Fiscal Stabilization and Fiscal Adjustment

Returning to a Sustainable Fiscal Path
I. Key Sectoral Challenges

Brazil is on an unsustainable fiscal path

• For the past two decades, Brazil has experienced a consistent increase in current spending which is now putting fiscal sustainability at risk.

• Gross public debt has increased from 53% of GDP in 2012 to 74% at end 2017, considerably above the threshold usually regarded as “safe” for emerging markets.

• Further public debt is projected to explode in the absence of reforms. Failure to stop the trend of rising debt could result in a loss of investor confidence, exchange rate depreciation, and high inflation, bringing Brazil back to the macroeconomic crises it experienced in the 1980s and early 1990s.

• Given reasonable assumptions of growth and real interest rates, Brazil’s consolidated government needs an adjustment of 5% of GDP in its primary balance just to prevent public debt from growing.
I. Key Sectoral Challenges

Faster growth or lower interest rates are not sufficient to fiscal stabilization

• In order to stabilize debt without fiscal adjustment, growth would have to increase to 5% per year for a decade, which is very unlikely.

• Alternatively if growth were to reach and stay at 4% per year and real interest rates were to remain at 2.5% the debt would almost stabilize—however both of these assumptions are very unlikely.

• This exercise ignores the fact that both growth and real interest rates are not policy variables but the results of policy choices, including the fiscal stance.

• In the absence of a plan to address fiscal imbalances, the risk of public debt default would push up real market rates and keep investment subdued.

• In other words, we do not believe the next administration can pin its hopes for fiscal sustainability on the resumption of economic growth.

Figure 1: Projections of General Government Gross Debt

150% 140% 130% 120% 110% 100% 90% 80% 70% 60% 50% 40%


Baseline - Growth 2.4% & Real Interest Rate 4%
1. Key Sectoral Challenges

Implementing the “spending cap” will be very challenging

• The “teto dos gastos” adopted in 2016 if implemented will gradually stabilize the public accounts.
  • The spending cap would force an adjustment of 0.6% of GDP per year, or about 5% in eight years
  • It would result in a positive primary balance by 2022 and stabilize public debt by 2026

• The “teto” is very difficult to implement:
  • Equivalent to a cut of more than 20% of the federal primary spending in 8 years compared to projections without the cap.
  • If all measures from the Expenditure Review were implemented, Brazil would only just meet its spending cap.
I. Key Sectoral Challenges

Key fact: Fiscal adjustment is only possible by alleviating rigidities

- The spending ceiling adopted in 2016 ("teto dos gastos") is not the only rule governing budget execution in Brazil. There is also
  - a "golden rule",
  - a large number of earmarks on revenues (affecting more than 50% of federal revenues); and
  - constitutionally set minimum amounts of spending on health and education.

- Together with legal entitlements for social security, these rules together imply that over 90% of Brazil’s federal budget spending is rigid.

- Without removing at least some of these rigidities it will be impossible to keep spending inside the teto beyond the very short run.

- Rigidity of federal budget is extremely high from international perspective (Table 1).

<table>
<thead>
<tr>
<th>Country and year</th>
<th>Rigid Spending (%)</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chile (2003)</td>
<td>68</td>
<td>Allier, 2007</td>
</tr>
<tr>
<td>Chile (2014)</td>
<td>65</td>
<td>World Bank, 2016</td>
</tr>
<tr>
<td>Colombia (2000)</td>
<td>84</td>
<td>Lozano, 2000</td>
</tr>
<tr>
<td>United States (1999)</td>
<td>80</td>
<td>OMB, 2000</td>
</tr>
<tr>
<td>Brazil (2003)</td>
<td>87</td>
<td>Allier, 2007</td>
</tr>
<tr>
<td>Brazil (2005)</td>
<td>89</td>
<td>World Bank, 2007</td>
</tr>
<tr>
<td>Brazil (2017)</td>
<td>92</td>
<td>World Bank, 2017</td>
</tr>
</tbody>
</table>
I. Key Sectoral Challenges

Fiscal adjustment is not possible without a pensions reform

• In the absence of a reform, the RGPS deficit is projected to increase from 2% in 2017 to 5% by 2027 to over 16% by 2067. In fact by 2030 pension spending will eventually consume all the space within the teto.

• Hence in the absence of a pension reform, any space created by cutting other expenditures would eventually be consumed by the growing pensions deficit.

Figure 4: Projection of pensions expenditures and spending rule (percentage of GDP)
II. Policy Recommendations

Maintain the focus on reducing spending

• Focusing the adjustment on the spending side is recommended for several reasons:
  • International experience suggests that the output costs of cutting spending are generally lower than those of increasing revenues (see Alesina et al., 2018).
  • In LAC the costs of a revenue-based adjustment are higher the higher the initial tax burden on the economy. Since Brazil is already a high tax country, further increases in the share of revenues in GDP are likely to impose higher output costs than dealing with the underlying expenditure pressures.
  • A review of federal government spending in Brazil reveals that a significant proportion of it is not in fact progressive, but rather benefits predominantly the middle and upper ranges of the income distribution.

• While the main focus should be on expenditures, this does not mean there is no scope for increasing revenues (to contribute to the fiscal adjustment), or for reforms to make the structure of taxation more progressive.

• Priority should be to focus to reduce the huge transfers to the relatively richer Brazilians implicit in: (i) in the pension system; (ii) the civil service payroll; and (iii) in the significant amount of perks (subsidies and tax exemptions).
II. Policy Recommendations

Strengthen the teto, without diluting the adjustment

• The risk of the current spending ceiling is that it could force a further sharp reduction in discretionary spending (investment and social transfers) which could be costly

• It is possible to introduce some modest improvements to the rule to mitigate this risk without compromising the underlying fiscal path:

• (1) Introduce harsher automatic correction measures if the expenditure ceiling is violated.
  • The teto already includes a few automatic correction measures, which would yield annual savings of around 0.3% of GDP annually (or half of the adjustment implied under the teto).
  • Additional automatic adjustment measures would be required to stabilize debt levels by 2027.
  • These should focus on pensions and payroll which are the drivers of current spending

• (2) Exclude public investment spending to protect the quality of the adjustment
  • To maintain the fiscal adjustment path, this would have to proceed in parallel with additional discipline on current spending along the lines suggested above.
II. Policy Recommendations

An alternative fiscal rule will depend on consensus on key spending measures

• A primary balance target would allow for revenues increases to contribute to fiscal adjustment.

• Such a shift should only be contemplated once agreement on an initial and substantial package of spending measures (most crucially pension reform) has been reached.

• Some revenue increases may have low output costs and there is thus good reason to include them in the fiscal adjustment strategy.
  • This is most obvious for the case of the many tax exemptions.
  • But it may also be true in other areas, including corporate and personal income taxation, where significant loopholes benefiting the wealthier parts of the population remain.
  • The argument made here does not apply, however, to the vast majority of taxes and hence should not be misread as a plea to shift the burden of adjustment towards higher taxation.

• The primary balance rule should be designed to achieve at least the same adjustment path as implied under the current expenditure rule—that is an annual improvement of at least 0.6% of GDP in the primary balance. Loosening the fiscal adjustment path at this point could undermine credibility. Once adjustment is well under way, Brazil could shift to a cyclically adjusted primary balance target.
III. Main Messages

• Brazil is on an unsustainable fiscal path: Failure to reform will result in a macro crisis.

• Faster growth and lower interest rates would make the adjustment slightly easier, but do not remove the need to reduce the level of primary spending.

• Fiscal adjustment is impossible without a pension reform and without removing the many spending rigidities and earmarking.

• “Spending cap” would stabilize debt by 2026, but requires a reduction of 5% of GDP in primary spending over 8 years, or 24% of federal budget, which is very challenging.

• Focusing the adjustment on primary spending is well justified.

• Subject to maintain the fiscal adjustment path, the fiscal rule can be strengthened by:
  • Adding automatic corrective measures and excluding investment; and
  • Allow for revenue measures which are pro-growth (i.e. move to a primary balance rule).

• A primary balance target could ease the adjustment burden on spending but should happen only after a substantial package of spending reductions has been secured.