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## BRAZIL

# Improving Fiscal Circumstances for Growth\*

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### INTRODUCTION

**Why has Brazil not been able to grow faster for an extended period of time?** Long-run real economic growth for Brazil seems stuck around 2-3 percent per year (2.4 for the period 1980-2004), in contrast with other middle-income countries (e.g. China (9.8%), India (5.8%), and Chile (5.1%)). Although Brazil experienced rapid annual average economic growth during the late 1960s and 1970s (8.5 percent), domestic and international events led to much weaker growth in the decades that followed.<sup>1</sup>

**Fiscal circumstances in Brazil are a key constraint to faster and more robust economic growth.** In part, this is due to accumulated public sector deficits in earlier periods that are represented in Brazil's persistently high net public sector debt (currently about 50 percent of GDP). During the 1980s and mid-1990s high debt was associated with debt crises and hyperinflation. Several attempts to control inflation failed, until the 1994 Real Plan. Moreover, to inhibit the accumulation of debt, and to promote economic confidence in capital markets, two successive administrations have pursued primary fiscal surplus targets (4.25 percent of GDP in 2006). However, the quality of fiscal adjustment has been poor.

**Legally mandated spending has increased rapidly, and without significant reform this type of spending is projected to become explosive.** An important part of this mandatory spending is tied to the 1988 Constitution. Less than 20 percent of the budget is discretionary.

Moreover, other policy decisions, such as minimum wage increases, have aggravated increased current spending. Rising minimum wages increase spending under mandatory programs, especially social security.

**Given the fiscal target and constraints on current spending, the most important part of the fiscal adjustment in recent years has been the increase in tax revenue, reaching about 38 percent of GDP in 2005.** High taxation provides disincentives to investment, and encourages tax evasion and informal sector growth, which in turn leads the authorities to search for additional tax revenue on a narrower set of formal activities. Thus, there is a vicious cycle of ever increasing mandated spending with increased taxation to meet the fiscal target. However, further tax increases would be difficult to implement and enforce.

**Budget rigidity, especially revenue earmarking, restricts policy action to resolve the fiscal conundrum.** Revenue earmarking is linked to transfers to sub-national governments, social sector spending, and specific taxes to cover the social security deficit. The federal government is required under the 1988 Constitution to share 47 percent of its tax revenue (personal and corporate income taxes, and taxes on industrial products) with lower levels of government. These transfers represent about 5 percent of GDP. Social sector spending is mandated as a share of current revenue.

**Total public investment since 1998 has dropped by more than 2 percent of GDP<sup>2</sup>.** Private investment has also been falling during this period. The drop in investment was caused by fiscal constraints and high



\* - This note is based on the World Bank Report (2007) Brazil: Improving Fiscal Circumstances for Growth (BR-36595).

interest rates (caused in turn by the high level of public debt and associated risks, weak regulatory environments, and public sector distortions in the domestic financial market).

**Spending levels are high relative to the quality of public services, pointing to weaknesses in expenditure management.** These weaknesses adversely affect public investment and spending on public services. Thus, increasing public investment alone will not accelerate economic growth; measures are also required to address expenditure management shortcomings.

## FIVE STYLIZED FACTS

### 1. BRAZIL'S SPENDING IS LARGE AND INCREASING

**Brazil has the largest public sector of any other middle income country.** General government spending exceeds 40 percent of GDP and tax revenue was about 38 percent of GDP in 2005 (an increase of over 10 percentage points since the 1990s). This is comparable to sizeable welfare states in northern Europe, such as Finland. When combined with non-financial public corporations, the size of the public sector represents about half of the economy.

**The bulk of public sector spending is devoted to primary current spending (roughly 33 percent of GDP) and is increasing<sup>3</sup>.** Social security schemes alone represent roughly 12½ percent of GDP. Sub-national government spending on social services also has been expanding; this spending devolved to state and municipal governments under the 1988 Constitution. Pressures to increase social security and social spending are mounting, due in part to the aging population.

**Off balance sheet transactions also have contributed to increasing the size of the public sector.** Contingent liabilities include pending judicial decisions. The discovery and recognition of liabilities not previously recorded (so called "skeletons") increased the stock of public debt substantially (with estimates ranging from 12-19 percentage points of GDP). The larger debt stock has increased debt servicing payments. Tax expenditures also contribute to fiscal pressures; the federal government tax expenditure was 2.5 percent of GDP in 2004.

### 2. SOCIAL SECURITY SPENDING REPRESENTS A MAJOR CHALLENGE

**Social security spending is mandated through the 1988 Constitution, which made the system generous**

**and rigid.** Pension spending covers: 1) social security for all public sector workers (RPPS); 2) social security for private sector workers (RGPS, the largest segment of the Brazilian pension system), and 3) a private complementary pension system. Brazil is an international outlier in almost every class of social security spending (old age, survivor, disability, and sick pay), due to extremely generous benefits. For example, survivor pension benefits represent 3.3 percent of GDP, which is over three times as large as OECD countries that have older populations and higher incomes.

**Pension reforms have had limited impacts.** The December 2003 reform reduced somewhat the RPPS pension deficit, in part due to increases in the average age of pensioners and slower growth in new pensioners. It also instituted contributions on retirement benefits, increased the minimum age for retirement, and equalized the benefits of public servants to the general RGPS system (but only for new entrants, so the effect has been delayed). On the other hand, administrative reforms to the RGPS system in 1998 had more limited impacts. They introduced changes in the formula (the fator previdenciário) to reduce incentives for early retirement, increased revenues (through recertification efforts) and reduced the number of sickness benefits (that took effect recently). However, both the average retirement age (54 for men and 51 for women) and average length of service remain low. RGPS expenditure and deficits continue to increase; so further parametric reforms are needed.

### 3. EFFECTS OF PUBLIC INVESTMENT AND CONSUMPTION ON GROWTH

**The present level and composition of public spending are not conducive to long-term economic growth.**

Econometric analysis of per capita GDP growth over 1950-2000 shows:

- Public (and private) investment increases growth;
- Government subsidies increase private capital accumulation (and thus growth), but this effect dampens over time as debt accumulates.
- The tax burden reduces capital accumulation (and thus growth).
- Government consumption, social security, and social assistance transfers all reduce growth (the latter in the long run because more financing translates into higher taxes).

*Over time, the composition of public spending has shifted to larger shares of government consumption, social security, and social assistance and away from public investment and targeted capital subsidies.*

Additional taxation needed to finance the enlarged public sector (along with inefficient expenditure composition) has dampened growth.

*Simulations show that Brazil would benefit from higher public investment within a tight fiscal constraint (however, increasing taxation or borrowing to pay for such investment would limit long-run growth prospects).*

Given the low level of public investment, a reallocation from social security to spending on infrastructure would likely have sizeable growth effects. On the other hand, increasing public debt to finance transfers would decrease growth. Moreover, increasing public debt to finance education expenditure would increase growth in the short run, but the debt accumulation would slow growth in the long run.

#### **4. THE BUDGET IS INFLEXIBLE**

*A major challenge is the excessive rigidity arising from legally mandated expenditure and extensive revenue earmarking.* There are essentially three broad sources of budget rigidity: (i) earmarking of tax revenue, (the most important are Constitutionally mandated spending on social protection, health and education, and transfers to states and municipalities); (ii) social contributions, which are used to cover part of the social security deficit; and (iii) non-discretionary expenditure that includes legal or Constitutional obligations for interest payments, wages and salaries, entitlements (such as social security), and social assistance benefits.

*So far government efforts in this realm have concentrated on an ad hoc measure to “de-earmark” federal revenue, called DRU (Desvinculação de Receitas da União).* However, given simultaneous increases in certain non-discretionary expenditure items (most notably social security benefits), the DRU has had innocuous impacts on budget rigidity and overall spending.

#### **5. THE BUDGET IS NOT WELL LINKED TO PLANNING AND EXECUTION OF PUBLIC EXPENDITURE**

*An expenditure management review highlighted institutional weaknesses in planning, budgeting, expenditure execution, and evaluation.* In particular, there is a lack of congruence between expenditure

allocations set in multi-year plans, annual budgets, and amounts of investment effectively executed. Since 1996, the government’s primary instrument for expenditure planning has been its Multi-year Plan (PPA, Plano Pluriannual), which does not contain a medium-term fiscal framework. The Budgetary Guidelines Law (LDO) defines revenue, expenditure, and balances in a three-year rolling framework, but the LDO targets are not well linked to the PPA, nor do they integrate the impacts of policy decisions, such as increases in the minimum wage. Moreover, Congress makes changes when the budget proposal gets finalized in the Annual Budget Law (LOA). In addition, a reversal of priorities results from reductions to the budget and restrictions on the release of funds (“contingenciamento”) during execution.

*As a result, the quality of spending is poor relative to the amount of spending.* For example, health indicators are well below the average for middle-high income countries, even though per capita health spending is above average. Moreover, the execution of spending is not well monitored and evaluated for outputs or results.

#### **FOUR RECOMMENDATIONS**

##### **1. REDUCE THE SIZE OF THE PUBLIC SECTOR (AND CONTROL EXPLOSIVE SPENDING)**

*To address the fiscal conundrum nondiscretionary expenditures need to be controlled and the rising trend reversed.* Changes to legal mandates are required to restrain the growth of the public sector and to reduce its size. This will require legal changes to break the rigidity in social security and to add flexibility in social spending. Measures should focus on:

- reducing spending on the pension system;
- reducing certain subsidies, (e.g. credit through public financial entities);
- increasing revenue by selectively applying fees for services and eliminating tax expenditures;
- revitalizing the privatization process to add efficiency and limit quasi-fiscal deficits;
- taking into account the full fiscal impacts of further increases in the minimum wage, including impacts on social protection spending; (ideally, spending offsets should be contemplated for such increases); and
- improving the quality of spending through better targeting in social assistance programs, health, and education.

To make these adjustments more persuasive, a certain share of the fiscal saving should be directed to increase public investment.

## 2. MORE AGGRESSIVELY DE-EARMARK REVENUE IN COMBINATION WITH REDUCED MANDATORY SPENDING

*Brazil should more aggressively pursue revenue de-earmarking, but not through DRU.* As a first step, all earmarked funding should be set in terms of reais in real terms (that is indexed to inflation) rather than as a share of revenue. Unused funds in a given year should be used for domestic debt reduction, or saved to fund additional infrastructure. De-earmarking should accompany reductions in mandatory spending.

## 3. IMPROVE PUBLIC SECTOR MANAGEMENT THROUGH STRENGTHENING PLANNING, BUDGETING, EXECUTION, AND EVALUATION

*Reforms to improve the coherence of planning, budgeting, execution, and evaluation should be implemented across all levels of the public sector.*

Efforts could focus on improving the budget cycle and developing a consistent medium-term macroeconomic framework consistent with the budget.

*The LDO is the most appropriate vehicle to develop a medium-term framework.* Even in the case of successful constitutional reforms to bring greater budget flexibility, there may not be sufficient information to determine where the budget should be cut, preserved, or increased in the absence of a medium-term framework. An institutionalized process of expenditure reviews for generating micro-level information about saving options would be a useful addition to Brazil's planning and budget process.

*To strengthen executing agencies, measures should improve financial management, increase flexibility regarding human resource management, and implement a solid set of monitoring and evaluation systems.* Eventually, a medium-term framework and the monitoring and evaluation system could be developed in a harmonized manner to support results-based budgeting for the entire general government.

## 4. INCREASE PUBLIC (AND RELATED PRIVATE) SECTOR INVESTMENT

*Part of the fiscal saving should be directed to increase public investment, while keeping the overall tax burden and indebtedness under control.* Systematic efforts also will be required to strengthen institutional capacities for planning, budgeting, and executing public investments. Improving infrastructure ministries' capabilities to manage these limited resources efficiently and effectively could involve: (i) a medium-term infrastructure investment strategy; (ii) a set of performance indicators to monitor efficiency and effectiveness of the infrastructure portfolio as a whole, as well as by sub-sector; and (iii) an organizational reform, including adoption of a human resource policy to enhance the professional quality of the staff working in the infrastructure sector and to streamline the ministries' business processes and organizational structures.

*Given the fiscal constraints, the private sector will need to play a more active role.* Public-private-partnerships; solid and reliable contracts (public and private); and public sector reforms that strengthen the regulatory environment are needed. Moreover, getting the size of the public sector under control and continuously working to reduce indebtedness would set enabling conditions for continued reductions in interest rates, leading to more private sector investment.

### Notes

1. See also the World Bank Report (2002) - Brazil: The New Growth Agenda. (BR-22950)
2. The central government dropped ½ a percent of GDP, over ½ a percent of GDP from sub-national governments, and about 1 percent of GDP from public corporations.
3. Interest payments represented approximately 7 percent of GDP per annum during 1995-2004.

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