Machinery and capital goods
The silent deindustrialization

Governance
How to improve regulation

Interview
Fernando Rezende
Professor at the Brazilian School of Public and Business Administration of FGV



THE BRAZILIAN ECONOMY

FGV IBRE A publication of the Getulio Vargas Foundation • January 2016 • vol. 8 • nº 1



Labor market at breaking point

Recession, persistent inflation, and wage indexation are eroding the labor market, pushing up unemployment.

FGV IBRE

GETULIO VARGAS FOUNDATION, FGV

The Getulio Vargas Foundation is a private, nonpartisan, nonprofit institution established in 1944, and is devoted to research and teaching of social sciences as well as to environmental protection and sustainable development.

Executive Board

President: Carlos Ivan Simonsen Leal

Vice-Presidents: Francisco Oswaldo Neves Dornelles, Marcos Cintra Cavalcanti de Albuquerque, and Sergio Franklin Quintella.

BRAZILIAN INSTITUTE OF ECONOMICS, IBRE

The institute was established in 1951 and works as the "Think Tank" of the Getulio Vargas Foundation. It is responsible for calculating of the most used price indices and business and consumer surveys of the Brazilian economy.

Director: Luiz Guilherme Schymura de Oliveira
Vice-Director: Vagner Laerte Ardeo

Directorate of Institutional Clients:
Rodrigo de Moura Teixeira

Directorate of Public Goods:
Vagner Laerte Ardeo

Directorate of Economic Studies:
Márcio Lago Couto

Directorate of Planning and Management:
Vasco Medina Coeli

Directorate of Publication:
Claudio Roberto Gomes Conceição

Comptroller:
Célia Reis de Oliveira

Address
Rua Barão de Itambi, 60
Botafogo – CEP 22231-000
Rio de Janeiro – RJ – Brazil
Phone: 55(21)3799-6840
Email: ibre@fgv.br
Web site: http://portalibre.fgv.br/

THE BRAZILIAN ECONOMY

Economy, politics, and policy issues

A publication of the Brazilian Institute of Economics of Getulio Vargas Foundation. The views expressed in the articles are those of the authors and do not necessarily represent those of the IBRE. Reproduction of the content is permitted with editors' authorization. Letters, manuscripts and subscriptions: Send to **thebrazilianeconomy.editors@gmail.com.**

Chief Editor
Vagner Laerte Ardeo

Managing Editor
Claudio Roberto Gomes Conceição

Senior Editor
Anne Grant

Production Editor
Louise Pinheiro

Editor
Solange Monteiro

Art Editors
Ana Elisa Galvão
Marcelo Utrine
Sonia Goulart

Contributors to this issue

Chico Santos
Claudio Conceição,
Solange Monteiro,
Vilma da Conceição Pinto

THE BRAZILIAN ECONOMY

IN THIS ISSUE

FGV IBRE Brazilian Institute of Economics | January 2016

News Briefs



5 Fitch ratings downgrade … unemployment still high … inflation up … current account deficit improves … industrial production plunges … Petrobras cuts investment … Congress lowers fiscal target … Rousseff approval dims again … Workers Party attacks central bank tightening … impeachment decision before April … Barbosa replaces Levy … 9.3% November budget deficit … minimum wage to go up … BNDES eases credit

Cover Story

8 Labor market at the breaking point



The labor market has been slowing since 2012, but until 2014 it inexplicably stayed buoyant; structural factors and cyclical policies kept the unemployment rate enviably low. In 2015 the first blow finally landed. Now not a single expert expects unemployment to be in the single digits by the end of 2016. Solange Monteiro consults those who analyze the labor market about what might be done to turn it around … and how long that might take.

Machinery and Capital Goods

16 The silent deindustrialization

In the 12 months ending in October 2015 production of capital goods declined on average by 22.3% — but the sector has been weakening for years: The shrinking of domestic industrial production has driven out hundreds of small machinery industry suppliers, and those in the industry believe recovery for the machinery and equipment sector is far away. Chico Santos reports on the problems caused by the Petrobras cuts in investment and the effects of the general loss of consumer and business confidence in the economy.

Governance

22 How regulatory agencies are governed

The erosion of the effectiveness of federal regulatory agencies in recent years has worsened to the poor Brazilian business environment. In 2015 the Center for Studies in Regulation and Infrastructure of Getulio Vargas Foundation (Ceri-FGV) initiated a study of what the data of nine federal regulatory agencies reveal. In the first phase of the study, Ceri researchers drew up an index to measure the professionalism of its directors since each agency opened for business. Solange Monteiro reports on the findings.

Interview

27 The roots of Brazil's fiscal problems



Fernando Rezende, an expert in fiscal and tax issues, is professor at the Brazilian School of Public and Business Administration of the Getulio Vargas Foundation, and former head of the Institute for Applied Economic Research. In a conversation with Solange Monteiro, Claudio Conceição, and Vilma da Conceição Pinto, 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. He also warns that "Over at least 20 years, the government has become addicted to extraordinary revenues. … It's a tough habit to quit."

Editors' Note

THE CHANGE AT THE helm of the economic team, with the rise of Nelson Barbosa to finance minister, should not be seen as enough, in the short term, to bring Brazil out of the current grave economic situation. Although allies of former president Lula are putting heavy pressure on the government to take action to boost growth, "we are not pulling a rabbit out of the hat," the president's Chief of Staff Jaques Wagner recently announced, making it clear there would be no new packages to stimulate the economy. The same point was emphasized by President Dilma Rousseff herself the next day at a breakfast with journalists.

The task of the new finance minister will be arduous. All economic indicators point to the coming year as being equal to or worse than 2015. IBRE staff estimate that in 2016 unemployment could reach an annual average of 11.7%, almost double the 6.8% recorded at the end of 2014. As production keeps dropping, industry's ordeal is likely to continue: in November, industrial production had its sixth consecutive fall; and compared to November 2014, it had contracted by 12.4%, the largest decline since 2003. The service sector, which had been tenaciously holding on and putting the brakes on the fall in GDP growth, is now clearly exhausted—as we had already anticipated last July.

To further cloud the outlook, the economy of China, the world's greatest commodity importer and our main trading partner, may grow even less than analysts predicted, which will have spillover effects on the Brazilian economy.

Although it is too soon to draw conclusions, the government has begun to outline its strategy for 2016; it seems that the approach to achieving fiscal balance will be gradual. Despite the political pressures, adoption of packages to stimulate the economy like those of the past two years seems to be off the table, at least for now. In other words, the administration will be concentrating its efforts both on preventing Brazil's economic indicators from getting any worse and on launching a pro-growth reform agenda, again bucking considerable pressure that might even go as far as Social Security reform.



THE BRAZILIAN ECONOMY

Subscriptions
thebrazilianeconomy.editors@gmail.com

POLITICS

Photo: Marcelo Camargo/ Agencia Brasil



President Dilma Rousseff

Congress approves smaller 2016 fiscal target

Congress has approved a reduction in the country's 2016 fiscal savings target to 0.5% of GDP; President Dilma Rousseff had asked for a steeper cut to zero if needed, meaning no savings. The government dropped plans to pursue its original goal of 0.7% of GDP to shield the popular Family Grant program. (December 17)

President Rousseff's approval still low

Amid political and economic turmoil, a Datafolha poll has found President Dilma Rousseff's approval rating up slightly, from 10% in November, but still near historic lows. Just 12% of respondents said her performance was "good or excellent according to the results of a poll released on Sunday by polling institute Datafolha. About 65% rated the president "bad or terrible," down from 67% in August. (December 20)

Ruling party calls for less central bank tightening

Brazil should refrain from cutting investments and consider raising its inflation target to avoid further interest rate increases, according to Rui Falcao, president of the Workers' Party, to which President Dilma Rousseff belongs. The party instead proposes raising the government's inflation target so there would be less pressure on the central bank to resume monetary tightening. Falcao said economic policy in 2016 should focus on saving jobs and protecting salaries to help struggling workers. Falcao also said a less rigid 2016 budget surplus target than Congress approved would have been more effective. Finance Minister Nelson Barbosa said he'll take "all measures necessary" to achieve the target set out by legislators, adding that there's no discussion "at this moment" of changing the goal. (December 28)

House to decide on impeachment by end-March

Brazil's lower house of Congress will decide before the end of March whether to recommend impeachment of President Dilma Rousseff. House Speaker Eduardo Cunha, a bitter political foe of the president, said he also plans to appeal recent Supreme Court decisions that raised Rousseff's prospects for blocking the impeachment process. Rousseff's opponents filed an impeachment request on the grounds she allegedly broke budget laws. (December 29)

ECONOMIC POLICY

Barbosa replaces Levy

President Dilma Rousseff on Friday picked close aide and current planning minister Nelson Barbosa to succeed Joaquim Levy as Minister of Finance. Levy left over disagreements about economic policy, a senior official told Reuters. Barbosa has been strongly opposed to Levy's aggressive austerity drive to regain the confidence of investors in an economy mired in its worst recession in a quarter of a century. (December 18) Although Barbosa pledged to push ahead with austerity programs, markets fell steeply as investors worried the leftist economist could undermine Levy's fiscal adjustment plan. (December 21)

November budget deficit 9.3% of GDP

Brazil's November budget deficit was equal to 9.3% of gross domestic product, the central bank said Tuesday. That was a slight improvement over October's 9.5%

Photo: Wilson Dias/Agencia Brasil



New Finance Minister Nelson Barbosa

deficit. Gross debt was 65.1% of GDP, up from 64.9% in October, the central bank said. The primary budget deficit, which excludes interest payments, was 0.89% of GDP, up from 0.7% in October. Instead of a budgeted surplus, analysts say, 2015 may now end with a primary deficit of as much as 2% of GDP. Full-year results are released in late January. (December 29)

BNDES eases credit limits

Brazil's national development bank, BNDES, eased limits on subsidized credit for capital goods purchases, to help mitigate the worst recession in a quarter century. BNDES said the changes will take effect next month. The easier lending terms aim to offset the removal of subsidies that were part of the Investment Support Program credit plan, which ended December 31. (December 29)

Government to raise minimum wage

Despite the delicate state of the public accounts in 2016, the government plans to raise the minimum wage by 11.76%, above the rate of inflation. "The federal government is continuing its policy of valuing the minimum wage, which will have a direct impact on nearly 40 million workers and pensioners," the presidency said. The government has calculated the hike will cost about US$743 million. (December 30)

ECONOMY

Fitch strips Brazil of investment grade rating

Fitch has downgraded Brazil's rating to BB+, citing concerns about an economic and political crisis that threatens to topple President Dilma Rousseff. Standard & Poor's cut Brazil's rating to junk in September, and Moody's Investors Service put the country on review last week for a possible downgrade to junk. (December 16)

Fewer jobless in November

In November the non-seasonally-adjusted jobless rate fell from 7.9% in October to 7.5%, statistics agency IBGE said. Many analysts are predicting that unemployment could reach 10% by yearend. Salaries have also fallen. Discounted for inflation, wages fell 1.3% from October 2015 and 8.8% from November 2014, IBGE said, to a monthly average of R$2,177.20 (US$558.59). (December 17)

Current account deficit narrows

Brazil's November current account deficit of US$2.9 billion is down from October's US$4.2 billion, the country's central bank said, and much less than the deficit of US$9.1 billion in November 2015. Brazil's currency, the real, has weakened considerably over the past year, spurring exports and discouraging imports. The 12-month current-account deficit through November was US$68 billion, 3.7% of GDP. (December 21)

Industrial production plunges

Brazilian industry contracted in November by even more than economists' dire predictions had indicated. Industrial production was down 2.4% from October in seasonally adjusted terms and 12.4% from November 2014, government statistics agency IBGE said. (January 7)

Inflation highest since 2002

Consumer price inflation in Brazil increased last year to the highest rate in 13 years, despite the country's economic contraction. The official consumer-price index (IPCA) rose 10.67% last year, compared with 6.41% in 2014, IBGE said. In December, the IPCA went up 0.96%, compared to a rise of 1.01% in November. (January 8)

Petrobras cuts investment

Petrobras has announced a new business plan that significantly reduces planned investment. Petrobras now intends to invest US$98.4 billion for 2015–19, a reduction of 24% from the previous US$130.3 billion. The company also revised its production forecast down from 2.185 million barrels/day in 2016 to 2.145 million; it produced 2.128 million a day in 2015. The company also plans to sell US$15.1 billion in assets by the end of 2016. Shares fell 9.2% on the day. (January 13)

DICOM

Follow FGV Brazil

Get the latest news from FGV,
world-renowned Brazilian Think Tank

Twitter
twitter.com/**FGVBrazil**

Linkedin
linkedin.com/company/**FGV-Brazil**

Google Plus
google.com/**+FGV-Brazil**

Facebook
facebook.com/**FGVBrazil**

Labor market at breaking point



Recession, persistent inflation, and wage indexation are eroding the labor market, pushing up unemployment.

Solange Monteiro

THE BRAZILIAN ECONOMY has been slowing since 2012, but until 2014 the labor market inexplicably stayed buoyant; structural factors and cyclical policies kept the unemployment rate enviably low. The first blow did not land until 2015, when industry and construction lost a record number of jobs. Unemployment has now reached the services sector, the largest employer in the country.

And the expectation is that the worst is yet to come: Not one labor market expert expects unemployment to be in the single digits by the end of 2016. IBRE staff estimates that for the year it will average 11.7%. "Unemployment is rising fast … If we consider that in 2014 unemployment closed at 6.8%, it will have practically doubled in three years," IBRE researcher Silvia Matos says. LCA Consultants predict that in 2017 unemployment could reach 13%. "Even if the economy starts heading up in 2017, the labor market recovery generally trails," says LCA's Fabio Romão.

The worst job losses are expected in the first few months of 2016, with Brazil's political and economic climate already critical. "In the first quarter of 2016, we estimate a net loss of 460,000 jobs. In the same period in 2014 the

net loss was 65,000." says Romão. For 2015, LCA estimates the total job loss will be 609,000. Flavio Castelo Branco of the National Confederation of Industries (CNI) agrees that the year will begin painfully: "Seasonally, demand is often weaker in this period. Now we have to add in tighter fiscal policy and the 11% increase in the minimum wage in January. In a shrinking economy, this will likely hurt employment."

Hidden deterioration

Since 2014, the signs of slowing economic activity have become clearer as employment declined by 0.1%. Till then, the number of the employed had grown by 2.1% in 2011 and 2.2% in 2012, though it went down to 0.7% in 2013. The decline in employment in 2014 did not push up unemployment because the labor force shrank by 0.7% as fewer people were seeking jobs. This, Romão explains, masked the deterioration in the labor market that was already underway.

IBRE researcher Fernando de Holanda Barbosa Filho, points out that fewer workers were actively seeking jobs then because the recent significant increase in family incomes allowed retirees to stop working and young people to postpone taking their first job. He noted that "In addition, in 2014 funds were injected into such educational programs as the student loan program and the National Program for Access to Technical Education and Employment (Pronatec), which attracted students out of the labor market." In 2014, funding for the student loan program jumped from R$7.57 billion in 2013 to R$13.75 billion. Pronatec expanded its enrollment from 2.7 million in 2013 to 3 million in 2014. In 2015, however, government fiscal tightening cut the budgets of these programs, Meanwhile, "although from 2006 to 2012 [household] income rose on average by 3.5% and in 2014 by 2.7%, we estimate that in 2015 incomes fell by 3.9%," says Romão. IBRE estimates that average real income stagnated in 2015 and will fall by 1.3% in 2016.

"Wages are the main cost for many companies; this makes the labor market the adjustment variable for the entire economy. But wage increases have become institutionalized based on the minimum wage."

Guilherme Mercês

National Household Survey data for the third quarter of 2015 indicates that unemployment for Brazilians aged 18 to 24 was much higher than the national average as a whole. Carlos Henrique Corseuil of the Institute of Applied Economic Research (IPEA) notes that "Young people tend to be more affected by economic cycles —this is not unique to Brazil. They are much more targeted during layoffs but they suffer more pressure to seek work to maintain the family income."

Domino effect

Changes in the number of Brazilians who were economically active and employed did not have much effect on the big employment picture

The worsening of the economic downturn, with inflation rising and incomes shrinking has now reached the service sector, which until recently was a major source of new jobs.

in 2015, Matos says. Rogerio Mori of the São Paulo School of Economics of Getulio Vargas Foundation (EESP-FGV) explains that "In the first half of 2015, some sectors resisted layoffs … hoping for a recovery of the economy, which did not materialize." Now, Barbosa Filho adds, "Companies see that investment has plummeted absurdly—IBRE estimates it fell by 12.3% in 2015, household consumption fell by an estimated 3.7%, and improvement in the trade balance was only minor, mostly due to falling imports. The only way out was for layoffs to grow."

In industry, layoffs began almost five years ago. "In 2010, Brazil had almost 750,000 new jobs in industry. But then creation of new jobs slowed to 400,000 in 2011 and to 300,000 in 2012 and 2013. In 2014, 20,000 jobs were actually lost and in 2015, through November the loss was 433,000 jobs," according to Guilherme Mercês, head of economic studies for the Industry Federation of the State of Rio de Janeiro (FIRJAN). According to LCA estimates, in 2015 industry lost 633,000 jobs. For 2016, LCA projects that it will lose another 550,000 jobs.

Job losses in construction were also heavy in 2015. Through November, construction had cut more than 309,000 jobs. José Carlos Martins, president of the Brazilian Chamber of the Construction Industry (CBIC), estimates that cuts in 2015 could total 500,000. And for 2016, he says, "Everything depends on whether the fiscal adjustment will again cut public investment and concessions for infrastructure projects resume." Barbosa Filho points out that in 2015 across the country infrastructure projects were halted; he explains that "There was too much credit for housing because of expectations of rising house prices. Now, with housing prices falling housing construction will cool," because there is still an inventory of houses to be sold. Meanwhile, "the state-oil company Petrobras has cut its investment by nearly 40% —and Petrobras accounts for 10% of total investment in Brazil."

The worsening of the economic downturn, with inflation rising and incomes shrinking, has now reached the service sector, which until recently was a major source of new jobs. Jaime Vasconcellos, economic adviser of the Federation of Commerce of São Paulo State (FecomercioSP), estimates that Brazil has lost 370,000 services jobs; with the losses in commerce, the number is 600,000. For 2016, he projects, the combined job losses will add up to 730,000. And these sectors have no prospect of recovery until households start spending again.

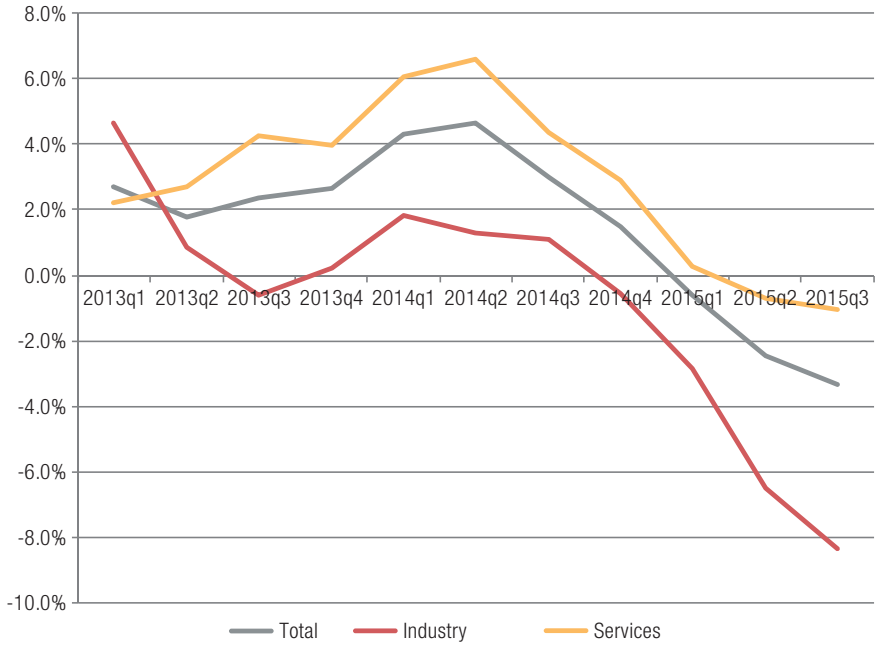
In December, IBRE estimates, household consumption fell by 3.7% in 2015 and forecasts that it will fall by another 3.2% in 2016 because household confidence is at its lowest since 2005.

"We have a crisis of confidence because consumers see they must tighten their budgets, entrepreneurs see sales revenues dwindling, and banking institutions see their bad loans increasing," Vasconcelos says.

Indexation complication

One problem economists think is aggravating unemployment is the high level of indexation in the Brazilian economy. Indexation prevents necessary adjustments in relative prices and perpetuates inflation. Minimum wage increases based on past CPI inflation determine wage increases throughout the economy: "Wages are the main cost for many companies; this makes the labor market the adjustment variable for the entire economy. But wage increases have become institutionalized based on the minimum wage," says FIRJAN's Mercês. The minimum wage, he says, "establishes a floor for regional wages and collective bargaining in the private market." When nominal wages cannot be adjusted to a weak labor market, companies simply lay off or do not hire.

Employment growth in the formal labor market has plunged since the second quarter of 2014.



Source: IBRE-FGV.



In times of economic downturn, the youth population is the most affected by unemployment.

"We have a crisis of confidence because consumers see they must tighten their budgets, entrepreneurs see sales revenues dwindling, and banking institutions see their bad loans increasing."

Jaime Vasconcellos

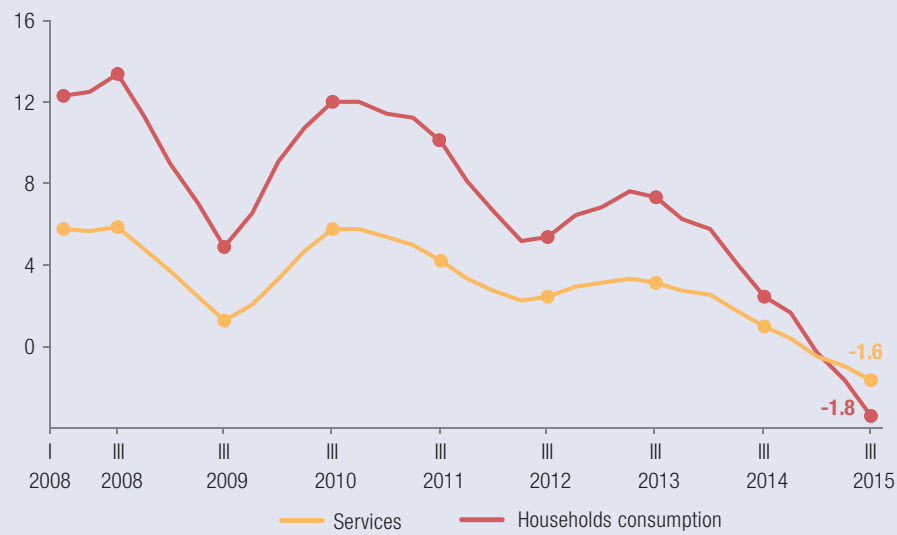
IBRE's Barbosa Filho compares the labor market in 2003 and today: "At that time the minimum wage was not indexed to inflation, so it was possible to make an economic adjustment so that incomes fell more than unemployment; wages declined 11% in 2003 compared to only 4% in January-October 2015. In 2016, wages are expected to decline little—at the expense of more unemployment."

His colleague Matos says that in addition to penalizing workers, indexing wages to past inflation means the economy takes longer to adjust. "Increases in administered prices and the exchange rate devaluation in 2015 end up being transmitted to other prices through minimum wage increases," she says. "Although the economy is weak, costs continue to rise. Inflation will keep on accelerating until demand drops enough." She believes the economy would adjust faster if wages were more flexible.

IBRE expects nominal wage adjustments of about 6.6% in 2016, compared with 9% in 2015. Fecomercio's Vasconcellos points out that last year bargaining negotiations began to reflect

Household consumption and services fell in 2015

(compared to the same period of 2014, percent)



Sources: CNI and IBGE.

concern about the crisis, and there were fewer wage adjustments that were above inflation. "In the first half of 2015," he says, "68% of the agreements exceeded past inflation, compared to 93% in the first half of 2014." For 2016, he says, the focus of negotiations will be alternatives that would guarantee employment. Among them are hiring employees for special working hours, keeping the hourly value of jobs but reducing working hours, and differentiating adjustments by salary range.

"If we had more flexible labor laws, we would have more tools to deal with the crisis," says CNI's Castelo Branco. FIRJAN's Mercês adds "The idea is to have labor contracts with fewer hours, but respecting the minimum wage. This would give more flexibility to companies and workers to adapt in times of crisis like the current one, avoiding layoff costs for companies and job losses for workers," He says that the inflexible labor market also affects Brazil's competitiveness: "Because of its rigid labor market, Brazil has lost space to other competitors, such as Mexico. In 2012, Mexico carried out a broad reform to make the labor market more flexible, mainly addressing the regulation of outsourcing —an issue we have not addressed yet. "

No magic

More flexible labor laws are important to make employment more resilient in future crises. In this one, though, the road to labor market recovery will require a long agenda that has no shortcuts. Castelo Branco warns that "Any attempt at ad hoc policies may have perverse effects. Demand stimulation measures such as those that failed in the recent past will not solve our productivity problems and may increase fiscal imbalances, raise inflation, and further undermine confidence."

Not one labor market expert expects unemployment to be in the single digits by the end of 2016.

Vasconcellos believes the priority should be curbing inflation, which erodes income and thus exacerbates debt and delinquencies. To do this, however, "The government must be able to generate higher primary surpluses in the coming years to ensure that Brazil's public debt will follow a sustainable trajectory. Without sound fiscal policy, monetary policy will not be



Data for the third quarter 2015 indicate an increase in the share of informal employment.

"Even if the economy starts heading up in 2017, the labor market recovery generally trails."

Fabio Romão

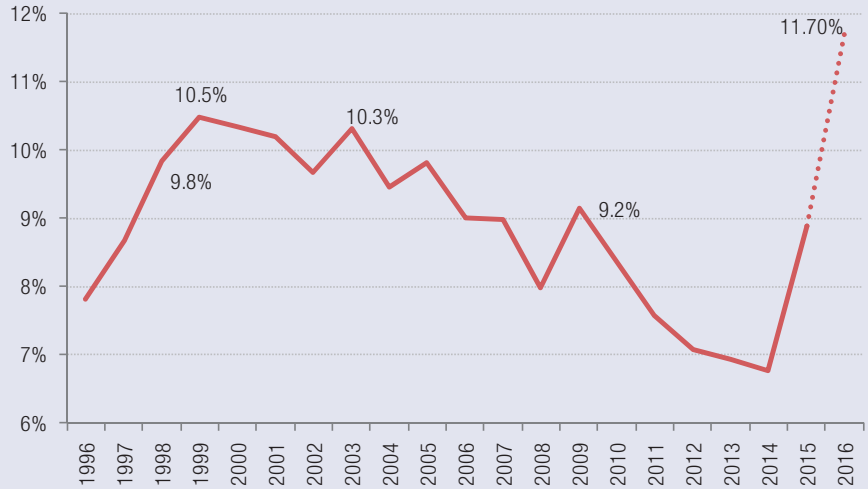
able to curb inflation, and confidence in the economy will not return."

The process will require patience and resignation, since no policy will be able to reduce double-digit unemployment until 2017. Matos says that the number of workers seeking jobs will grow faster than new job vacancies, keeping unemployment high.

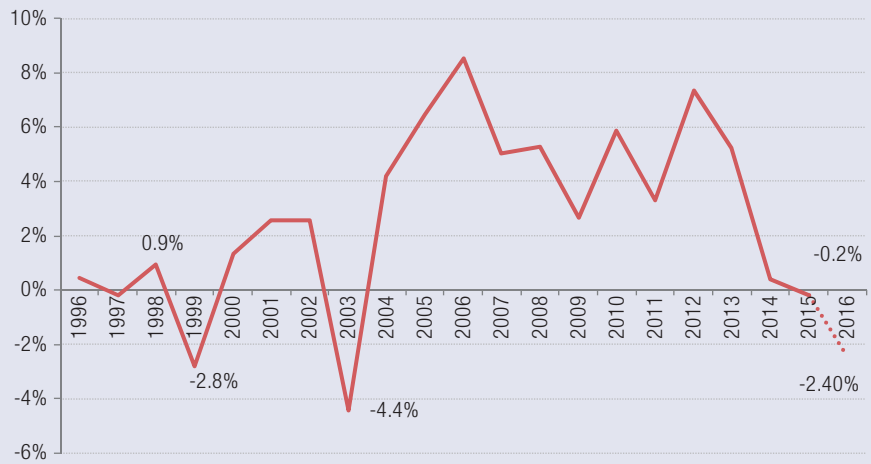
EESP's Mori points out that the current crisis reflects the high cost of Brazil's postponement of economic adjustments: "If we had not lost the year 2015, today we would already be thinking about cutting interest rates and stimulating economic activity." Now, he says, the government has few tools to stimulate the economy other than exports and resumption of infrastructure concessions. Corseuil warns, though, that "To attract investors, resolution of the political crisis is vital. With the US dollar at R$4, Brazil is cheap for foreign investors. All we need to resume investment is predictability."

The current recession has increased unemployment and reduced wages.

Unemployment rate, percent



Average wage adjusted for inflation, year-on-year, percent



Sources: IBGE.
Note: For 2015 and 2016, IBRE projection.


FGV IBRE
Research, development and dissemination of important economic and social performance indicators:
FGV's Brazilian Institute of Economics carries out economic research and analysis, stimulating the growth of public and private businesses across the country. The Institute's statistics forecast principal short-term economic trends, serving as an excellent tool for planning and strategic decision-making.
Present in 100% of Brazilian State Capitals
Sound Understanding of Market Dynamics and Practices
Highly Skilled Technical Team
Tradition and Experience in Price Research and Economic Surveys
ibre@fgv.br | +55 (21) 3799-6799 | www.fgv.br/ibre

The silent deindustrialization

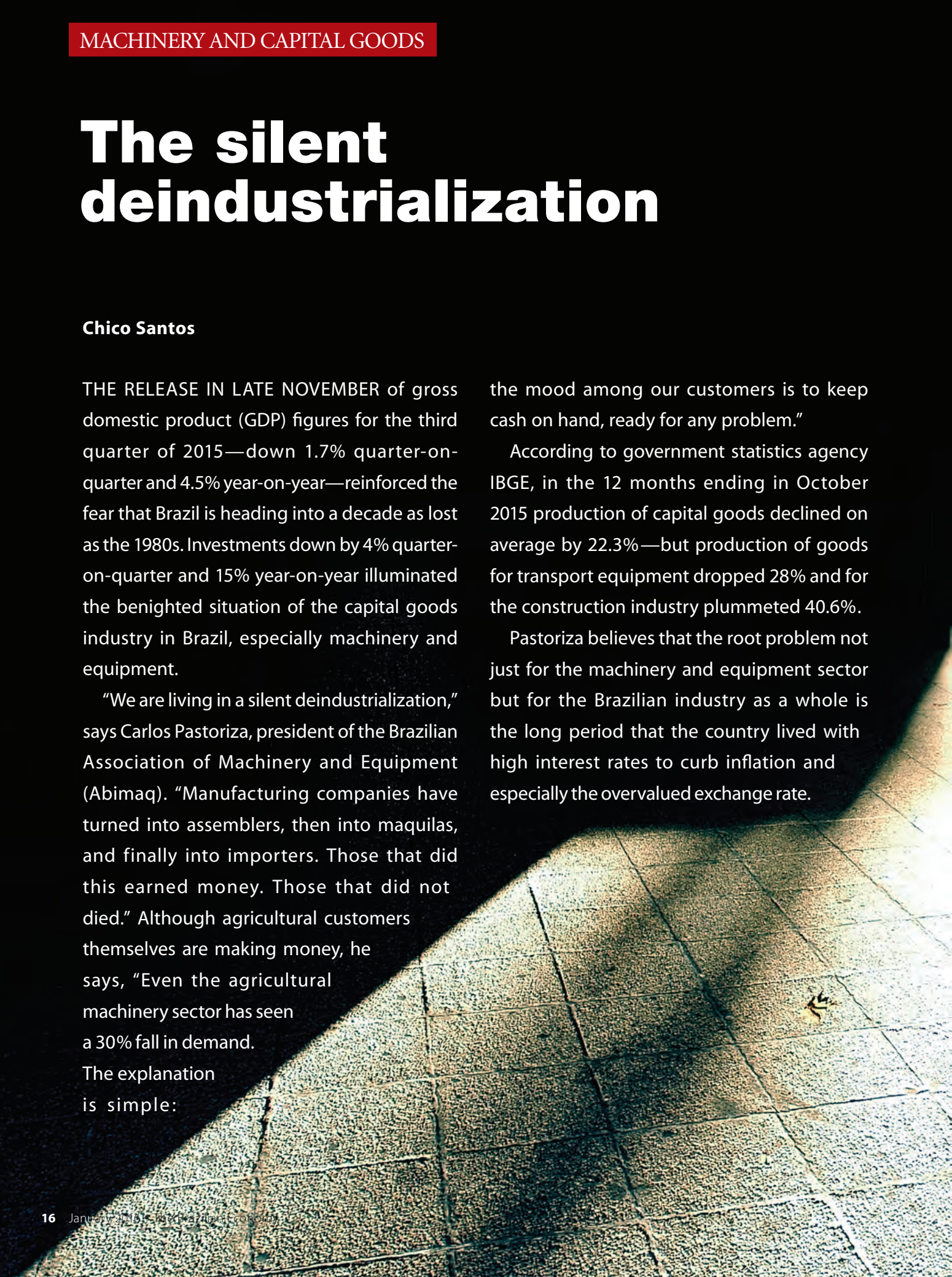
Chico Santos

THE RELEASE IN LATE NOVEMBER of gross domestic product (GDP) figures for the third quarter of 2015—down 1.7% quarter-on-quarter and 4.5% year-on-year—reinforced the fear that Brazil is heading into a decade as lost as the 1980s. Investments down by 4% quarter-on-quarter and 15% year-on-year illuminated the benighted situation of the capital goods industry in Brazil, especially machinery and equipment.

"We are living in a silent deindustrialization," says Carlos Pastoriza, president of the Brazilian Association of Machinery and Equipment (Abimaq). "Manufacturing companies have turned into assemblers, then into maquilas, and finally into importers. Those that did this earned money. Those that did not died." Although agricultural customers themselves are making money, he says, "Even the agricultural machinery sector has seen a 30% fall in demand. The explanation is simple: the mood among our customers is to keep cash on hand, ready for any problem."

According to government statistics agency IBGE, in the 12 months ending in October 2015 production of capital goods declined on average by 22.3%—but production of goods for transport equipment dropped 28% and for the construction industry plummeted 40.6%.

Pastoriza believes that the root problem not just for the machinery and equipment sector but for the Brazilian industry as a whole is the long period that the country lived with high interest rates to curb inflation and especially the overvalued exchange rate.



"The manufacturing sector has been maimed and dying for years," he claims. The shrinking of domestic industrial production has driven out hundreds of small machinery industry suppliers, dismantling a supply chain that is unlikely to be restored.

This breakdown, he believes, was masked for years by the beneficial boom in commodity prices in the first decade of this century. With a lot of money circulating and business opportunities and jobs multiplying in other sectors, de-industrialization was taking place silently. According to IBGE, the share of the manufacturing in Brazilian GDP dropped from 17.9% in 2004 to 10.9% in 2014.

"The industrial brands are still here, but often not even the packaging is made here now," says Pastoriza, adding that often consumers buy a familiar Brazilian appliance brand but the product has been imported from China.

Over the past few years, the quantities of imported manufactures have been rising on the Brazilian market, according to a study by Claudio Considera and Juliana Carvalho, both of IBRE. The study found that in 2014 imported machinery and equipment accounted for 37% of total supply, having shot up from 17% in 2000.

Against the background of silent deindustrialization, Pastoriza thinks that the fiscal, political, and confidence crisis in Brazil was the tipping point. He explains that "In a situation of generalized insecurity, what you do first is to put your foot on the brake."

According to Abimaq, production of machine tools has plunged by 80% because major customers prefer to import from Asia. "We are being pushed down in the supply chain of the world economy, becoming a mere commodity supplier," Pastoriza says. The only way out, in his opinion, is a consistent recovery in industrial production stimulated by such corrective measures as improving education, encouraging innovation, carrying out structural reforms to support macroeconomic balance with low interest rates and competitive exchange rate, and addressing the dearth of decent infrastructure.

"Manufacturing companies have turned into assemblers, then into maquilas, and finally into importers. Those that did this earned money. Those that did not died."

Carlos Pastoriza

Pastoriza recognizes that little can be done given the institutional deadlock resulting from the proposed impeachment of President Dilma Rousseff, but he recommends alternatives. One would be a program to renovate Brazil's industrial facilities, whose average age is 17 years compared to 7 in Germany, for example. An industrial renewal program would align Brazil with the technological level of developed economies. The program would require incentives through the National Development Bank (BNDES), although that might be difficult given the current broken public finances.

The shrinking of domestic industrial production has driven out hundreds of small machinery industry suppliers, dismantling a supply chain that is unlikely to be restored.

A distant reality

However, recovery for the machinery and equipment sector is far away, according to Pastoriza. One of its biggest problems is the collapse of investment in the oil and gas sector. The main investor, state-owned oil company Petrobras, is now too indebted to invest. It owes more than R$500 billion and is required to participate in all consortiums as an operator with a minimum 30% stake, according to the sharing contract established for deep-sea oil.

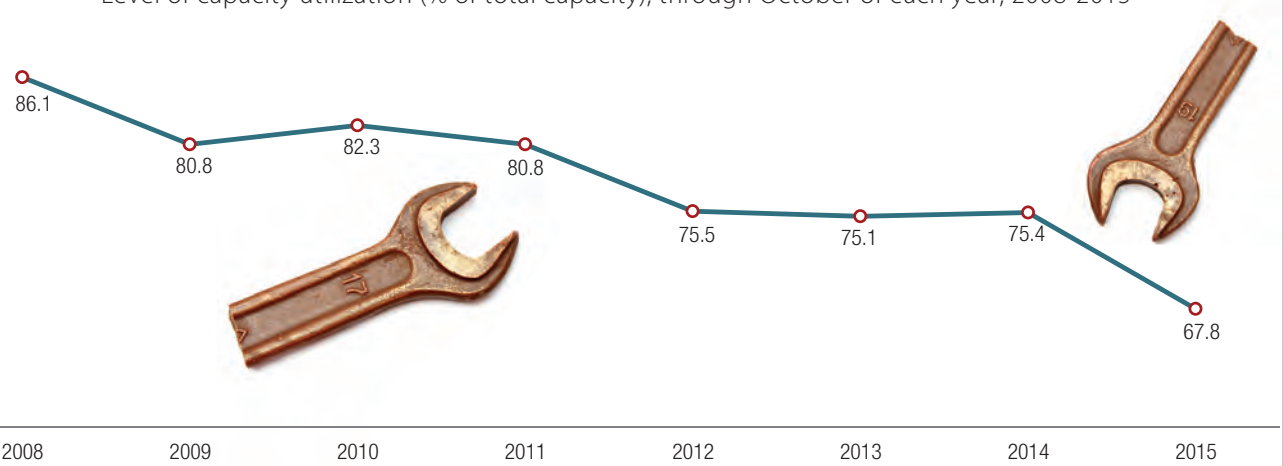
IBRE economist Silvia Matos thinks it is time to correct the "irrationality" of domestic content rules, which requires oil and gas companies to buy local goods and service, and also modify the deep-sea oil sharing contract by eliminating the Petrobras minimum participation of 30%. That would help free up Petrobras to resume investments in oil and gas, and thus encourage recovery of the machinery and equipment sector.

Matos estimates that in 2015 investments fell by 12% and the news may be worse in 2016. In the machinery and equipment sector, capacity utilization as measured by Abimaq was 66.4% in October 2015, down by 13.4% compared with same month in 2014.

Considering these numbers, Matos believes the machinery and equipment sector will not recover for a long time—"and a new investment cycle requires confidence." Also, "replacement and modernization of machinery and equipment are not enough to boost investment vigorously,"

Capacity utilization in the machinery and equipment sector collapses.

Level of capacity utilization (% of total capacity), through October of each year, 2008-2015



Source: Abimaq.

she says. Overall fixed investment has to increase significantly. The Brazilian fixed investment-to-GDP ratio declined from 20.4% in the last quarter of 2013 to 18.1% in the third quarter of 2015. Another alternative to investing in capital goods would be to import machinery and equipment, but "devaluation of the exchange rate is bad for investment [as it raises the cost of importing capital goods]," she said.

Matos believes that increasing exports is not an option either, since there is considerable idle capacity throughout the world, which works against resumption of investments in Brazil aiming at foreign markets. Also, Brazil invests little in research and development.

Matos sees some scope for car sales to Mexico and Colombia. In Argentina, although the prospects are good with the new president's liberalizing economic policy, she believes that it will take two or three years for Argentina to grow enough to buy more Brazilian industrial products.

Politics and uncertainty

IBRE deputy superintendent of business cycles Aloisio Campelo also does not see investment picking up any time soon. "Companies are always thinking about adequate profit margins and adequate credit. Expecting adequate returns is the condition for investing," he says. Without those conditions and with political uncertainty, capacity utilization has hit a historically low rate and industry confidence is down to 75 points.

Campelo agrees with Matos that 2016 is already lost in terms of investments, particularly in machinery and equipment. Both Fitch and

Often consumers buy a familiar Brazilian appliance brand but the product has been imported from China.

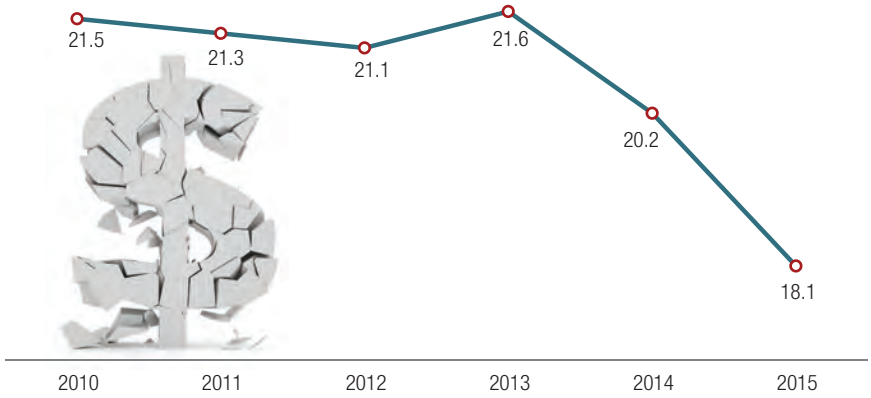
Standard & Poor's have downgraded Brazil's rating below investment grade, and Moody's is about to do the same. "Foreign capital inflows will drop because some foreign institutional investors will be legally prevented from investing resources in Brazil," he says.

"Uncertainty is the enemy of productive investment," Campelo points out, adding that when it is not clear what will happen in 3, 6, or 12 months, both entrepreneurs and consumers pull out. But he sees a possible positive aspect in the Brazil's current calamitous situation: After a long period without investing entrepreneurs see their physical capital depreciating and are inclined to invest more. Also, he believes, domestic capital goods products may begin to substitute for imported because of the more devalued exchange rate. But Campelo also conditions his restrained optimism on resolution to the political deadlock and of the Petrobras governance crisis.

The steep drop in Petrobras investments is a major cause of both Brazil's current crisis and the difficult investment recovery, according to Carlos Frederico Rocha, associate professor, Institute of Economics of the Federal University of Rio de Janeiro (UFRJ). Rocha estimates that Petrobras had been responsible for 12% to 14% of total investment in Brazil. When Petrobras cut

Fall in Brazil's gross fixed investment since 2013 has affected negatively the capital goods' sector.

Investment-to-GDP ratio in the third quarter of each year, 2010-2015



Source: IBGE.

a third of its investments, it pushed down GDP by 1 percentage point by itself, but because Petrobras investments affect the entire industry supply chain, the total loss to GDP was 2 percentage points. And Rocha sees no prospect of public investment recovering in the short term.

In debt and with oil by the barrel worth less than half its value in mid-2014, Petrobras cannot afford to invest. Rocha says it will have to concentrate all its efforts on producing what it has already discovered, putting oil exploration and refining on ice for now. He does not see public investment growing and laments that there is no room for initiatives such as the Growth Acceleration Program (PAC).

With the exchange rate devalued, Rocha believes there may be some revival in production of capital goods, suggesting that agricultural machinery, turbines, electric motors, and generators could be competitive. But he points out that because Brazilian exports contribute less than 10% of GDP, we cannot count on export-led growth to support a recovery in investment.

Although thoroughly globalized and recognized as one of the most competitive and innovative companies in Brazil, WEG has not been immune to setbacks in the domestic market. André Luís Rodrigues, WEG administrative and financial CEO, says that until the third quarter growth in the domestic market had been modest because of the macroeconomic situation. However, one bright spot was generation, transmission, and distribution, particularly wind power generation.

Externally (the company operates on every continent), Rodrigues said it had "healthy growth," averaging 12%. Growth was both organic and through acquisitions, including in China. He says that the devalued exchange rate has offset increases in domestic costs, making company products more competitive in foreign markets.

Rodrigues believes that Brazil must definitely create a more enabling environment for entre-

preneurship, competitiveness, and productivity. To do so it needs appropriate infrastructure, structural reforms in taxes and social security, among other areas, and more flexible labor legislation that would result in internationally competitive interest rates.

Data from the National Development Bank (BNDES), Brazil's main long-term financing institution, confirmed the difficulties of Brazilian machinery and capital goods manufacturers. Disbursements by FINAME, the BNDES agency that finances machinery and equipment, fell 45.5% between January and November 2015 compared to the same period 2014, according to Édson Moreti, manager of operations of BNDES. Loans fell 59.7% for transportation, 26% for agricultural equipment, and 34.6% for capital goods (industrial machinery and others).

Because Brazilian exports contribute less than 10% of GDP, export-led growth in investment is not possible.

Moreti says part of this poor performance is attributable partly to the fact that BNDES, also affected by the country's fiscal crisis, has tightened its financing conditions. Also, credit approvals, which indicate future demand, fell 57.6% from January to November. In December BNDES was considering what could be done to stimulate demand for its financing. Despite cuts in its 2015 budget, it is generally believed BNDES ended the year with a cash surplus because of a lack of borrowers.

Fixed investment intentions in major industries fall.

(R$ billions)

Sector	2014-2017 (A)	2015-2018 (B)	Variation B/A (%)
Oil and gas	458	323	-29.5
Mining	48	36	-25.0
Automotive	74	55	-25.7
Paper and cellulose	19	27	42.1
Electronics	26	25	-3.8
Chemicals	25	17	-32.0
Steelmaking	10	10	0
Total	660	493	-25.3

Source: Ernani Torres/BNDES.



How regulatory agencies are governed

Professional directors make a difference in how agencies operate.

Solange Monteiro

THE EROSION OF THE EFFECTIVENESS of federal regulatory agencies in recent years has contributed to the poor Brazilian business environment. Victims of both political interests and government regulatory activism—such as the misguided interventions in the electricity sector since 2012—serious governance problems in regulators can be a disincentive to both investment and economic activity.

In 2015 the Center for Studies in Regulation and Infrastructure of Getulio Vargas Foundation (Ceri-FGV) initiated a study of what the data of nine federal regulatory agencies reveal. According to Sebastian Azumendi, Ceri researcher, "Unlike other studies supported by personal interviews and perceptions, we have set up a broad data base to bring empirical evidence to the debate."

For one aspect of the study, Ceri researchers drew up an index to measure the professionalism of agency directors since each agency opened for business. The professionalization index (ratings are between 0 and 1) has three items: the academic background of directors; their political ties—party affiliation and whether they ever held political office; and whether they were appointed after a hearing in the Senate or were directly appointed by the president.

The results indicate wide variation in the professionalization of agencies over time, with ups and downs that show discontinuities in

the evolution of most of them. Joisa Dutra, Ceri director, points out that decline in professionalism in many cases cannot be attributed only to a single government; agencies perform differently in each political cycle. In the second Cardoso administration the more professional agencies were the National Water Agency (ANA), National Waterway Transportation Agency (ANTAQ), and National Land Transportation Agency (ANTT). In the two Lula administrations, the Brazilian Electricity Regulatory Agency (ANEEL), National Heath Agency (ANS), and National Civil Aviation Agency (ANAC) stood out. In the first Rousseff administration the National Petroleum Agency (ANP) and the National Telecommunications Agency (ANATEL) performed best.

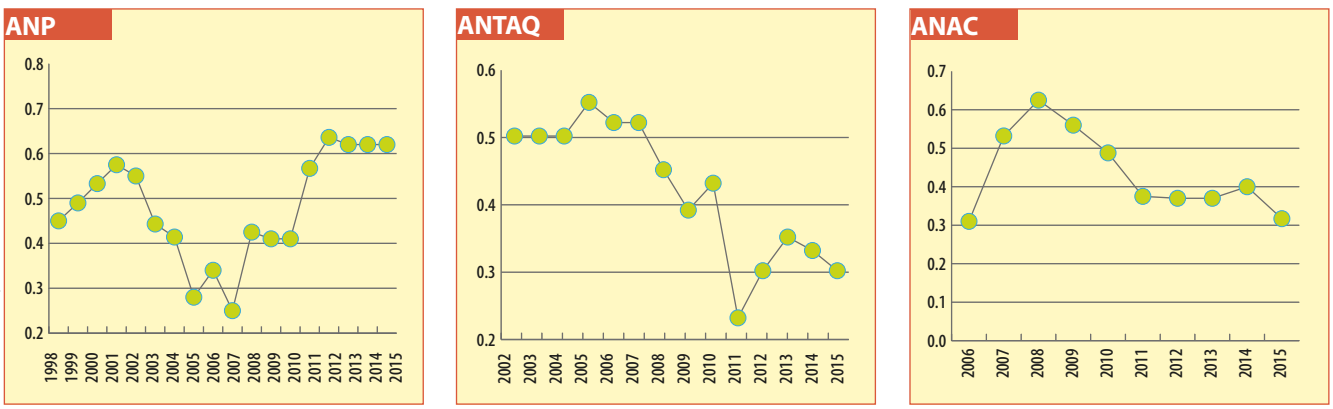
The agency that has recorded the highest level of professionalism since its establishment —and the highest of all agencies in 2015—is ANP, which scored 0.62. Azumendi points out that among the factors that contribute to the good ANP performance is its well-trained executives,

Serious governance problems in regulatory agencies can be a disincentive to both investment and economic activity.

adding, "In general, agencies whose industry is more technically complex require more training." Among the 100 directors who have passed through or are in the ANP, 36 have PhDs, 24 have master's degrees, and 40 bachelor degrees. Next is ANAC (25 PhDs, 25 master's and 50 bachelor's) and ANEEL (24, 16, and 60). However, although ANAC has highly trained directors, it scored lowest on the index in 2015, mainly because, among other factors, one of five board members was a political appointment.

Dutra points out that one factor that makes it difficult to attract directors with high academic degrees is remuneration: "A director in a federal

Index of professionalism (0 to 1) of the directors of the regulatory agencies



Source: Ceri-FGV, 2015.

"A director in a federal regulatory agency earns less than the starting salary of an employee with a college degree in the same agency. This is a perverse incentive."

Joisa Dutra

regulatory agency earns less than the starting salary of an employee with a college degree in the same agency. This is a perverse incentive." she says. Directors' salaries are also limited because of budget restrictions, according to CERI researchers, in some agencies, among them ANP, ANEEL, the National Health Surveillance Agency (ANVISA) and ANTT.

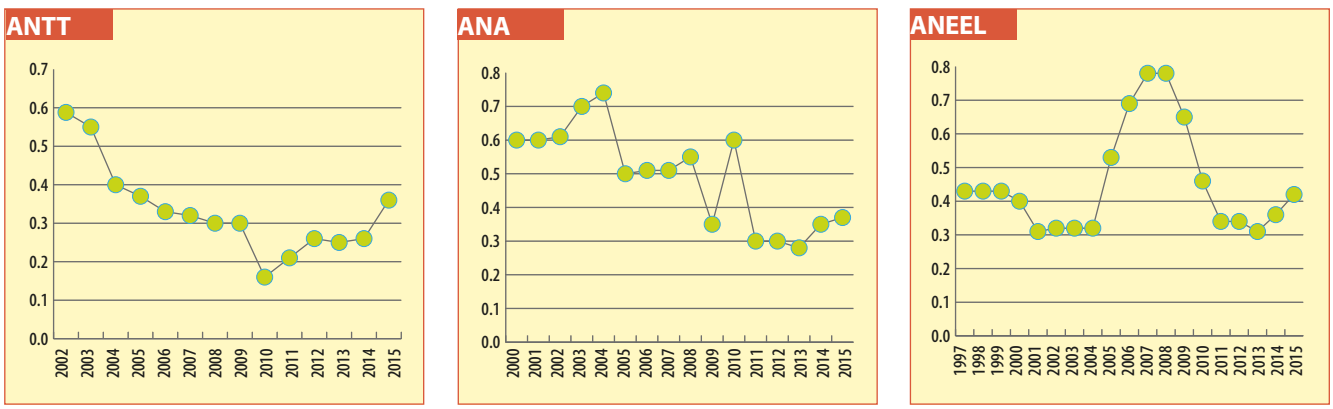
Temporary director, permanent problem

Many agencies scored low on the professionalism index because they were headed by acting directors for long periods. In this regard, ANTT scored lowest: since its inception in 2002 it has been governed by acting directors for almost 10 years. "This is dramatic because ANTT is responsible for regulation of sectors involved in the government's Logistics Investment Plan (PIL)," Dutra says. She notes, however, that the process was reversed last year with the appointment of the current general director. Just above ANTT are ANTAQ and ANATEL, which has had the largest number of acting directors: 21.

The Ceri researchers looked into whether the extended temporary administrations had to do with government difficulty in getting nominations confirmed by the Senate. However, Azumendi says, "The vast majority of government nominees were approved by the Senate, so one cannot attribute [extended temporary administrations] to the Senate. In our view, the difficulty in appointing managers is related more to the political apparatus," says Azumendi.

Dutra points out that the analysis of the

Index of professionalism (0 to 1) of the directors of the regulatory agencies



Source: Ceri-FGV, 2015.

professionalism of agency directors helps to illuminate factors that contribute to the decision-making process. She points out that the consolidation of the workforce in each agency is strengthening agencies' technical culture and decision-making process. "But deterioration in these agencies is always possible, so we looked into factors that can contribute to deterioration: budget restrictions, lack of adequate remuneration of directors, political appointees, and absence of a thorough selection process, with examination by a Senate panel," Dutra said. She emphasizes that the selection of an executive board that has highly trained directors from different specialties is essential to the proper functioning of a regulator.

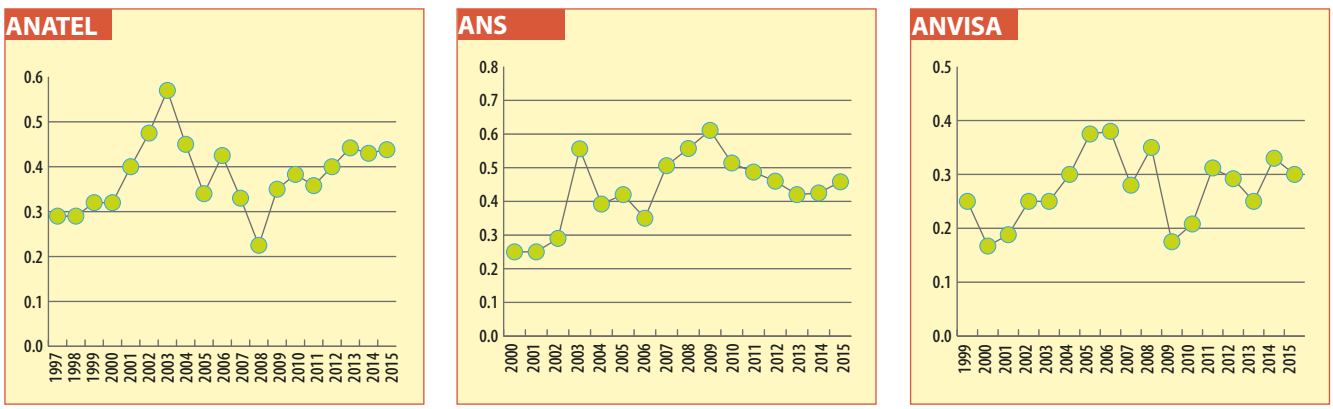
More participation

How to improve the performance of regulatory agencies is not a just a question in Brazil. In the latest issue of its *Regulatory Policy Outlook*, released in October, the Organisation for Economic Co-operation and Development (OECD) pointed out that the issue has been on the working agenda of member countries since 2011. According to the OECD, after the global crisis, in most countries fiscal constraints and increased unemployment caused pressure for improvements in the regulatory framework to mitigate risks and stimulate the economy.

The agency that has recorded the highest level of professionalism since its establishment—and the highest of all agencies in 2015—is ANP.

The OECD *Outlook* emphasizes the need for greater engagement of all parties—not just regulators and experts, but also businesses, citizens, and groups representing them. According to the *Outlook*, the economic crisis

Index of professionalism (0 to 1) of the directors of the regulatory agencies



Source: Ceri-FGV, 2015.

The economic crisis that began in 2008 has undermined public trust in government, so that greater transparency and openness in decision-making have become crucial to ensure the legitimacy of regulatory decisions.

that began in 2008 has undermined public trust in government, so that greater transparency and openness in decision-making have become crucial to ensure the legitimacy of regulatory decisions. That is why there has been an explosion of government initiatives involving social media, such as Linkedin, Facebook, and Twitter, as well as websites and discussion forums.

The CERI study is also looking into transparency and openness. According to Dutra, ANEEL is a pioneer in openness and transparency initiatives: it has been broadcasting weekly public meetings on the Internet for over 10 years. The study analyzed over 1,000 public consultations and hearings ANEEL has held since 1998. The result repeats the findings in other countries: low participation, especially of users. Dutra explains: "Of course there are asymmetries. [Electricity] companies have more ability to understand and influence the decision process because it involves costs to them and technical knowledge; users will participate more the more they understand." Another point that influences participation is the topics discussed. For ANEEL there is more activism around auctions and tariff decisions, "especially because hearings in the case of tariffs are mandatory," Dutra says.

Azumendi points out that agencies should promote greater participation by encouraging and educating user organizations and other NGOs, among others. "This is a challenge that must be seen as a regulator responsibility, not a burden on consumers. Regulators should be facilitators," he says. Dutra suggests the promotion of audiovisual content—in models similar to TED talks (www.ted.com)—in order to help more people to understand the content and encourage more contributions to the regulatory debate. "Greater inclusion of consumers is on the government agenda," she says.

After analyzing the professionalism of the boards of regulatory agencies, transparency, and participation in the regulatory process, Ceri researchers are now studying the decision-making process by analyzing board minutes and the effectiveness of comments contributed in consultations and hearings. "We know that regulation has two dimensions: content and form. Content is price, quantity, quality; but the economic literature shows that the governance of regulatory agencies has a positive effect on how a regulated sector performs," Dutra concludes.

Photo: Pedro França/ Senate Agency



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

We have an institutional crisis because here the main fiscal institution of any government, the budget, has not been relevant for many years.

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

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.

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

Spending choices have never been discussed in Brazil. They have accumulated in an almost archaeological process layer upon layer.

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

Over at least 20 years, the government has become addicted to 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.

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

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.

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.