A recessive adjustment

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The 2015 Fiscal Adjustment will bring about more recession than necessary because it rests more on increasing taxes than on cutting public spending. The economic research literature shows that fiscal adjustments based on cuts in spending are far more sustainable and of better quality than those that rely more on tax increases.

Reducing spending has clear advantages: it cuts fat and inefficiencies, fights corruption and “rent seekers” (those trying to obtain benefits for themselves through political connections), increases public sector savings, and reduces the tax burden on businesses, freeing resources for private investment. In contrast, although fiscal adjustments based on raising taxes are easier to carry out, they are recessive; they choke private investment and household consumption.

Alberto Alesina and Silvia Ardagna of Harvard University concluded that fiscal adjustments based on spending cuts and no tax increases are more effective in reducing fiscal deficits and the public debt-to-GDP ratio than when adjustments are based on increasing taxes. Moreover, adjustments in spending have fewer recessionary effects.

The fiscal adjustment in Brazil is the most perverse option, since it primarily involves raising taxes. Estimates are as yet preliminary, but it may make the tax burden much heavier by increasing tax rates, creating new taxes, and eliminating exemptions. The return of the Contribution of Intervention in the Economic Domain tax (Cide), the end of exemptions of the Industrial Products Tax (IPI), a higher Tax on Financial Transactions (IOF) and PIS-COFINS (Social Integration Tax and Social Contribution Tax), the new tax on beverages and possibly on financial activities—together these may expand the tax burden by more than 2% of GDP, an increase of considerable magnitude.

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On the other hand, even if absolutely necessary the public spending cuts envisaged are only hypothetical. The federal government’s primary balance (budget balance excluding interest payments), which reached a surplus of 2.5% of GDP in 2007–08, ended 2014 with a deficit of 0.3%, partly because primary spending had gone up from 15.7% of GDP in 2002 to 19% in 2014, according to the estimates of Planning Minister Nelson Barbosa. Unfortunately, spending related to the quality and availability of public services has not expanded in the same proportion as other spending. Spending on personnel, goods and services, and investment—which define the availability and quality of the public services offered to the population—decreased by 0.5 percentage points of GDP between 2002 and 2014, while total primary spending increased by 3.3 percentage points.

Inefficiency
It is not surprising that Brazilian society suffers from an inefficient public sector. Discouraged, poorly paid, and poorly trained staff and less public investment directly affect the quality of such essential services as health, education, security, and justice.

In contrast, spending on cash transfers, subsidies and tax exemptions grew explosively, from 6.6% of GDP to 10.1% between 2002 and 2014. This is a relative increase of 53%.

The urgency of the fiscal adjustment and the political difficulties of cutting social benefits and transfers have shifted the weight of fiscal adjustment to increasing the
national tax burden, which amounts to 36% of GDP, a level that is unprecedented for developing countries like Brazil.

The rigidity of public spending in Brazil deserves wide-ranging discussion. Reducing public spending is notoriously difficult worldwide, but it is particularly noticeable in Brazil, which in the late 1980s opted for significantly expanding social welfare programs without having the means to finance the expansion.

Corporatism, demagoguery, populism, and “political correctness” have trumped objective questions of equity and efficiency. Spending on social welfare programs is subordinated to the logic of income distribution and the alleged equality targets at any cost.

Supported by media and populist politicians, organized groups who feel disadvantaged by reductions in public spending, even though they are a minority, mobilize forcefully to defend their rights, at the expense of the social interests of the vast majority of the population. In this environment, cutting spending becomes a cyclopean task.

Another difficulty in cutting spending is Brazil’s cumbersome process of public decision-making. Deliberative political bodies are numerous, and there are ample opportunities for intervention by the judiciary and various organs of control and supervision, official and private.

Moreover, the Brazilian budget process is incremental. Those who have worked in public administration know that the budget proposals for future years take as baselines current projects and programs. This practice works on the premise that current spending is justified by the simple fact that a program already exists. That leaves little room for spending cuts. Budgets become rigid, burdened by huge increments of mandatory spending.

Once incorporated into the public budget, social programs and activities are rarely evaluated to ascertain whether they should be continued or eliminated. They often turn into antiquated institutions unrelated to any real needs of a society in constant evolution. They survive by inertia, and sometimes without goals, but still consuming scarce public resources.

Finally, cuts in public spending in Brazil confront huge ideological, political, and operational difficulties. Only 10% of federal revenues are available for discretionary spending, such as investments. To complicate matters, during the presidential campaign President Rousseff said that “social spending” is untouchable, regardless of any objective evaluation of its merits.

To carry out the necessary fiscal adjustments expeditiously, the government should consider adopting zero-based budgeting, which every year evaluates the efficiency of the spending of the previous year. The zero-based budget would reverse current spending premises: it requires continuous evaluation of the effectiveness of public activities. Decisions to retain or eliminate programs and undertake new activities—and spending—require systematic and insightful annual assessments. Every year, each project, new or existing, must undergo a strict cost-benefit analysis before it can be included in the annual budget. If the government were to adopt zero-based budgeting, it would discover a plethora of spending that cannot be justified by any objective criterion of social value but that survives because of the sheer inertia of the public sector.