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Assessment and recommendations

The Brazilian economy is bouncing back

Brazil's growth performance has been erratic in recent years but the foundations for a sustained recovery appear to be broadly in place. The measures implemented by the new administration, which took office in January 2003, have contributed to gradually restoring confidence, which had faltered during and in the aftermath of the presidential election in 2002. These measures have succeeded in stabilizing foreign exchange markets, reducing sovereign credit risk, and taming inflation. At the same time, the remarkable external adjustment since the floating of the *real* in 1999, with continued strong export performance and the ensuing turnaround in the external current account, is making the economy less dependent on foreign financing and, consequently, more resilient to changes in market sentiment. But more is needed, particularly in keeping the momentum of the reform process, to ensure that this positive outlook ushers in a virtuous circle of improved confidence and resilient, equitable growth.

Growth is becoming more balanced across sectors

Having posted anaemic growth in 2001-02 and then stagnated in 2003, following the faltering of confidence in 2002, the economy grew briskly in the first half of 2004, well above market expectations. GDP growth is expected to be about 4½ per cent in 2004, facilitated by the monetary easing that took place from the second half of 2003 to mid-2004, and the restoration of confidence. Domestic demand is strengthening, taking over from a period of strong increase in net exports. Private consumption is recovering, pushed by the expansion of credit and improvements in the labour market. Formal unemployment remains high in the major cities but is trending down and real wages are on the rise, having stagnated or fallen in recent years. An improving climate for business is providing further impetus for private investment, which is showing signs of recovery. Net exports will continue to contribute positively to growth, in addition to keeping the external current account in surplus. This is important for sustained recovery as the external sector has been Brazil's Achilles heel for many years, constraining growth. The gradual reduction in trade restrictions throughout the 1990s has made foreign trade more responsive to external price signals and changes in relative prices. Continued effort to further remove trade restrictions is therefore welcome. It is also important to note that export growth remains constrained in key markets by tariff and non-tariff barriers, particularly in agriculture.

Macroeconomic institutions have strengthened, underpinning the recovery

The improvement in the economic outlook owes much to the strengthening of institutions. The maintenance of macroeconomic discipline and the prompt policy response to adverse

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shocks would probably not have been possible without the reforms in this area. This perception seems to be entrenched in Brazilian society, making the strengthening of institutions an on-going process. Of particular importance in the macro area are the inflation targeting framework for monetary policymaking and the Fiscal Responsibility legislation. These have become the main institutional pillars for macroeconomic management and consolidation. These institutions have been put to the test but have withstood the succession of negative shocks the economy has faced in the past few years. The *2001 OECD Survey of Brazil* had been particularly sceptical about the resilience of Fiscal Responsibility legislation. The authorities should be praised for their continued resolve in defending and strengthening these institutions, even in adverse conditions.

Despite recent achievements, the consolidation of macroeconomic stabilisation should continue

The consolidation of macroeconomic stabilisation, which will require vigilance on the part of the authorities, is of paramount importance in the years to come, anchored by a prudent monetary-fiscal policy mix in pursuit of continued disinflation and a steady reduction in public indebtedness.

- On the *fiscal side*, high public indebtedness remains an important source of vulnerability. In the years to come, a consolidated primary surplus of at least 4¼ per cent of GDP will need to be maintained to ensure a steady decline in the debt-to-GDP ratio, reinforcing the recent trend with an estimated reduction of almost five percentage points in the debt-to-GDP ratio in 2004 relative to 2003. An increase in the primary surplus target – not only in 2004 as recently announced in the wake of higher-than-expected GDP growth, but over the medium term – would be welcome to allow for a faster reduction in the public debt ratio. This is desirable because high indebtedness introduces a pro-cyclical bias in the fiscal stance, making corrective tightening in "bad" times and loosening in "good" times difficult to avoid. *Against this backdrop, a reasonable medium-term objective would be to bring the public sector borrowing requirement into balance over the business cycle, underpinned by robust primary surpluses and resulting in a sustainable decline in real interest rates. This would create room for manoeuvre as economic conditions change, allowing the fiscal policy to be more counter-cyclical while ensuring a steady reduction in indebtedness*.
- *Public debt management* needs to remain prudent. Much progress has been made to strengthen the institutional framework for public debt management, including measures to increase liquidity in secondary markets and to clarify the roles of the Central Bank and the Treasury in issuing public debt securities in domestic and foreign markets. But the relatively high, although falling, share in public debt of instruments paying floating interest rates and securities indexed to the exchange rate makes the debt dynamics overly sensitive to financial volatility. *Public debt management should therefore continue to focus on mitigating rollover risks in "bad" times and reducing exposure to foreign exchange and interest rate volatility in "good" times.* In doing so, the debt dynamics would become less vulnerable to changes in market sentiment, allaying concern over the sustainability of Brazil's public debt dynamics and, thereby, contributing to further reducing risk premia. At the same time, pressure for renegotiating the debt restructuring arrangements between the Treasury and the regional governments (states and municipalities) should also continue to be firmly resisted, which will continue to require strong political resolve.

- *Monetary policy* will need to carry on responding swiftly to inflationary pressures. The Brazilian authorities should be praised for setting up a fully-fledged institutional framework for inflation targeting following the floating of the real in 1999. The policy regime is working well – although targets have been missed a number of times, due essentially to adverse supply shocks – and has been instrumental in anchoring medium-term inflation expectations, particularly in situations of financial stress. In a volatile macroeconomic environment, the monetary authorities have been successful in communicating to markets their policy response to adverse shocks, consisting of accommodating the first-round effects of these shocks, while acting to mitigate their secondary effects on prices and economic activity. In 2004, market expectations have consistently placed inflation within the bands set by the government, despite movements in commodity prices. There also seems to be broad agreement that the ultimate goal of inflation targeting is to deliver low, stable inflation over the longer term to reduce risk premia and to encourage longer-term investment by the private sector. *Improvements are welcome, possibly including a strong commitment to achieving the second-year target, without losing sight of the importance of meeting the easier-to-verify first-year target. But drastic institutional changes, such as a formal extension of the time horizon for achieving the inflation target, should be avoided in the course of disinflation. At the same time, while the Central Bank is broadly perceived as being de facto independent, granting it de jure operational autonomy would contribute further to enhancing credibility in macroeconomic institutions.*

The main challenges for Brazil are to improve the quality of fiscal consolidation, enhance the investment climate, and improving the cost effectiveness of social programmes

Notwithstanding several accomplishments, there are three main challenges identified in the *Survey* which need to be addressed. These are:

- Improving the quality of fiscal consolidation,
- enhancing the investment climate, and
- improving the cost effectiveness of social programmes.

These challenges are interrelated. They also require a comprehensive set of measures in order to consolidate recent achievements, boosting the economy's resilience to shocks and paving the way for sustainable, more resilient growth and for a faster catch-up in relative living standards.

The quality of fiscal adjustment needs to be improved, focusing on retrenching expenditure rather than hiking taxes

On the fiscal side, the government's record in meeting the annual budget targets is commendable, even in adverse conditions, making the fiscal effort all the more impressive. But fiscal adjustment has been achieved in recent years primarily by hiking revenue and compressing public investment, against a backdrop of rising primary current expenditure. Non-mandatory spending has at times been curbed through the *ad hoc* sequestration of funds during the fiscal year, making budget execution more difficult, in part to accommodate higher-than-expected increases in commitments. This is because the

retrenchment of current spending has become increasingly difficult owing predominantly to downward rigidities in the budget. Revenue earmarking is widespread and minimum expenditure levels have been introduced over the years, often through constitutional provisions, severely curtailing budget flexibility. Also, until 2003, reform of the social security regime for civil servants had lagged behind that of the private-sector regime, placing a heavy burden on the budget. The authorities should be praised for avoiding increases in the minimum wage above inflation, which would have had a detrimental impact on the budget, underscoring their commitment to fiscal rectitude. *In spite of recent progress, more emphasis should be put on rationalizing the largest items of current spending to improve the quality of on-going fiscal consolidation.*

Fiscal consolidation will pave the way for reducing Brazil's already high tax burden

By tackling these problems, the need for fiscal consolidation can be reconciled with that of alleviating Brazil's already high tax burden in the years to come, better channelling budgetary resources to meet society's economic and social priorities. Brazil's revenue ratio, at close to 35 per cent of GDP, is already high by international comparison and close to the OECD average. It is detrimental not only to growth but also to the labour market, encouraging informality. This is confirmed by international comparison, based on the OECD methodology for assessing the rigidity of employment protection legislation, which suggests that informality in Brazil appears to be more of a fiscal, rather than legal, problem. Alleviating the tax burden on labour would make social security more affordable to lower-productivity workers in the informal sector, while making it more attractive for employers to hire them with a formal contract. Nevertheless, there appears to be limited agreement on how this can be achieved, underscoring the need for a comprehensive labour reform. Options for making social insurance affordable to those with low incomes include, for example, variable contribution rates, either by making them progressive or by allowing individuals to choose between alternative levels of protection. By the same token, discussion on the gradual replacement of at least part of employers' social security contributions by levies on value added could be encouraged. Brazil's indirect tax system has become more efficient in recent years through the conversion of federal levies on enterprise turnover (starting with PIS/Pasep in 2002 and COFINS in 2003) into value added-type taxes. Against this background, *policy effort is needed to reduce the tax burden over time, once public finances have strengthened, and to gradually increase reliance on direct, rather than indirect, taxes. This would require an assessment of corporate income taxation, including the tax on net profits (CSLL).*

Downward rigidities in current spending need to be tackled

There appears to be widespread recognition that rigidities in the budget adversely affect the quality of fiscal adjustment. Of particular importance is the on-going policy debate about the constitutional provision linking adjustments in the minimum pension to those in the minimum wage. The option of severing this link while preserving the purchasing power of pensions should therefore be considered. In health care, a constitutional amendment enacted in 2000 sets a floor for aggregate federal spending, while the earmarking

of federal transfers also increases sub-national spending, placing Brazil among the countries with high levels of public expenditure on health care in relation to GDP. In education, minimum spending levels per student enrolled in primary and lower-secondary education (1st to 8th grades) have been established, requiring the federal government to top up outlays in the states that cannot afford the national spending floor. In this context, *a comprehensive assessment of existing revenue earmarking and mandated spending requirements against the achievement of their intended policy objectives could pave the way for more cost-effective spending.*

Further reform is needed to put the social security system on a sounder financial footing

Further social security reform will be needed to ensure that the social security system is financially sustainable over time. This is a pre-requisite for making room in the budget for higher spending on more cost-effective programmes, and for increasing Brazil's preparedness to cope in the years to come with the spending pressures associated with a fairly rapidly ageing population. The share of population aged 65 and over is projected to nearly double to about 9 per cent by 2020, a rapid pace of demographic change in comparison with OECD countries. An important problem in this area is that the social security regime for civil servants acts as a drain on the budget, accounting for two-thirds of the overall social security deficit. And civil servants continue to benefit from more advantageous pension entitlements than their counterparts in the private sector. These distortions underscore the need for reform, which is under way. *The main pending issues in this regard are twofold: i) to create defined-contribution complementary pension funds for civil servants subject to the same prudential regulations and operational rules as those for private-sector workers; and ii) at a later stage, to aim at unifying the pension regimes for federal, state, and municipal civil servants, and standardizing entitlements between the regimes for private- and public-sector workers. Further reform in the social security regime for private-sector workers is also needed and could focus on the introduction of a minimum retirement age, further elimination of exemptions and increasing the contribution period.*

Enhancing the investment climate is critical to improving the economy's growth performance and resilience

The current level of investment, particularly in infrastructure, is insufficient to sustain robust growth over the medium term. On the one hand, there is limited room in the budget to boost public capital spending at the current juncture. On the other, private investment is discouraged by a scarcity of credit, high intermediation costs, and regulatory uncertainty in several sectors. Macroeconomic volatility also weighs heavily on private investment. This is despite the fact that Brazil appears to offer a reasonably investor-friendly environment for business, based on OECD work on the restrictiveness of product market regulations and legislation on foreign direct investment (FDI). In this respect, policies that promote investment and reduce firms' costs of doing business more generally would also contribute to tackling informality. *Enhancing the investment climate will therefore be critical to improving the economy's growth performance and resilience.*

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Fiscal consolidation will restore the government's ability to invest, and public-private partnerships should be encouraged

The rationalization of current public expenditure would free budgetary resources which could be channelled to finance higher, externality-rich public investment. At the same time, the reduction in indebtedness, as discussed above, should help reduce the crowding out of private investment. New legislation on public-private partnerships (PPPs), which have hitherto been confined predominantly to leasing operations and concessions, will complement the current legal framework for public procurement, thereby militating to encourage private investment, particularly in infrastructure. Public-private partnerships will need to be encouraged in a fiscally-sound manner, adequately balancing risks between the government and its private-sector partners. *There appears to be widespread recognition that fiscal consolidation should not be undermined and that the federal government should set standards for the states and municipalities in this area*. An important policy objective is therefore to standardize requirements for the accounting and reporting of PPP operations, as well as the dissemination of information to markets and society at large, together with the risk assessment of individual projects. Draft legislation envisages a leading role for the Treasury in this area. In this regard, the Fiscal Targets Annex of the Budget Guidelines Law (LDO), which each level of government is required to submit to their legislatures, could be the main vehicle for the dissemination of information on PPPs in budget documentation.

Private investment can be encouraged by facilitating access to cheaper, more abundant credit, while tackling regulatory uncertainty

Brazil's financial markets will need to develop further to facilitate access by private investors to more abundant, cheaper credit. At the same time, the regulatory framework for network industries (*i.e.,* electricity, oil and gas, water and sanitation) will need to clearly define the role of government in these sectors. The main challenge in this respect is two-pronged:

- *First,* new bankruptcy legislation, once approved, is expected to ease constraints on loan recovery, while protecting the value of collateral and jobs in the course of enterprise restructuring. This is a necessary, although not sufficient, condition for encouraging credit creation and reducing intermediation costs. The real test for the reform strategy will nevertheless be in implementation. Additional measures to encourage the expansion of credit and reduce intermediation costs would include the gradual phasing out of directed credits to agriculture and housing, while remaining attentive to the need for public action in the case of market failures, especially with respect to low-income households; the gradual alleviation of the tax burden on financial intermediation, once public finances improve; and continued strengthening of the credit information industry, primarily by enhancing portability of positive information on credit history**.** The government's broad structural reform agenda also include the on-going reform of the legal system and initiatives to encourage housing finance, which can do much to improve the security of property rights, lowering borrowing costs.
- *Second,* regulatory uncertainty weighs on private investment and therefore needs to be reduced, particularly in network industries. The overall approach to regulatory reform in

the electricity sector, based on arms-length operations and public auctions, is well thought out but the risk of regulatory failure should not be underestimated, given the enhanced role of government in long-term planning. But, again, implementation will be the ultimate test of reform in this area. In natural gas, the dominance of Petrobras, the national oil company, throughout the industry has often been perceived as an obstacle to its development. Private investment in water and sanitation, which is much needed in light of relatively low connection rates to sewerage, is constrained by a lack of clarity over the assignment of regulatory powers across different levels of government. The share of wastewater that is treated is also low, with a detrimental impact on the environment.

Brazil's social indicators are not always commensurate with high spending levels on social programmes

There seems to be widespread agreement within the government and beyond that social disparities do not allow for the benefits of sustained growth to be evenly spread among different social groups. Social exclusion prevents vulnerable groups from acquiring labour market-relevant skills, contributing to high unemployment and informality among these groups, as well as perpetuating income inequality. The main challenge in this respect is to strengthen the social policies that will allow for the pursuit of the government's social agenda while maintaining fiscal discipline and galvanising support for furthering structural reform. Much has been done in the social area over the last decade or so, with unquestionable improvements in key social indicators, particularly in education. The government nevertheless continues to have an important role to play, ensuring that social outcomes are commensurate with Brazil's already high levels of spending on social programmes, including pensions. General government spending on social programmes – including education, health care, housing and urbanisation, social security and assistance, and unemployment insurance – accounts for about one-quarter of GDP, well in excess of average spending in countries with a comparable level of income. *In light of these high spending levels, emphasis should gradually be shifted to improving the cost-effectiveness of social programmes, focusing on continuity through an incremental strengthening of existing programmes and improvements in service delivery.*

Social disparities need to be reduced in pursuit of the government's growth agenda

The distribution of income remains stubbornly skewed in Brazil. Public social spending is a poor instrument to redistribute income because contributory programmes, such as pensions and unemployment insurance, account for the lion's share of public social spending. These programmes are also reserved for formal-sector workers, who tend to have above-average incomes. Public spending on pensions alone already accounts for a higher share of GDP in Brazil than in the average OECD country, despite Brazil's younger population. But spending on means-tested programmes, such as income transfers for the care of children, and elderly and disabled persons, accounts for a relatively small share of public social spending, well below the OECD average. Rural pensions, which are essentially non-contributory, are considered one of the best-targeted social programmes currently in

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place. Due to broad recognition that these income transfers are important poverty alleviation tools, they have been preserved from cuts in periods of fiscal retrenchment. *To correct these structural imbalances within the current budget envelope, the financial sustainability of the social security system will need to be restored to make room for higher spending on programmes which are more pro-poor and conducive to the accumulation of human capital.*

Social policies can become more pro-poor through emphasis on means testing and conditionality

Untargeted social spending, especially on education and health care, can also become more pro-poor. This can be achieved by continuing to shift the composition of spending towards preventive care and primary and lower-secondary education, which tend to benefit the poor more than others. For example, the share in GDP of public spending on education is close to the OECD average but Brazil fares poorly in the OECD's PISA measurement of student performance in comparison with countries with similar levels of public spending on education. Tertiary education accounts for about one-fifth of government spending on education, close to the OECD average, but the average cost to the budget of higher education per student is about 150 per cent of GDP *per capita*, about three times as high as the OECD average. The option of increasing cost recovery in higher education through the better targeting of existing tax expenditures directed to philanthropic institutions is thus welcome. With regard to improving access to primary and lower-secondary education, the experience of FUNDEF (a fund to finance sub-national spending on primary and lower-secondary education based on minimum spending per student and federal top-up grants), with its impact on school enrolment rates, is welcome. This is also true for greater reliance in programme design and service delivery on the conditional, means-tested income transfers, including those now under the *Bolsa Família* umbrella. In recognition of the fact that poverty can be alleviated and income distribution can be improved over the longer term through human capital accumulation, *continued use of school attendance as a condition for enrolment in income transfer programmes is strongly advisable. So is the appropriate monitoring of compliance with programme conditionality*.

In sum, the foundations for sustained growth are by and large in place

This *Survey*'s general assessment is that Brazil is currently reaping the benefits of macroeconomic consolidation, underpinned by a prudent policy stance and the strengthening of institutions for macroeconomic policymaking. External adjustment has been far-reaching and is set to continue, reducing vulnerabilities and boosting the economy's resilience to shocks in the years to come. Macroeconomic adjustment has been costly but is bearing fruit, as the conditions for sustained growth are by and large in place. Continued commitment to fiscal probity will be a major factor in fostering the gradual decline in real interest rates, broadening the range of affordable investment projects and opportunities for growth. This positive outlook therefore provides the federal government and its state and municipal counterparts with an invaluable opportunity to make headway into structural reform and for addressing policy areas where progress has so far proved difficult to achieve.

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List of acronyms

ANA National Water Agency
Agência Nacional de Águas

ANATEL National Telecommunications Agency
Agência Nacional de Telecomunicações

ANEEL National Electricity Agency
Agência Nacional de Energia Elétrica

ANP National Petroleum Agency
Agência Nacional do Petróleo

ANTAQ National Water Transport Agency
Agência Nacional de Transportes Aquaviários

ANTT National Land Transport Agency
Agência Nacional de Transportes Terrestres

ANVISA National Public Health Agency
Agência Nacional de Vigilância Sanitária

BB Bank of Brazil
Banco do Brasil

BCB Central Bank of Brazil
Banco Central do Brasil

BNDES National Economic and Social Development Bank
Banco Nacional de Desenvolvimento Econômico e Social

BOVESPA São Paulo Stock Exchange
Bolsa de Valores de São Paulo

BVRJ Rio de Janeiro Stock Exchange
Bolsa de Valores do Rio de Janeiro

CADE Administrative Council for Economic Defense
Conselho Administrativo de Defesa Econômica

CEF National Savings Bank
Caixa Econômica Federal

CMN National Monetary Council
Conselho Monetário Nacional

COPOM Monetary Policy Committee
Comitê de Política Monetária

CVM Securities and Exchange Commission
Comissão de Valores Mobiliários

FAT Unemployment Insurance Fund
Fundo de Amparo ao Trabalhador

FGTS Unemployment Severance Fund
Fundo de Garantia por Tempo de Serviço

IBGE Brazilian Institute of Geography and Statistics
Instituto Brasileiro de Geografia e Estatística

INEP National Institute of Studies and Research on Education
Instituto Nacional de Estudos e Pesquisas Educacionais Anísio Teixeira

INSS National Social Security Institute
Instituto Nacional de Seguridade Social

IPEA Institute of Applied Economic Research
Instituto de Pesquisa Econômica Aplicada

SDE Secretariat for Economic Law
Secretaria de Direito Econômico

SEAE Secretariat for Economic Monitoring
Secretaria de Acompanhamento Econômico

SPC Secretariat of Complementary Pensions
Secretaria de Previdência Complementar

STN National Treasury
Secretaria do Tesouro Nacional

SUSEP Department of Private Pensions
Superintendência de Seguros Privados

TCU Federal Court of Accounts
Tribunal de Contas da União

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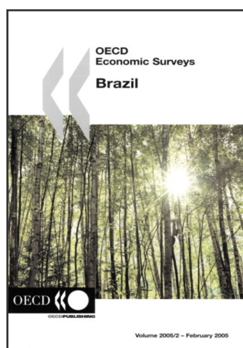
BASIC STATISTICS OF BRAZIL (2003 unless noted)

Area (thousands sq. km)	8 515.0
POPULATION	
Total (million)	179.0
Inhabitants per sq. km	21
Net average annual increase over previous 10 years, per cent	1.5
EMPLOYMENT	
Total employment (thousands)	57 902.4
In per cent: Agriculture	18.9
Industry	19.0
Services	62.1
GROSS DOMESTIC PRODUCT (GDP)	
GDP at current prices and current exchange rate (USD billion)	506.8
Per capita GDP at current prices and current exchange rate (USD)	2 831.0
Average annual volume growth over previous 5 years (in per cent)	1.8
In per cent of GDP: Agriculture	9.9
Industry	38.8
Services	56.7
INVESTMENT	
Gross fixed capital formation (GFCF) as a percentage of GDP	17.8
Average annual growth of ratio over previous 5 years (per cent)	–4.0
CONSOLIDATED PUBLIC SECTOR (AS A PERCENTAGE OF GDP)	
Revenue	34.9
Primary balance	4.3
Nominal balance	–5.1
Net debt	58.2
INDICATORS OF LIVING STANDARD	
Internet subscribers, per 100 inhabitants (2002)	8.2
Television sets, as a percentage of households (2002)	90.0
Doctors, per 1 000 inhabitants (2001)	2.1
Infant mortality per 1 000 live births (2001)	27.0
FOREIGN TRADE	
Exports of goods (USD billion)	73.1
As a percentage of GDP	14.4
Average annual growth over previous 5 years (per cent)	7.4
Imports of goods (USD billion)	48.3
As a percentage of GDP	9.5
Average annual growth over previous 5 years (per cent)	–3.5
Total official reserves (million SDRs)	33 049.6
As ratio of average monthly imports of goods	12.2



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