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Estabilização e ajuste fiscal

NOTA DE POLÍTICA PÚBLICA

Brazil Policy Note

Returning to a Sustainable Fiscal Path

KEY MESSAGES

1. **Restoring fiscal sustainability is presently the most urgent and most important economic policy challenge for Brazil.**[1] A substantial fiscal consolidation of about 5 percent of GDP (see figure 4) is necessary to ensure medium-term debt sustainability, maintain investors' confidence, improve growth prospects, and resume the poverty reduction path. The crisis originates in the long-term steady growth in primary recurrent spending over the past 20 years and the recent fall in revenues associated with the deep recession of 2015-2016 and the weak recovery of 2017.

2. **Significant expenditure rationalization measures and revenue raising measures are needed to stabilize public debt and create fiscal space for investment**. The Brazil Public Expenditure Review provides a detailed menu of possible expenditure savings. Many of these proposed actions are structural, demand constitutional reforms and will only have fiscal effects in the medium term. However, their signaling value is immediate thus helping to regain confidence in the short-run and accelerate the return to macroeconomic stability. Revenue raising measures complementing the expenditure side fiscal consolidation are also discussed in this note.

3. **Adherence to both fiscal rules will become increasingly difficult in coming years, suggesting the need to adapt the fiscal adjustment strategy to increase revenues as well as reducing primary spending.** Brazil has two main fiscal rules[2], imposed by the Federal Constitution: (i) The federal government adopted a primary expenditure ceiling rule in December 2016, which forces a gradual reduction of 5% in federal primary spending as a share of GDP over a decade; (ii) Brazil also has a "golden rule" which states that borrowing cannot finance current expenditures, and which is becoming increasingly difficult to comply with given the steadily rising current spending. Since a fiscal adjustment done purely on the expenditure side appears politically too challenging, it makes sense to pursue a combination of measures both on the revenue and on the spending side. This would require adjustment to the rules. It is paramount however that any changes to the fiscal rules should aim to make them tighter, and not postpone the adjustment. In this context, there is a need to introduce automatic correction mechanisms that are sufficiently harsh to incentivize the adoption of the needed reforms.

4. **Brazil institutional framework for the operation of fiscal policy is contradictory and needs to be reinforced, in a manner which does not dilute the overall fiscal effort.** To enhance their effectiveness, it is important to situate the fiscal rules within the country's fiscal framework, which consists of the set of laws, regulations and instruments that determine the framework where fiscal policy is defined and implemented. Notably, Brazil is characterized by an array of mandatory spending and revenue earmarkings which imply that over 90 percent of the budget is rigid. It is evident that the two fiscal rules (the expenditure ceiling and the golden rule) are inconsistent with the combined impact of the many rules on mandatory spending and revenue earmarkings. A few actions are needed to improve the current fiscal framework by providing more flexibility while improving the quality of the fiscal adjustment: (i) lessen expenditure pressures coming from the indexation of recurrent mandatory spending and the revenue earmarking rules; (ii) strengthen the expenditure ceiling rule by enabling the operation of more forceful correction

[1] The Policy Note on Subnational Fiscal Issues gives detailed assessment of subnational governments' public finance challenges. This note focuses on the federal government's fiscal situation.

[2] The Fiscal Responsibility Law approved in May 2000 introduced a few other fiscal rules to discipline the fiscal policy: (i) personnel expenditure limits; (ii) debt ceilings; (iii) borrowing limits for states and municipalities; and (iv) a request that the Annual Budget Guidelines Law contains multiyear targets for the primary balance. However, the experience during the last decade showed that the setting of primary balance targets can be a relatively weak fiscal rule in Brazil, since the federal government can approve an amendment to the Budget Guidelines Law at the Congress altering the primary balance target during the year of implementation of the budget.

mechanisms in case of deviations; (iii) improve the quality of the fiscal adjustment by exempting investment spending from the rule[3]; and (iv) adopt an accrual accounting regime to monitor the compliance to the fiscal rule. If adopted in such a manner not to dilute the level of adjustment envisaged by the expenditure ceiling, such measures could provide a boost to the fiscal adjustment by signaling to markets increased credibility in the sustainable implementation of the fiscal consolidation efforts, and thereby allow a reduction in the risk premia.

Background and Key Challenges

5. **Macro-fiscal projections show that the current fiscal stance is unsustainable: Brazil needs a package of fiscal measures amounting to at least 5 percent of GDP.** A summary of recent macro-fiscal performance is provided in Annex 1. Looking ahead, despite some revenue increases related to the recovery of GDP growth, the persistent increase in social security benefits is expected to further worsen primary and overall balances. Baseline projections using the fiscal model (Annex 2), and assuming that GDP will grow at around 2.4 percent per year, with inflation stabilizing at about 4 percent, suggest that the federal debt may surpass 100 percent of GDP by 2024 and reach 120 percent of GDP by 2027 and become explosive in the following years (unless decisive action is undertaken in the short term and maintained over the 2020s; Figures 1 to 3).[4] Stabilizing the fiscal accounts requires an adjustment of at least 5 percent of GDP[5], for which debt is expected to stabilize at around 89 percent of GDP by 2026, and to start declining afterwards. Simulations shows that faster GDP growth and/or lower interest rates would help reduce the amount of adjustment required, but only marginally. Notably, GDP growth does not help much in solving the fiscal challenge because a lot of expenditures are automatically linked to (and increase with) faster GDP growth.[6]

6. **If Brazil cannot fix its fiscal problems, ultimately inflation will increase to force the inevitable adjustment.** Failing to address this situation would entail significant costs for Brazil. Unsustainable debt prospects will push the depreciation of the exchange rate which will translate into higher inflationary pressures, which will reduce the real value of incomes and force the adjustment which politicians were unable to carry out. This type of adjustment, however, is very unfair as the poor carry the greatest weight

[3] Because the source of the fiscal disequilibria has been the growth of the primary current spending, limiting its growth is key to the expenditure ceiling rule. Limiting current spending can also improve the current savings and, consequently, help the federal government to comply with the golden rule. In addition, as the fiscal multiplier of public investments is usually higher than of current spending, incentivize public investments can boost economic growth.

[4] Looking beyond the next few years, expenditure pressures will grow as demand for public services grow with income and aging. Brazil is undergoing a rapid demographic transition which will lead to substantial additional fiscal pressure on pensions, social assistance and publicly financed health care (World Bank, 2011, 2017). The speed of population aging in Brazil will be significantly faster than that experienced by more affluent societies over the last century. The elderly population will more than triple within the next four decades, from less than 20 million in 2010 to approximately 65 million in 2050. The elderly population will increase from about 11 percent of the working-age population in 2005 to 49 percent by 2050, while the school-age population will decline from about 50 percent of the working-age population in 2005 to 29 percent by 2050. These shifts in population age structure will lead to substantial additional fiscal pressure on publicly financed health care and pensions, along with substantial reductions in fiscal pressures for publicly financed education (World Bank, 2011). The population above 65 years is growing at 4 percent is expected to increase the already high deficit of the social security system. Non-contributory pension transfers are also expected to increase with aging, higher poverty rates and informality. The aging of the population and increasing healthcare costs associated to the evolving population disease profile is shifting the disease burden from acute communicable diseases to chronic degenerative diseases which require more expensive treatments than the used to combat communicable diseases. In addition, large disparities in the quality of health services across states may intensify pressure on the health sector spending.

[5] Simulation encompasses two different scenarios for the primary expenditure: the baseline scenario at which expenditures grow at historical patterns and an alternative scenario where the spending rule is complied with. To comply with the spending rule, simulation assumes that fiscal adjustment measures are taken to control total primary spending growth, As figure 4 shows, in 2026, the difference in primary balance between these scenarios is 5% of GDP, and corresponds to the necessary fiscal adjustment required by Brazil to meet the spending rule by 2026.

[6] Simulations using the fiscal model suggest that GDP growth would need to remain above 5 percent for an entire decade in order to stabilize the level of public debt, something which Brazil has never experienced. Moreover, expecting economic growth to rise sharply without first resolving the fiscal imbalance is a bit like hoping for money to grow on trees.

proportionally. Brazil has seen many examples of this process taking place in the 1980s and 1990s. Moreover, the dire fiscal conditions at the federal and subnational levels are already threatening the continuity of service delivery in education, health, public security and other social programs.

7. Recognizing that the persistent increase in spending is the main factor contributing to the unsustainable fiscal stance, in December 2016, Congress approved a constitutional amendment introducing a ceiling on federal primary expenditures (in real terms) for twenty years, which will force Brazil to continuously choose priorities within federal public spending. The new fiscal regime ("*teto dos gastos*") limits the growth of federal primary expenditures (net of transfers to other levels of government) to the previous year's inflation (as observed in the 12 months to June), therefore maintaining constant these expenditures in real terms.[7] The adoption of the "*teto*" constitutes a pivotal first step towards restoring fiscal sustainability. It directly targets the main structural source of fiscal imbalance that is the growth in primary spending. It will also help limit the pro-cyclical spending policies of the past.[8] Further, the rule is simple which makes it easy to explain and to monitor.

8. If complied with, the federal primary expenditure ceiling rule would force a gradual reduction in spending as a share of GDP, which would restore primary surpluses and stabilize primary public debt over a decade. Simulations of the adherence to the spending cap rule over 2017-2030, indicate a gradual resumption of a sustainable fiscal and debt path (Figures 4 to 7). Assuming growth of the economy and revenues close to long term historical trends, this rule would gradually reduce spending as a share of GDP and generate a fiscal adjustment sufficient to stabilize public debt in about 10 years. Compliance with the expenditure rule may result in the primary balance turning positive by 2022 and improving at a pace of about 0.6 percent of GDP per year to reach 2 percent by 2026. The overall deficit would improve from 7 percent of GDP in 2017 to around 5.6 percent by 2026. The adoption of the spending rule may result in better debt dynamics than the simulated in the baseline scenario (no policy reforms). Debt is expected to stabilize at around 89 percent of GDP by 2026, and to start declining afterwards. Of course, higher growth and lower real interest rates could facilitate a more rapid stabilization of debt. This would

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[7] The reform includes provisions that trigger a series of corrective measures in case of rule breach. Specifically, the "power" exceeding the limit will be prohibited in the following years to: (i) grant increases or adjustments in the remuneration of its public servants (except those derived from a judicial decision or determination of legal acts prior to the publication of the PEC); (ii) create new positions, jobs or functions that imply an increase in expenses; (iii) make changes to the career structure that imply an increase in expenses; (iv) hire personnel in any capacity (except for replacement or vacancy of positions that by law are for life – e.g. Supreme Court Ministers - and the replacement of managerial positions that do not increase expenses); (v) conduct any public tender for the hiring of public servants, except for replacements in the positions mentioned in item (iv); (vi) create any type of bonus or payments not classified as wages for civil servants; (vii) create new compulsory expenses; (viii) increase existing mandatory expenditures at rates higher than the inflation rate. In addition, if the executive branch is not in compliance, it is prohibited in the following year to: (i) increase nominal expenditure with economic subsidies higher than those incurred in the previous year; (ii) give concession or extension of incentives or tax benefits (resulting in a reduction of tax revenues).

[8] Several studies have highlighted that the lack of medium term fiscal policy in Brazil contributes to cyclical expansions and short-sighted adjustments. The focus on year-to-year primary balances left little impetus for spending constraint in times of strong revenue, resulting in pro-cyclical expansions. The practices of targeting a constant primary surplus and the abundance of expenditure indexation to revenue, GDP or the minimum wage reinforced this tendency. In times of falling revenues, the fiscal adjustment typically fell heavily on public investment or was achieved through ad-hoc revenue measures. In this context, the expenditure ceiling will serve to define the long-term spending envelope and to prevent pro-cyclical expansions. By introducing a limit on spending growth which is delinked from revenue performance or economic activity, the new fiscal regime would preclude such pro-cyclical expansions. It also serves to reduce macroeconomic uncertainty since the maximum level of federal expenditures (adjusted for inflation) will be predetermined, increasing the predictability of fiscal policy. However, the implementation of the expenditure rule would benefit from multi-year budgeting. The current system of revenue earmarking and indexation is a relic from a hyperinflationary past and also an effort by the legislative to establish spending priorities beyond the annual budget cycle and protect them from executive discretion in execution. A medium-term expenditure framework (MTEF), which includes macro-fiscal forecasts with bottom-up projections of the expenditure baseline, would enhance expenditure prioritization under the expenditure ceiling. A multi–year budgeting process in which executive and legislative agree on medium term spending priorities should also reduce the need for indexing of expenditures to specific revenue streams.

create fiscal space to restore the federal government's investment capacity and thereby support more sustainable growth in the future.

9. **While the fiscal consolidation strategy delineated by the spending cap rule is gradual, compliance with the rule is still very challenging as it implies an accumulated reduction of the federal primary spending of more than 20 percent over an eight-year period.** Starting in 2019 the adjustment of the primary expenditure required to comply with the rule averages 0.6 percentage points of GDP per year, for an accumulated adjustment of 5 percentage points of GDP for the period 2019-2026. Since the adjustment is focused on federal primary expenditures, it would entail a reduction of about 25 percent in the federal budget (relative to the baseline scenario) over the period 2019-2026. This is a significant downsizing, which highlights the magnitude of the challenge ahead, and raises questions about its political feasibility.

10. Another challenge is the increasing difficulty to comply with the Golden Rule in the Constitution that dictates that financing cannot be higher than capital spending. The persistent increase of mandatory recurrent spending has reduced the fiscal space for federal government investments which fell from an average of 5 percent of GDP in the 1990s to around 2 percent in the 2000s and to 0.5 percent in the 2010s. A so-called "Golden Rule", limiting new borrowing to financing of investment rather than current expenditures[9] (which is one of the most common fiscal rules adopted by countries around the world and) which has been part of Brazil's fiscal framework since 1988 through Article 167 of the Federal Constitution. In practice the rule allows the government only to run deficits if those deficits are used to finance capital investments. Any borrowing beyond this would require special parliamentary approval. Since 2015, fiscal deficits (net-borrowing) have exceeded federal investment spending, suggesting non-compliance with the "Golden Rule".[10] In fact, the Government complied with the rule by making use of some forms of exceptional financing.[11] Compliance with the golden rule is increasingly unlikely as the gap between large borrowing needs and depressed investment has been growing. In the short term the government can seek ask Parliament for authorization to breach the rule. However, looking further ahead, in the absence of significant adjustment in fiscal balances, compliance with the "Golden Rule" will remain a challenge facing Brazil for several years. Indeed, projections using the fiscal model (see Figure 5) suggest that already in 2019 the Golden Rule will not be met.

11. **Compliance with both fiscal rules is not possible without alleviating the rigidities affecting several primary spending categories and revenue earmarking mechanisms.** Under current laws, over 90 percent of the federal government's primary spending is considered mandatory.[12] Most of this is made up by rules-based transfers to other levels of government, civil servants' salaries, social entitlements and minimum spending requirements (Annex 3). Social security benefits are automatically indexed to the minimum wage, which in turn is indexed to (positive) GDP growth and inflation—resulting in a steady increase in social security expenditures. It is estimated that a one percent increase in the minimum wage results in a 0.11 percent increase of general government primary spending (and 0.17 percent in central government primary spending). Given that the average annual real increase of the minimum wage between the 2000 and 2016 was 4.8 percent, this raised primary spending of the General Government by about 0.5 percent per year (0.8 percent for Central Government). In this scenario, the recovery of GDP growth will trigger inertial expenditure increases that are inconsistent with the rules. Since important rigid spending

[9] Specifically, the Brazil's "Golden Rule" states that total borrowing cannot exceed capital expenditures, which are defined as the sum of debt amortization, financial investments and net acquisition of non-financial assets (physical investment).
[10] Paradoxically the implementation of the primary expenditure ceiling rule results in further reductions of capital spending that will make even more stringent the compliance with the Golden Rule.
[11] The law allows exceptional forms of financing, for instance, re-evaluation of international reserves held by the Central Bank to be accounted for as capital revenues, even if no reserves are sold (equivalent to R$116.7bn in 2016). Further, credit extended by the National Treasury to BNDES is accounted as financial investment and repayment of these loans in 2017 was used to amortize federal debt, generating increased capital expenditures, allowing compliance with the "Golden Rule.
[12] Further, the small, discretionary budget contains important priorities such as public investment in infrastructure and the flagship anti-poverty program *Bolsa Família*.

components, especially old-age entitlements, are bound to grow, total mandatory spending under current rules is expected to rapidly exceed the envelope set by the spending cap. Therefore, changes will need to be made to mandatory spending programs. Similarly, revenue earmarking affect more 50 percent of government revenues. As revenue earmarking rules introduce pro-cyclicality to government spending, they clearly make more difficult to keep spending growth frozen in periods of revenue growth. In fact, without removing the factors reigning the persistent increase of mandatory current spending, the adoption of the spending cap rule (of December 2016) will just bring another constraint to the already overdetermined and inconsistent government fiscal framework (see Annex 4). Further, it is unlikely to be sustainable and paradoxically may end up further undermining policy credibility.

POLICY OPTIONS

1. Pursue a balanced fiscal adjustment, not focusing only on expenditures

12. **Stabilizing the fiscal accounts is not optional: it is urgently needed to enable faster economic growth and remove the risk of macroeconomic crisis. This requires a package of fiscal measures amounting to at least 5 percent of GDP.** Given the size of the challenge it seems important to pursue all possible measures to deliver this fiscal adjustment, both on the spending and on the revenue side. As part of this it is critical to halt the source of the projected steady increase in primary spending, which is primarily the social security system. Several reform options were identified in the Brazil Public Expenditure Review (World Bank 2017) amounting to possible expenditure savings to the federal government of over 7 percent of GDP. In addition, several revenue enhancement measures are identified below which would amount to around 3 percent of GDP. Below we briefly mention the main policy options to cut spending and/or increase revenues. A more detailed discussion presented in Annex 6 and Annex 7, respectively.

13. **Revenue enhancement measures could make viable and accelerate the speed of adjustment; however, their use is inhibited by the expected contractionary effect on the economic recovery and significant political resistance to a higher tax burden**. Increases in taxation may delay the already slow recovery of private consumption and investment, in the absence of a deep overhaul of the tax system aimed at enhancing its quality. Given the strong expenditure rigidities, previous fiscal adjustment efforts were based on increases in the overall tax burden (including subnational taxes and social security contributions), which peaked at 35 percent of GDP in 2008-2010 (up from 25 percent in the 1990s). While the tax burden has decreased by 3 percentage points of GDP in the 2010s, the large public discontent with the effectiveness of government service delivery and with the size of the state (considered excessive), hinders actions to increase tax revenues. In fact, the Brazilian tax system is characterized by so many distortions and loopholes that it is possible to design a tax reform that is growth enhancing (due to allocative and efficiency gains) and has positive distributive impacts (see Policy Note on Tax Reform).

14. **The proposed options for revenue enhancement are focused on tax policy measures with positive efficiency and distributive impacts.** Specifically, about 3 percent of GDP could be raised by: reducing substantially tax expenditures (including to eliminate the tax expenditures in personal income tax; and phase out the of the payroll tax exemption[13]; and revise the Manaus Free Zone); increasing the tax rate of excise taxes on tobacco, alcohol and sweetened beverages, and expanding the excise taxes bases to high-caloric food; converting the CIDE fuel tax into an excise ecological tax; establishing a state piggy back (surcharge) on the federal personal income tax (which may enhance its progressivity effects and tax payers oversight by promoting collaboration between federal and state tax administrations)[14]. Finally, tax revenues

[13] Federal Law no. 13.670/2018 set that the payroll tax exemption will be extinct to all economic sectors by 2020.

[14] Personal Income Tax (PIT) is collected by subnational governments in the most important federations (for example, US and Canada), and it is recommended by the large majority of fiscal decentralization specialists as the best option to enhance the ability of subnational to mobilize tax revenues. PIT base has lower sensitivity than Value Added Taxes (VAT - origin principle) or Corporate Income Tax (CIT) to economic fluctuations, providing a stable source of revenue to the government. Given individual

may be raised while leveling the playing field between domestic and non-resident suppliers of digital services by corporate income taxation of digital platforms.

15. **On the expenditure side the main measures focus on the largest items in the public budget, namely pensions, wage bill and subsidies to the private sector (see Brazil Public Expenditure Review).** As mentioned, a comprehensive reform of social security is essential to halt the projected increase in the deficit of the social security system—which itself is at the root of the projected steady increase in primary spending. Other possible expenditure measures could include: reducing the civil service remuneration; rationalizing programs to support the private sector; de-linking social assistance benefits and non-contributory pensions from the minimum wage; and adopting other measures to improve the efficiency of public procurement, increasing cost recovery in higher education, reducing tax exemptions for private health insurance, and rationalizing social assistance and labor market programs.

2. Finetune the fiscal rules

16. **Compliance with the fiscal rules (expenditure ceiling rule and Golden Rule) in the next several years appears extremely challenging, suggesting the need to adjust the rules.** Other countries have adopted different types of fiscal rules which present advantages and disadvantages. A summary of international experience with fiscal rules is provided in Annex 5. Notably, many countries have binding rules which focus on the fiscal balance, thus allowing for the contribution of revenues to fiscal adjustment, or put a ceiling on the level of public debt. Some countries have rules that distinguish between different types of public expenditures (current versus investment), or more sophisticated rules which target the estimated budget balance that would result if output were at its long-term potential or the cyclically adjusted balance. A few have opted combinations of rules, for instance combining an expenditure rule with a debt ceiling or balance budget rules. In addition, good practice suggests the use of well-defined escape clauses, to allow for flexibility at times of economic crisis or to cope with exogenous shocks.

17. **It is paramount however that any changes to Brazil's fiscal rules should aim to make them tighter, and not postpone the adjustment.** Below we focus on options to revise the two main rules to make their implementation more automatic, such that if the government and congress fail to adopt the required adjustment, then a package of predetermined adjustment measures is triggered which by itself is able to gradually stabilize the fiscal accounts—and thereby increase the credibility of the fiscal consolidation path.

2.1 Finetune the primary expenditure ceiling rule

18. Strengthening the design of the expenditure ceiling rule by tightening the automatic correction mechanism would increase the credibility that the rule will deliver the fiscal adjustment required. The expenditure ceiling rule states that deviations from the rule in each year should be corrected by prohibiting increases in the federal government payroll due to adjustment of wages and salaries of the civil service, new recruitments or career reforms, and increases in subsidies and tax expenditures in the following year. However, these prohibitions can be challenged by other legal mechanisms.[15] More forceful

income distribution and regional disparities in Brazil, PIT piggybacking could benefit richer states and facilitate a more aggressive equalization transfer system as they will have an important revenue source to compensate their potential losses associated to stronger equalization grants.

[15] For example, the autonomy of the legislative and judiciary branches, public attorney office or court of accounts to increase salaries or allowances within their constitutional limits (defined in percentage of government net current revenues). In the same vein, some fiscal incentives and subsidies are automatically adjusted (and not discretionarily defined). For example, the exemption of the payroll tax (*Desoneracao da Folha*) or the Manaus Free Zone have rules defining benefits according to the number of employees in specific sectors, the amount of investments in capital goods or the amount of goods and services produced. Discounts of healthcare and education expenses on the personal income tax (PIT) is another point in case, with total expenditures not controlled by policy makers. Indexation to minimum wage of certain civil service categories. More importantly, increases in social

correction mechanism may regulate the suspension of some legally allowed or mandated upward adjustments on certain primary spending items.

19. **It would be desirable to introduce a package of harsher automatic correction measures if the expenditure ceiling is violated which is sufficient to stabilize the fiscal path.** The rule could be revised to envisage stronger automatic adjustment measures in case of violation of the expenditure ceiling in the previous year. The package of automatic corrective measures would need to have a clear legal basis such that its implementation cannot be challenged/halted. As an example, in addition to the freezing of nominal wages of the civil services and the freeze on new hiring, which are already envisaged under the teto, additional corrective measures could include: (i) increasing the minimum wage only by inflation[16]; (ii) increasing the employee contributions to the Federal RPPS to 14 percent and the employee contributions to RGPS by a similar proportional amount (i.e. an increase of 27% in contributions); and (iii) freezing the RGPS and RPPS federal pensions in nominal terms. Simulation of an alternative scenario in which the expenditure ceiling is breached in 2019, and this package of automatic adjustors are triggered starting in 2020 (and remain in place until reforms are adopted to comply with the expenditure ceiling), would result in a primary surplus by 2024 and would stabilize the level of debt by 2029 (Figures 1 to 3).

20. **Moving to a legally binding primary balance rule whose target cannot be amended easily within the fiscal year would allow for revenues increases to contribute to fiscal adjustment, but should only be contemplated in the context of tightening (not loosening) the 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. 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.

21. **A further adjustment to the rule, which does not dilute the objective to control and rationalize current spending, would be to exclude investment from the rule (which in this case will reign primary current spending).** The rule could be adjusted to remove capital spending from the calculation of the ceiling, which would protect investment spending and allow some space for countercyclical measures. In practice, the adjustment path of the primary current balance (the main source of fiscal disequilibria) would be almost the same, while the adjustment in the overall balance and overall level of debt would depend on the level of investment spending. Limiting primary current spending can also improve current savings and, consequently, help the federal government to comply with the golden rule.

2.2 Finetune the Golden Rule

22. **It is important to simplify and tighten the golden rule to focus it on the policy objective for which it was established, that is to avoid financing of current spending and ensure fiscal space for investments.** Specifically, it would be important to simplify the rule avoiding that certain categories of intra-government and off-budget transactions affect the compliance to the rule making it more aligned with the golden principle of public finance: you should not borrow to finance recurrent spending. Related to this, it would be also useful to introduce revisions to prevent the use of creative accounting.

benefits derived for indexation rules, which in quantitative terms could be much higher than adjustments in the federal payroll, subsidies or tax expenditures, are not included in the list of correction mechanisms to return to the spending cap rule.

[16] Increasing the minimum wage only by inflation is already allowed by the Art. 109, clause VIII, of the Transitional Constitutional Provisions Act (ADCT) of the Federal constitution.

23. **In addition, since compliance with the Golden Rule is all but impossible for the next several years, there is a need to introduce some correction mechanisms**. In the short term the government can propose a waiver to Parliament to authorize the government to borrow more than what is permitted by the rule. However, since Brazil is facing a structural problem which will prevent compliance of the rule for several years, it would be appropriate to strengthen the rule by introducing automatic adoption of politically challenging fiscal adjustment measures on current spending, if the rule is violated. Violation of the rule would automatically impose structural measures to control current primary expenditures, such as freezing civil servants' salaries in nominal terms, freezing new hire of civil servants, delinking of social benefits from minimum wage, imposing special contributions on civil servants' pensions, and freezing of all other primary current expenditures in nominal terms (with the possibility to protect key priority spending for instance in social assistance programs, health services and public security). The key objective would be to guarantee a substantial level of adjustment, while at the same time generating political support for better designed alternatives.

24. **A Constitutional Amendment to the Golden Rule has recently been proposed in the Congress along these lines.** The proposal envisages that when the Golden Rule is at 95% of its limit, the government will already be prohibited from raising mandatory expenses above inflation, creating jobs, granting more subsidies or tax and tax incentives. It will also need to present a plan to reduce expenses and increase revenues. If the golden rule is in fact broken, the harder adjustments begin, which include suspension of salary bonuses, cancellation of 40 percent FAT transfers to the BNDES, reduction of the number of hours worked by civil servants (with proportional wage cut) for up to 12 months, at least 20 percent reduction in political appointments (*Cargos commissionados e de confianca*), dismissal of civil servants who do not have a an open ended contract, increase by three percentage points in the social security tax rate for active and inactive civil servants or military servants, a 10 percent cut in benefits and tax exemptions for each year of non-compliance with the golden rule, among others. Further, when the rule is broken for three consecutive years, the government will be able to lay off servers with stability if it is found that expenditure on personnel and social charges has outpaced inflation.

3. Simplify the existent institutional fiscal framework

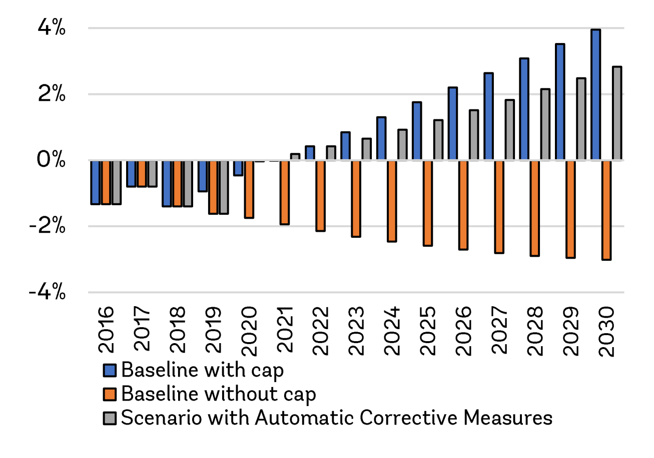
25. **The existent institutional fiscal framework is also not conducive to the transparent and predictable operation of a rule-based fiscal policy.** The fiscal rules can support the return to a sustainable fiscal path and make fiscal policy more predictable, enhancing the government's overall policy credibility, but their operation, compliance and effectiveness is influenced by the overall fiscal framework. The proliferation of rules, minimum spending levels, indexation and earmarking rules governing spending create inconsistencies with the control of current primary spending inherent in the expenditure ceiling and in the golden rule.

26. **Notably it would be important to increase the percentage of de-earmarking revenues under the Federal Revenue de-earmarking mechanism (*Desvinculacao de Receitas da Uniao*).** With the aim of decreasing the level of earmarking of the federal budget and gain flexibility to cut spending categories protected by earmarking mechanisms, in the early 2000s, the government created the DRU for a period of 3 years, a mechanism, which "de-earmarked" 20 percent of the earmarked federal revenues. The DRU has been renewed several years and in 2016 the percentage has increased to 30 percent and renewed until 2023. To further increase flexibility, the DRU could be increased to 50 percent and become a permanent mechanism rather than a temporary one that, to be renewed, entails difficult political negotiations in the Parliament. A more definitive option to be explored would be to fully de-earmark the federal budget and use a hold harmless clause by freezing in nominal terms the amount of revenues currently earmarked and fully releasing the revenue increases, enabling a gradual but fully de-earmarking of the federal budget. to avoid

27. **Finally, it would also be important to use accrual accounting for the spending cap rule**. The spending cap rule considers spending in cash terms which allows the possibility to comply with it carrying arrears for the next fiscal year or the use of the well-known fiscal pedaling to meet the cap. Cash basis accounting rather than accrual accounting may therefore encourage the generation of arrears and the use of extraordinary credits to keep compliance with the rule. In this regard, it is suggested to apply accrual accounting regime to monitor the compliance with the rule. To keep consistency, other fiscal indicators (such as the primary balance) should also converge to an accrual accounting regime. Weak enforcement devices and correction mechanisms inhibited by other regulations may also prevent the proper functioning of the rule. Finally, off-budget transactions and financial flows with other public-sector entities out of the scope of the rule may also negatively undermine transparency and credibility.

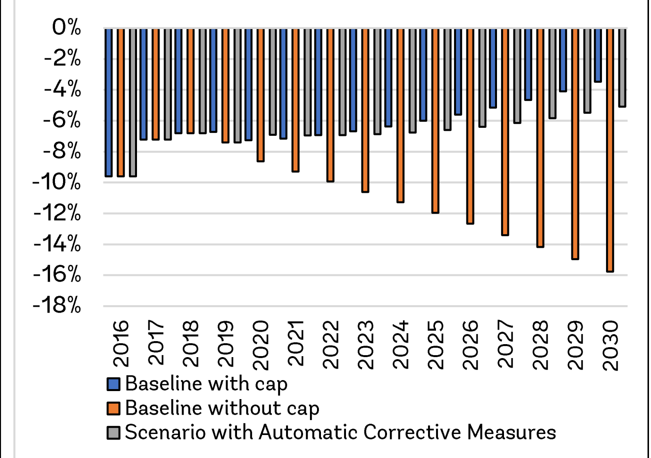
Simulation of: (i) baseline scenario (in the absence of reforms, and with "teto" being violated); (ii) scenario with adoption of the "teto"; (iii) scenario with "teto" being violated in 2019 and stronger automatic correction measures

Figure 1: Primary Balance projections, various scenarios, 2016-2030



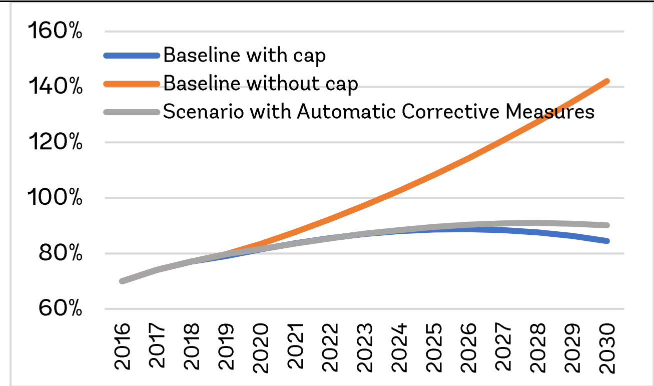
Source: Simulation using World Bank fiscal model

Figure 2: Overall Balance projections, various scenarios, 2016-2030



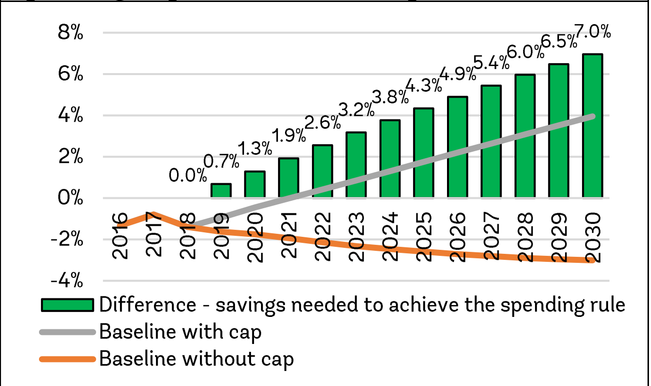
Source: Simulation using World Bank fiscal model

Figure 3: Gross Public debt projections, various scenarios, 2016-2030



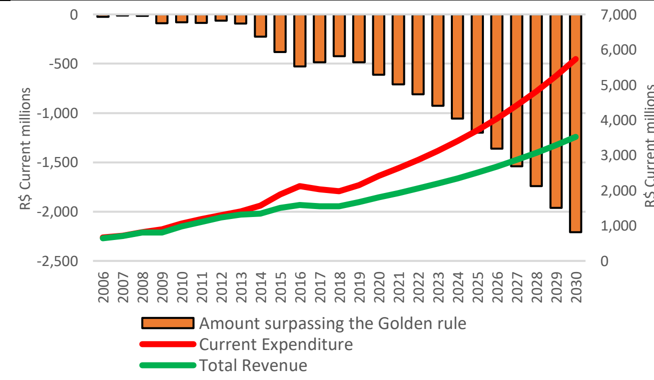
Source: Simulation using World Bank fiscal model

Figure 4: Cumulated fiscal adjustment in primary spending required under the cap, 2016-2030



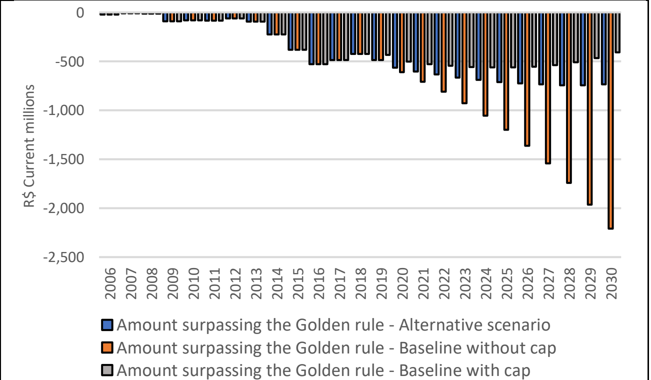
Source: Simulation using World Bank fiscal model

Figure 5: Projection of the Golden Rule, baseline scenario without cap, 2016-2030



Source: Simulation using World Bank fiscal model

Figure 6: Projection of the Golden Rule, various scenarios, 2016-2030



Source: Simulation using World Bank fiscal model

ANNEX 1: RECENT MACRO-FISCAL DEVELOPMENTS

28. **Since 2014, Brazil's government finances have severely deteriorated with increasing deficits and an explosive debt trajectory.** The delay in withdrawing the countercyclical fiscal stimulus adopted to weather the effects of the Global Financial Crisis in 2009-10, coupled with a GDP growth slowdown in 2011-2014, followed by a strong recession in 2015-2016 and a weak recovery in 2017, led to tumbling fiscal balances and to an accelerated debt accumulation. The primary balance of the federal government shifted from surpluses of around 1.5 percent of the Gross Domestic Product (GDP) in 2010-2013 to deficits averaging 1.8 percent in 2014-2017. With lower primary balances and higher interest payments, overall deficits increased from around 3 percent of GDP in 2010-2013 to deficits averaging 7.5 percent in 2014-2017. As a result, the federal government gross debt escalated from 51.5 percent of GDP in 2013 to 74 percent in 2017. Fiscal distress situations have been also observed at the subnational level. While SNGs' financial debt has not grown substantially (it rose from 11.5 of GDP in 2011 to 13.0 in 2017) due to the lack of access to credit market, many SNGs have faced severe fiscal distress due to liquidity problems (large financing gaps), resulting in accumulation of arrears with providers and with their civil service. In response, the federal authorities agreed to restructure States' debt service profiles in 2014 and 2016.

29. **While the economic downturn and the fall in government revenues accelerated the fiscal deterioration, the unabated increasing trend of government spending has been the underlying driver of the unsustainable fiscal trajectory**. From 2011 to 2014 tax revenues declined by 0.6 percent in real terms, and because of the downturn of 2015-16, tax revenues are 7 percent lower than its 2014 levels. Higher unemployment and informality also reduced social contributions by 4 percent between 2014 and 2017 (they had grown 7 percent in 2011-2014). In the opposite direction, government primary current spending has not interrupted its increasing trend seen in the last decades. Current primary expenditures grew 17 percent per year in real terms between 2011 and 2014 (they grew 60 percent from 2006 to 2014), and another 6 percent between 2014 and 2017 (68 percent from 2006 to 2017). Indeed, increasing rigidity associated to the permanent growth of mandatory recurrent spending and its indexation rules—especially social-security benefits—constitutional revenue earmarking mechanisms to protect spending in specific sectors—in particular education and health—and other largely inflexible expenditures in the short run—wages and salaries—have been the underlying factor behind the current fiscal distress both at the federal and subnational government levels.

ANNEX 2: BRIEF DESCRIPTION OF THE FISCAL MODEL AND ASSUMPTIONS

30. **The fiscal projections included in this spending review were created using a complex fiscal model.** The model projects all the main elements of revenue and expenditure for all three levels of government (federal, state and municipal) by linking them to a set of economic variables. The projections for economic variables draws on World Bank growth and commodity price forecasts, United Nations population forecasts and market consensus on financial variables. They reflect expectations as of early March 2017.

31. **Broadly, the projections assume a recovery of the Brazilian economy between 2017 and 2019, with real GDP growth rising to 2.4 percent.** Inflation is assumed to remain at the target of 4 percent over the projection period. Interest rates are expected to fall, but remains relatively high in real terms (at 5 percent) under the base case, consistent with experience. The minimum wage is expected to continue to be adjusted by the current formula (past year inflation and real GDP growth of the year before that).

Table A1.1: Modeling of Fiscal Variables

Fiscal variables	Explanatory Variables
Revenues	
RGPS, Other Contributions, IRPF, Salário Educação	Payroll of the private sector
IRPJ, CSLL, Cofins, PIS/PASEP, IOF, CIDE, Dividends	GDP growth
Subnational VAT (ICMS)	Payroll of private sector payroll and GDP growth
Property Taxes (Ex: ITR)	Inflation and population growth
Expenditures	
Personnel	Payroll of Federal Government
Goods and Services	Inflation (IPCA) and population growth
Subsidies	GDP growth
Transfers to State and Municipalities	Earmarking rules on tax revenues
Private Sector Social Security benefits	Inflation, minimum wage, growth of the elderly population (>60)
Unemployment insurance, Abono Salarial, social pensions (BPC)	Minimum wage and Population growth
Bolsa Família	Inflation (IPCA)
Public Sector Social security	Payroll of the federal government and growth of the elderly population (>60)
Interest payments	Debt stock, exchange, interest rate, spreads

Table A1.2: Key economic assumptions underlying the fiscal model

Variable	2017	2018	2019	2020	2021
Real GDP growth	0.3%	1.8%	2.3%	2.3%	2.3%
Inflation (IPCA, EOP)	3.6%	4.0%	4.0%	4.0%	4.0%
Interest rate (SELIC, average)	10.10%	6.63%	7.13%	8.50%	9.00%
Exchange Rate (R$/US$, average)	3.18	3.30	3.48	3.65	3.80
Minimum Wage (R$, nominal)	937	954	1002	1061	1130
Payroll Federal Government	6.0%	6.0%	6.0%	5.8%	5.8%
Payroll Private Sector	1.0%	1.8%	2.5%	2.4%	2.3%
Oil Price (US$ / barrel, Brent, average)	55	60	61.5	62.9	64.5
Non-Oil Imports (US$ Billions)	157	173	195	216	240
Population Growth	0.77%	0.73%	0.70%	0.67%	0.64%
Population >60	4.14%	4.12%	4.10%	4.08%	4.04%

Source: World Bank staff projections/assumptions

ANNEX 3: DRIVERS OF EXPENDITURE GROWTH, BUDGET RIGIDITIES AND INEFFICIENCY

32. **A major reason for the steady fiscal pressure is the indexation of large parts of federal primary expenditure to GDP, revenues or the minimum wage.** Expenditure is subject to automatic increases due to indexation. For instance, the minimum wage determines a large part of pension benefits (due to the minimum pension being set equal to the minimum wage) as well as social programs (benefits under the largest social assistance program, BPC, are also set to the minimum wage).

Table A4.1: Revenue linkage rules

Federal Revenues	Rules
IR (income tax) 3.47% of GDP in 2015	21.5% for the States' Participation Fund (FPE), 10% for exporting states, 24.5% for the municipalities' participation fund (FPM). Of the remainder, 18% for education (MDE), the rest (about 36% of total) becomes ordinary federal revenue.
IPI (tax on industrial products) 0.80%	21.5% for the States' Participation Fund (FPE), 10% for exporting states, 24.5% for the municipalities' participation fund (FPM). Of the remainder, 18% for education (MDE), the rest (about 36% of total) becomes ordinary federal revenue.
IOF-ouro (tax on financial operation on gold)	30% returned to the state of origin, 70% to the municipality of origin
IOF (tax on financial operations, excluding gold) 0.58% of GDP in 2015	18% earmarked for education (MDE).
Imposto de Importação (Import tax) 0.65% of GDP in 2015	18% earmarked for education (MDE).
ITR (tax on rural properties) 0.02% of GDP in 2015	Most of this is returned to the municipalities where the tax is raised. Of the remainder, 18% is destined for the MDE, the rest becomes ordinary federal revenue.
COFINS and CSLL (taxes on corporate profits) 4.32% of GDP in 2015	20% delinked (DRU). The remainder is destined to the social security budget.
CIDE-Combustíveis (fuel tax) 0.05% of GDP in 2015	20% delinked (DRU). Of the remainder, 71% is used by the Federal Government to pay subsidies for ethanol fuel and natural gas as well as environmental projects related to the oil and gas industry and transport infrastructure. 21.75% are transferred to states for transport infrastructure and 7.25% to the municipalities for the same purpose.
Pis/Pasep (payroll tax) 0.73% of GDP in 2015	20% delinked (DRU). 80% to the workers' support fund (*Fundo Amparo ao Trabalhador*, FAT) which pays unemployment insurance (*Seguro Desemprego*) and wage subsidies (*Abono Salarial*). The FAT is also used as investment capital for BNDES.
Salário Educação (payroll tax for education) 0.32% of GDP in 2015	100% to the National Education Fund (FNDE, *Fundo Nacional de Desenvolvimento da Educação, do Ministero da Educação*).
CPSS (public sector payroll tax)	100% for public sector pensions
Royalties and special participation for oil and gas	Resources from areas commercialized before December of 2012: 50% for the Social Fund (health and education); resources form areas commercialized after December of 2012: 75% for education 25% for healt
Social Security Contributions 5.34% of GDP in 2015	100% to social security fund (Fundo do Regime Geral de Previdência Social)

33. **Minimum spending requirements impose further rigidity.** Beyond indexation of individual benefits, rigidities and structural spending pressures also originate from minimum spending requirements. In particular, before the adoption of the new fiscal regime (EC 95/2016), minimum spending on health and education was defined as a share of tax revenues. Since revenues tend to increase with economic growth and have grown significantly as a share of GDP in recent decades, this implied a structurally increasing and pro-cyclical spending mandate, unrelated to drivers of spending needs, such as the number of students in public schools. These spending minimums have now been adjusted as part of the new fiscal regime and future adjustment in the minimums will be by inflation only, in line with the overall expenditure ceiling.

34. **Constitutional transfers to states and municipalities as well as earmarking to special funds and spending purposes greatly reduces the Federal Governments discretion over its resources.**

Ordinary taxes (*impostos*) leveled by the Federal Government are subject to revenue sharing with States and Municipalities. To raise revenues for exclusive federal use, the Federal Government has introduced several "contributions" (*contribuições*, de-facto taxes). However, these are destined for specific purposes, such as social security or transport infrastructure. To gain more budgetary flexibility, the government in 1994 introduced the delinking of federal revenues (*Desvinculação de Receitas da União*, DRU) which frees up 20 percent of revenue from contributions (as well as some smaller revenues) for general budget use.

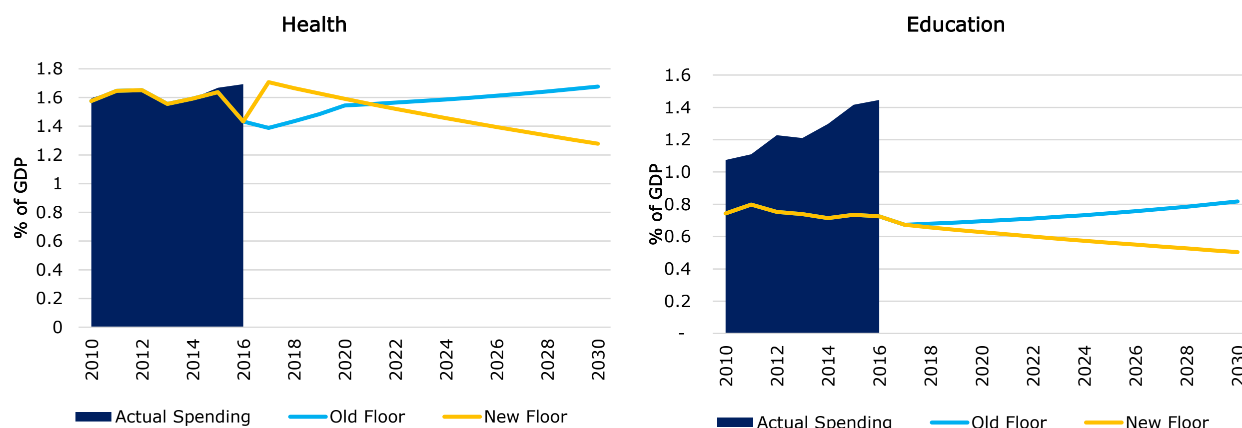
35. Fragmentation across programs, levels of government, budget and non-budget sources results in efficiency loss from overlaps and lack of coordination. As shown in the sectoral chapters, spending in key areas is spread over three levels of government, many programs and often comes from various (on and off budget) funding sources, without those elements being coordinated. This fragmentation makes effective monitoring and policy evaluation difficult and in many cases results in inefficiency and overlap. Public expenditures in several areas would benefit from fundamental reform aimed at better aligning programs and expenditures with policy objectives.

36. Federal and subnational fiscal policy interact in important ways. Federal fiscal policy affects subnational governments' finances, which in turn constitute an important fiscal risk for the federal government. Federal rules on pensions, health, and education dictate much of subnational spending. A good example is the salary floor for teachers, which is set annually by the federal government and obliges all states to pay the teachers in their public school system a specific wage, without providing the resources to do so. Federal tax policy, such as tax exemptions granted between 2011 and 2014, also have consequences for subnational finances, as these taxes are subject to revenue sharing and tax breaks awarded by the federal government reduce the budget transfers that subnationals receive. On the other hand, solvency risks of the subnationals, such as the fiscal crisis in Rio de Janeiro, present a contingent liability to the federal government as states might default on their debt to the federal government or receive bailouts.

Rules for health and education under the spending cap

37. The Constitutional amendment introducing the ceiling on federal primary expenditures (EC 95/2016) also changed the indexation of the federal minimum spending requirements on health and education. Health and education spending used to be set as a share of revenues but will now depend on inflation adjustment, freezing spending in real terms in line with the overall spending cap. This means that there is no pressure from these minimums to demand greater shares of capped spending. However, as health and especially education expenditures have been above the ceiling in recent years, there is space for real spending cuts in these areas, especially in education the floor is almost half of the current education budget.

Figure B2.1: Spending floors Vs actual spending in health and education



Source: Simulation using World Bank fiscal model

ANNEX 4: BRAZIL'S FISCAL FRAMEWORK

38. **Fiscal Responsibility Law (FRL).** The FRL of 2000 sets the framework and procedures for fiscal management and the budget process.

39. **Primary Balance Target.** The FRL introduced overall targets (primary balance) and limits on the wage bill, debt and guarantees for all levels of government. The primary balance targets are set every year at the beginning of the budget process. The primary balance target is specified for the current year and, indicatively, for two additional years. The debt ceiling for subnational governments has been enacted; however, a similar provision for the central government debt has yet to be approved by the Senate.

40. **The Brazilian Golden Rule.** The Golden Rule is a device inscribed in the Federal Constitution of 1988 that prohibits the governments of the three administrative levels (federal, state and municipal) from performing credit operations that exceed the amount of their capital expenditures. This device is inspired by international practices, such as Germany, which adopted a variant of the Golden Rule between 1969 and 2009, as well as being enshrined in the traditional literature of public finance. The basic principle of the rule is to establish a dual budget that separates capital expenditures, which can be financed through credit operations, in relation to current expenditures, for which the financing alternative through debt is prohibited. The separation of budgets is motivated by two basic objectives: (i) to establish a rigid control for the current budget that must be at least balanced; and, at the same time, (ii) provide flexibility for the implementation of investments that strengthen public assets and generate benefits for future generations.

41. **Public Expenditure Cap (PEC).** In order to reverse the deterioration in the public finances, in December 2016 Congress approved a constitutional amendment imposing a ceiling on central government noninterest expenditures starting in 2018, defined as the 2016 primary expenditures indexed each year to the rate of consumer price inflation of the previous year (measured in June). The constitutional amendment also establishes that: (a) The rule on expenditure increase is mandatory for ten years, to be renewed for another ten years, which means that primary expenditure in real terms will be frozen for at least ten years. (b) The rule excludes from the ceiling the revenue-sharing transfers to subnational governments, other mandatory transfers, Electoral Justice's expenditures during elections, capitalization of public enterprises and extraordinary credits associated to natural disasters. (c) The rule is on expenditures on a cash basis accounting, which introduces the issue of payments of arrears (RAP) from previous years. (d) Deviations from the rule in a year will be corrected by prohibiting increases in compensation of employees, subsidies and tax expenditures in the following year. (e) The rule includes escape clauses for natural disasters, war, and civil unrest, however there are no details on the procedures for initiating and ending these escape clauses.

42. **Combination of fiscal rules.** According to the authorities, given the current high debt levels, the PEC rule will need to be combined with seeking the generation of robust primary balances at least in the short run so as to favor a faster reduction of debt than the one that is projected by the exclusive adoption of the PEC rule.

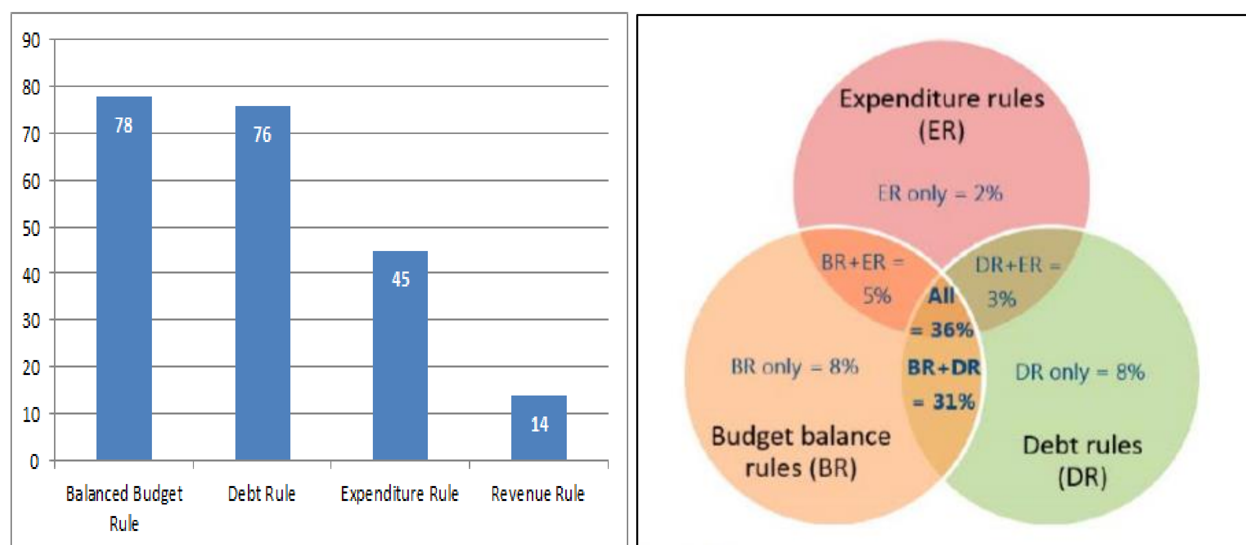
43. **Detachment of Union Revenue (DRU).** Also, in 2016 Congress approved a legal instrument, the DRU, releasing the earmarking on 30 percent of federal taxes through 2023, which should help in meeting the expenditure ceiling.

44. **Independent Fiscal Institution (IFI).** The IFI was created in 2016 and is based in the Senate. It has a three-member board and three permanent staff members. Its remit includes regular analysis of the government's fiscal performance; elaboration of medium-term forecasts of macro parameters, fiscal indicators and fiscal impacts; and advice to the Congress on fiscal issues.

ANNEX 5: INTERNATIONAL EXPERIENCE WITH FISCAL RULES: OPTIONS FOR BRAZIL

45. **The expenditure rule adopted in Brazil is not the only type of rule, or even the most common adopted internationally.** Other types of rules focus on debt control, budget deficit, and revenues. A study published by the IMF in March 2017 ("Fiscal rules at glance") compared these rules in 96 countries since 1985 (Figure B2). Models that limit the budget outcome (primary and/or overall) and those that restrict public debt are clearly dominant. A minority of countries chose to limit the increase in the level of expenditures. Of the 96 countries surveyed by the IMF, only 14 of them (less than 16 percent of the total) adopted a rule which limits the real growth of public expenditures. Further about 79 percent of these countries also apply a ceiling on public debt. The practice of combining the two rules is common among emerging economies. Studies have already concluded that this improves the effectiveness of controls aimed at the sustainability of public accounts in the short and long term. In the few cases where it is sought to limit the expansion of expenditure in real terms, it is possible to note different methodologies to define the control system.

Figure A3.1: Fiscal rules adopted in 96 countries since 1985, by type of rule (LHS) and combinations of rules (RHS), (2015 data)



46. **Some rules consider the economic cycle, others differentiate the nature of the expenditures (current versus investment), others focus on the fiscal balance, and several allow for escape clauses**. In Australia, since 2009, real expenditure growth cannot exceed 2 percent, but if economic growth is above potential GDP, and the fiscal surplus is above 1 percent of GDP, the rule is relaxed. Potential GDP is also a benchmark in Croatia, where since 2014 real expenditure growth is limited to the same rate as potential GDP (unless the excess is financed by specific measures). The rules also often have a relatively short life span: For instance, France, Finland and the Netherlands revise the rule every four years. Incidentally, the Netherlands also illustrates how the scope of the rule changes over time: unemployment insurance benefits and social assistance were excluded from the ceiling in the 2009/2010 biennium. Denmark, Iceland, Kosovo, Peru and Mexico opted to limit only the expansion of current spending. Studies also point out that such rules can undermine public investment. Escape clauses have been shown to reinforce the stability of the rules. The Peruvian case is interesting: the increase in current expenditures has been limited since the year 2000, but the rule can be suspended for three years if there is low growth or Congress decrees emergency. Thus, in 2013-2014, Peru applied only the rule limiting the fiscal deficit.

Source: IMF, Fiscal Rules at Glance, 2017; available at: http://bit.ly/2cNFwIU

ANNEX 6: AGGRESSIVE REFORMS TO REDUCE PUBLIC EXPENDITURES

47. **Far reaching expenditure reduction measures are urgently needed to ensure compliance with the fiscal rules.** The Brazil Public Expenditure Review provides a detailed menu of possible savings in federal primary current expenditures (Table X and Figure X). Here is a summary of the main measures:

a) *Eliminate the deficit of the social security system:* Due to its size and persistent rising trend, social security benefits are the most important source of disequilibria and rigidity of the federal budget (see Policy Note on Social Security). Reduction of social benefits which in turn depends on a pension reform for both the civil service (RPPS) and private sector (RPGS) pension systems. Pension reform measures include the increase of the minimum age of retirement to 65 for all, the elimination of length of contribution retirement, equalization of access rule and benefit formula for female/male workers, urban/rural and public/private workers, elimination of integrality of survivors' replacement rates, pensions, increase in the contributions of the civil service to the RPPS regimes, among other parametric reforms[17].

b) *De-link social assistance benefits and non-contributory pensions from the minimum wage:* Other non-contributory pensions and social assistance programs have exhibited high growth rates due to its link to the minimum wage which was aggressively increased in the last decade. To keep constant in real terms these spending categories it will be important to release the indexation of pension and social assistance benefits to the minimum wage or alternatively replace the minimum wage readjustment formula to preserve it in real terms.

c) *Reducing the civil service remuneration:* While the size of the Brazilian civil service is not large by international standards, controlling for education, the level of wages of federal civil servants is more than 90 percent higher than in the private sector. The reduction of these exceptionally high wage premiums for federal civil servants may contribute to the fiscal consolidation and can be obtained by freezing nominal remunerations for a defined period (4 to 6 years). An important component of the civil service remuneration are the allowances for children daycare, food and housing (this last at the Judiciary). The allowance for children daycare (*Auxilio Creche*) per child varies from 470 BRL (Executive) to 720 BRL (Judiciary), around four times the befit received by household under the cash transfer program of 178 BRL (Bolsa Familia). The food allowance amount 460 BRL and the housing allowance for the Judiciary members more than 4,000 BRL. The first best option would be their elimination. Other option would be to at least include these allowances in the taxable income of the civil service. These allowances added to the vacation (*Auxilio Ferias*) and Christmas (*Decimo Terceiro*) bonuses, represent about 30 percent of the total remuneration of the civil service that is not included in the tax base of the PIT which implies a revenue loss of around more than 0.1 percent of GDP.

d) Rationalizing programs to support the private sector is a further priority reform area to ensure compliance with the rule. ……………..

e) Other measures are possible to improve the efficiency of public procurement, increase cost recovery in higher education, reduce tax exemptions for private health insurance, and rationalizing social assistance and labor market programs. All the measures are politically difficult.

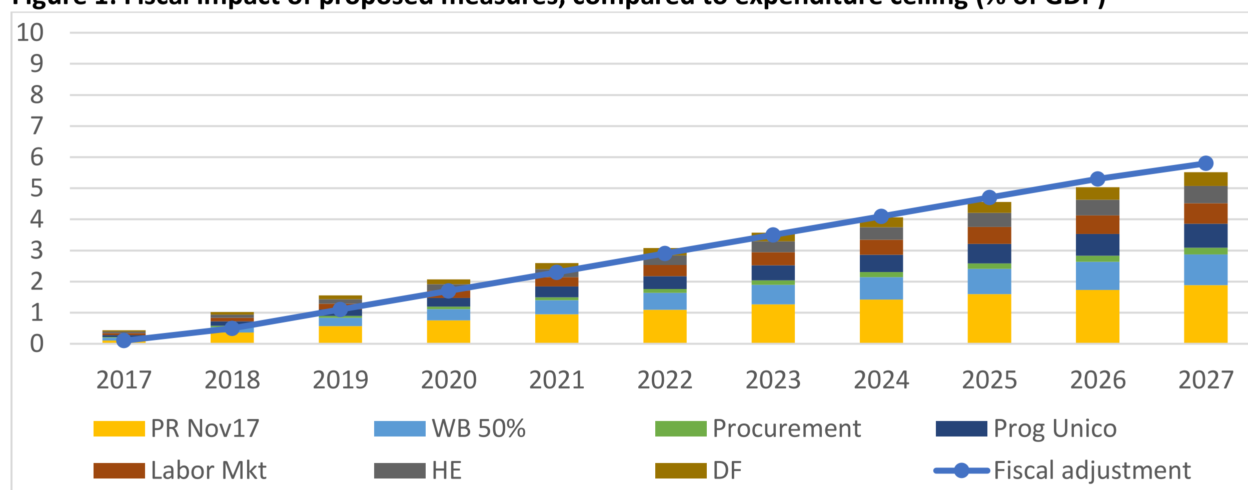
[17] The policy note on the Social Security system provides more details and estimations of the effects of these measures.

Figure 1: Expected fiscal impact of proposed measures (cumulated by 2026, as % of GDP)

Setor	Medidas	Economia potencial até 2026 (% do PIB)
Previdência	Reforma do sistema previdenciário (conforme negociada no Congresso em maio de 2017)	1,8%
Massa salarial	Diminuição pela metade do prêmio salarial dos servidores públicos federais em relação ao setor privado	0,9%
Aquisições Públicas	Otimização dos procedimentos para bens e serviços selecionados	Até 0,2%
Assistência Social	Novo programa integrado de assistência social (fusão BPC, aposentadoria rural, Salário-Família e BF).	Até 0,7%
Mercados de Trabalho	Reforma do Abono Salarial e do Salário-Família	0,01%
	Reforma do FGTS e do Seguro-Desemprego	0,6%
Saúde	Melhoria da eficiência dos profissionais de saúde	0,09%
	Expansão da cobertura da atenção primária à saúde (de 65% para 100%)	0,03%
	Melhoria da integração entre atenção básica e avançada	0,12%
	Melhoria da eficiência hospitalar	0,05%
	Remoção dos subsídios tributários federais para seguros privados de saúde	0,33%
Educação	Eliminação da ineficiência no ensino fundamental em nível municipal	0,5%
	Eliminação da ineficiência no ensino fundamental em nível estadual	0,3%
	Eliminação da ineficiência no ensino médio em nível estadual	0,2%
	Ensino superior federal	0,5%
Programas para o desenvolvimento do setor privado	Reforma do SIMPLES (idealmente como parte de uma reforma tributária mais ampla)	Até 1,2%
	Eliminação da Desoneração da Folha	0,4%
	Reforma do Inovar-Auto	0.03%
	Reforma da Zona Franca de Manaus (para uma alternativa menos distorciva e menos custosa)	Até 0,4%
Total		**8,36%**

Source: World Bank, Brazil Public Expenditure review, 2017

Figure 1: Fiscal impact of proposed measures, compared to expenditure ceiling (% of GDP)



Source: World Bank, Brazil Public Expenditure review, 2017

ANNEX 7: INCREASING TAX REVENUES BY IMPROVING THE QUALITY OF THE TAX SYSTEM

48. The proposed options for revenue enhancement are focused on tax policy measures with positive efficiency and distributive impacts. Taxation in Brazil is considered not only high but also highly distortive, with indirect cumulative taxes, unbalanced tax distribution burden across sectors, tax bases explored by more than one tax while other tax bases are unexplored. Thus, extracting additional resources from the economy is increasingly costly in terms of economic efficiency. In addition, as the system strongly relies in indirect taxes, its income distribution effects are regressive. In this context, proposals for tax revenue increases over a strongly inefficient tax system are considered inappropriate. However, the suggestions below go in the opposite direction, they are expected to improve the quality and fairness of the system while having a considerable tax revenue increase potential.

49. Reduce substantially tax expenditures. According to the Secretariat of Economic Policy at the Ministry of Finance, federal tax expenditures amounted 4.5 percent of GDP or 20 percent of the federal government budget in 2015-16. Brazil's extensive tax-expenditure regime include exemptions, deductions, deferrals, and preferential rates applied to specific activities or types of taxpayers. Below some preliminary options include:

a) Due to its efficiency and distributional impacts, it is proposed to eliminate the tax expenditures associated to the personal income tax. Proposed measures include: (i) the reduction of the of threshold income level for exemption which correspond to 1.5 times the country's per capita GDP, a relatively high level in international perspective; (ii) freeze nominal values for the discounts on private education and health care expenses; and (iii) tax allowance components of civil service staff remunerations at the three branches and three levels of government. The estimated savings effect amount 0.2 percent of GDP

b) Phase out the of the payroll tax exemption (*desoneracao da folha*). In 2016, this tax expenditures amounted 0.3 percent of GDP. To reduce the tax wedge for low income earners, authorities may explore the establishment of a negative income tax as a employment subsidy.

c) Other tax expenditures could be revised including the Manaus Free Zone and other free trade zones that represent 0.4 percent of GDP, the tax simplification program (Simples) corresponding to 1.2 percent of GDP, other tax exemptions for industry (PSI, Inovar Auto, etc.) amounting 1 percent of GDP.

50. **Establish a state piggy back (surcharge) on the federal personal income tax may enhance its progressivity effects and tax payers oversight by promoting collaboration between federal and state tax administrations.** The equalization impact of the country's taxation system is modest. The reliance on indirect taxation and the limited progressivity of direct taxes explain the low distributional impacts of the tax system. Piggybacking the federal PIT with a state surcharge may enhance the equalizing effects of direct taxes. At the same time, a state-level piggy-back is possibly one of the best options to expand subnational tax bases enhance alternative for a state level administration and is in fact the most widely used across the world. Federal and unitary countries use a PIT surcharge for financing their state and local governments, among them Canada, Switzerland, Spain, Italy and Korea. Levied on the basis of the residence of taxpayers, surcharges are consistent with the benefit principle and not exported to other local jurisdictions. With reasonably low state tax rates, they can generate substantial revenues, given the size of the (potential) tax base. Giving the state governments piggybacking in a potentially increasing tax base, would generate incentives for the states to support a better exploitation of the tax base. This could be through sharing information between the Federal Tax Office and the state tax administrations, to the mutual benefit of the two levels of government. It could also provide political support for substantially reducing deductions and exemptions.

51. Increase tax rate of excise taxes on tobacco, alcohol and sweetened beverages, and expand excise taxes bases to high-caloric food. Seeking to reduce the incidence of diseases associated to the consumption of these goods it is suggested increases the rates of specific taxes on tobacco and alcoholic and non-alcoholic sugar-containing beverages (corrective taxes). These taxes are intended to discourage the consumption of goods that have a negative impact on the health of the population and that generate high costs considering the substantial financial resources governments allocate to the public healthcare system to treat diseases associated to the consumption of these goods. There is a vast literature on the effects of taxes on the consumption of tobacco and alcohol that shows that excise taxes are successful tools in reducing consumption of these goods. Excise taxes on tobacco and alcohol are found to pass through to prices to a large extent, often even increasing the price more than one for one with the tax Sugar-sweetened beverage (SSB) taxes are much more recent, and are used in a limited number of countries including several US states, Norway, Australia, France, Finland, Hungary, France. In Latin America, Mexico, Chile and Colombia have recently introduced sugar-beverage taxes and taxes on high caloric content. In the case of Chile, estimated revenue effects of the excise taxes on tobacco, alcohol and sugar-sweetened beverages are of the order of 0.2 percent of GDP. While excise on consumption are deemed regressive as poorest families tend to allocate larger shares of their budgets to purchase these goods, as these taxes discourage their consumption, some of the most adverse effects, including higher medical expenses, added years of disability and lower life expectancy would be reduced, and their overall effect may become positive.

52. **Convert CIDE into an excise ecological tax.** As part of the government efforts to prevent fluctuations, CIDE has been adjusted to smooth the impact of changes in the international reference prices and exchange rate on domestic retail sales prices. Nonetheless, stabilizing domestic prices comes at high fiscal and efficiency costs. Final domestic sales prices for gasoline and diesel are administratively determined, and any difference between the final sales price and the underlying international price have been reflected in variations in CIDE or on PETROBRAS income. In recent years the revenue foregone by not fully passing on international price fluctuations to domestic consumers has been substantial. In addition, it incentivized the fuel consumption, including air pollution, traffic congestion, and greenhouse gas emissions. Converting CIDE into a fixed excise tax on gasoline and diesel while allowing its sales price to vary with international market conditions would enhance efficiency as it will enable to reflect its opportunity costs while generating additional revenues amounting around 1 percent of GDP[18]. This would eliminate the persistent subsidies that have been generated in the past due to the domestic pricing regime. In addition, this proposal has positive effects on income distribution as the current system of energy subsidies accrue largely to the richer segments of the population.

53. **Finally, tax revenues may be raised while leveling the playing field between domestic and non-resident suppliers of digital services by on corporate income taxation of digital platforms.** Given that countries have had difficulties taxing digital services companies, tax policy measures targeting the digital economy is being hotly worldwide and there is no international consensus on how to address tax policy challenges posed by the development of digital services activities. The OECD/G20 prepared a Base Erosion Profit Shifting action plan in 2015 and the European Commission presented a Digital Tax Package that includes an interim equalization tax on turnover of digitalized companies intended to address a disparity in tax treatment between foreign and domestic businesses where the foreign business had a sufficient economic presence in the country. In addition, the OECD prepared guidelines on VAT collection mechanisms that may be adopted by Brazilian state governments on e-commerce and services provided by digital platforms taxed by the ICMS (Uber, Netflix, Airbnb and others).

[18] Excessive price volatility may require more symmetric smoothing mechanisms. For example, Chile has established a Mechanism for Stabilizing Fuel Prices (*Mecanismo de Estabilización de Precios de los Combustible,* MEPO) based on a fuel excise tax with both a fixed and a variable component. Unlike the Brazil's policy, which adopts variations in CIDE, to smooth international prices movements, the variable component of the MEPO includes both discounts and surcharges while the fixed component ensures positive tax collections.

54. **Revenue-enhancing tax measures may frontload the fiscal consolidation and the stabilization of debt at a lower level than the projected with the simple adoption of the spending rule.** Estimating an accumulated revenue increase of 3 percent of GDP to be obtained between 2019 to 2012 while keeping the spending rule governing the primary spending by implementing the expenditure reforms proposed above, the generation of positive and higher primary balances will be anticipated to 2021, the increasing debt trend is projected to be curbed by 2024 at 80 percent of GDP falling to 72 percent of GDP in 2027 and continue to fall to 65 percent of GDP by 2030. The revenue increase will ease fiscal pressures and broad fiscal space for higher investments. Assuming that investments are excluded from the primary spending cap, this broader fiscal space may also facilitate the compliance with the fiscal rule.