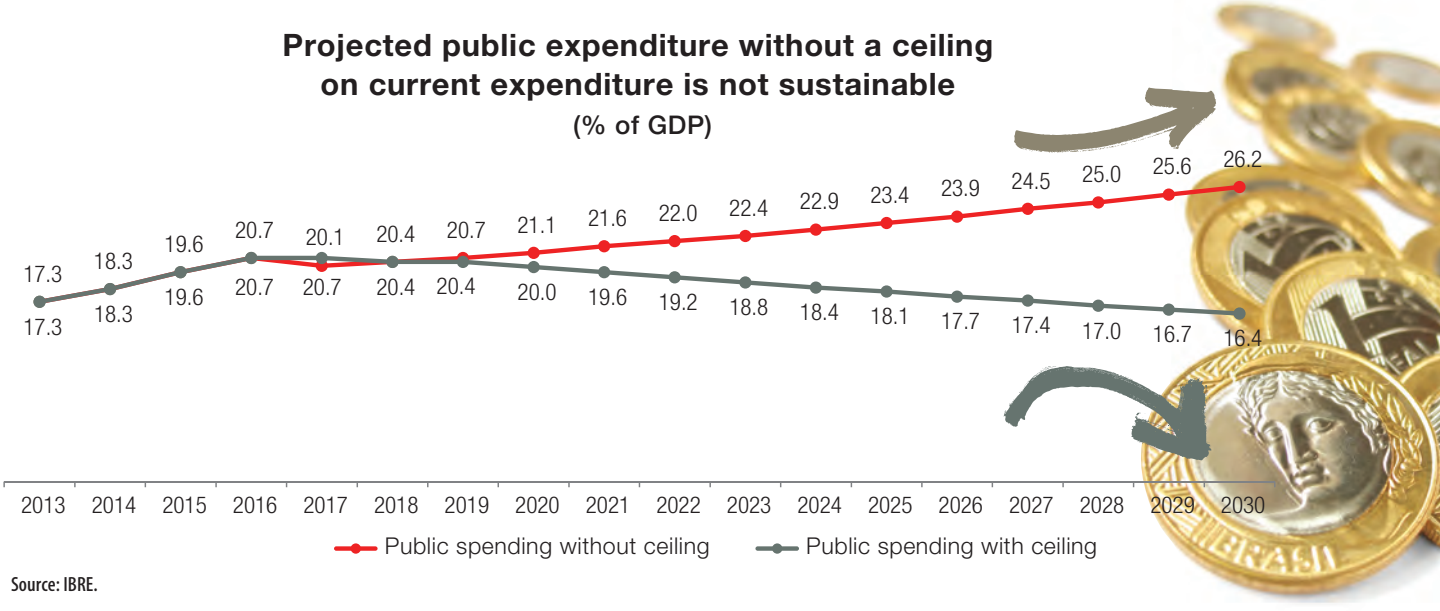
been careless about reviewing the records of beneficiaries to identify who no longer should be receiving benefits." Mendes estimates that continuous cash benefits in 2017 will cost about R$53 billion; this category of expense has risen very fast in recent years, not only because of such carelessness but also because of the activism of the Supreme Court, noting "We are talking to the Supreme Court and checking beneficiaries' records to stop the growth of continuous cash benefits." However, Mendes recommends caution about proceeding too fast: "You cannot carry out a tax reform or cut taxes at a time when the economy is weak. The economy has reached a very high level of disorganization, and only with long-term strategy and gradual reforms can we reach higher potential growth."

Pinto's budget projections indicate that the president elected in 2018 should be particularly concerned about balancing the budget and mediate between the various interest groups to adjust primary spending to the PEC ceiling. "It will be a very difficult balancing act in the short term," says Leonardo de Andrade Costa, professor at FGV Rio Law School. He believes that the constitutional ceiling alone cannot change the fiscal situation because the federal debt limit established under the Fiscal Responsibility Law has not been applied so far. Also, to meet the spending ceiling it will be necessary to address not only the inter-generational and redistributive spending conflict, but also the conflict between the federal government and the states.

Government's primary balance collapsed in recent years
(% of GDP)



Source: STN.



Source: IBRE.

Possible pact?

If the current government reforms and introducing a constitutional spending ceiling are not successful, the new government taking office in 2019 will have to carry out reforms under the pressure of sanctions from the new spending ceiling—including no new hires, no raises for public employees, and no increases in subsidies and grants—and these mandated cuts in public spending carry a risk for economic activity. "This proposal reduces the policy space. It is a bad idea. It will not last long," said Reinaldo Gonçalves, professor of the Economics Institute of the Federal University of Rio de Janeiro (UFRJ). Gonçalves believes the government economic team is establishing policies based on an ill-founded view of the government's role in the Brazilian economy, caused by the misguided polices of the Lula and Rousseff administrations. "There are many examples of bad policies. … But any attempt to oversimplify the government's economic functions is fallacious," he says.

Fernando Nogueira da Costa, professor of the Economics Institute of the University of Campinas (Unicamp), is also critical of a constitutional spending ceiling. "The initiative to create laws that tie government's hands is not new … today it is often said that the government does not fit the budget, and I counter that Brazil's high interest rates do not fit the budget," he says pointing out that interest payments are the heaviest burden on the budget. "I have always advocated that a good macroeconomic policy coordinates fiscal and monetary policies, foreign exchange and capital controls. As long as the Central Bank focuses on a single mandate, control of inflation, our economy will not grow much," he says.

Luiz Carlos Bresser-Pereira, emeritus professor of the FGV São Paulo School of Economics, also questions the need for a constitutional ceiling to reach a consensus on social spending. "What we need is an understanding of the Brazilian tax revenue level, which should be maintained, and

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spending as determined in a serious budget law that would indicate how much of fiscal revenues would be spent on social spending and how much on interest payments. Today there is no political control over the decisions of the central bank," he says. Unicamp's Nogueira believes the fiscal discipline, a spending ceiling would require, may have high social costs as well as reduce the space for necessary countercyclical policies during economic slumps such as that of 2008–09.

Another point of concern is mandated spending in education and health. Mendes argues that the change in the calculation of mandated education and health will make spending more efficient: "Linking these expenses to total revenues creates a terrible management problem, because when revenue is increasing, the public manager must spend money even when there are no programs to receive it." Mendes explains that as a result of a tax revenue bonanza between 2004 and 2008 governments built schools and hospitals, and staffing increased, generating unsustainable higher fixed spending when tax revenue went down. De-linking mandated spending from the economic cycle will give more stability and predictability to education and health spending.

Productivity versus spending

EAESP's Abrucio agrees that mandated constitutional spending does not assure resources for education and health. "The best would be to set up medium-term goals for two or three years, as Australia and New Zealand do, to assess and determine the optimal pattern of public spending," he says. "I do not know whether this would necessarily reduce spending; it could improve efficiency. But Brazil still needs a lot of investment in education and health," he says. Aloisio Araujo, professor at the FGV Graduate School of Economics, agrees: "With the need for a large fiscal adjustment, we must remember that investments in education should be preserved, because education is important for long-term economic growth."

Abrucio believes the linear cut proposed with the constitutional spending ceiling leaves no room for differences in the weight of each sector in terms of the development and productivity of the Brazilian economy. Sharing out tax revenues would become a power play between interest groups fighting to preserve their share of spending. "This does not mean we do not have

to take steps to improve public expenditure efficiency. But a linear cut could prevent the implementation of progressive reforms," he says. Abrucio argues that there is plenty of scope to reform public administration to increase productivity, for example, introducing more flexibility in setting public employee salaries to create opportunities to motivate employees and remunerate productivity. "We must be careful not to sell an illusion: improving public service delivery is not done through layoffs, but through reform. We have to improve the quality of public service."

Abrucio argues that, before cutting public spending, the government should cut BNDES-subsidized loans, payroll tax exemptions, and subsidies. Subsidies doubled between 2013 and 2016, surpassing R$100 billion. "This caused the mess we are in," he says. Mendes said that dismantling subsidies is a priority, but he cautions against cutting subsidies abruptly: "Tax exemption and subsidy policies have to be reviewed carefully. We are now in a very serious recession. If we raise taxes on companies suddenly, it is highly probable that there will be considerable damage to economic activity," he says, pointing out that "when the economy strengthens and tax revenues recover, it will be time to end tax exemptions and carry out tax reform."

"Everything discussed so far has been about plans of an interim government to reverse expectations. Despite the positive initial reaction, the markets are not content with announcements, they want to see progress,"

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points out Leonardo Costa, FGV Law School. As the constitutional spending ceiling proposal is debated, Costa sees little risk that it would be overturned by the Supreme Court. But he and others see the amendment as having a possible problem in the lack of individual accountability for violating the spending ceiling. Another problem would be exceptions from the ceiling if public employee salaries are adjusted because of judicial decisions in lawsuits before the amendment enters into force. For several years, public employees have accounted for the largest number of Supreme Court suits against the government. President Michel Temer has already acknowledged the power of some segments, increasing salaries for 14 categories of federal employees including the judiciary that will raise the federal payroll by R$56 billion by 2019. If the social security reform does not produce the expected savings, pressure to maintain spending could end up at the Supreme Court challenging the constitutional spending ceiling.