

From expansion to austerity: challenges and risks of the radical fiscal policy turn in Brazil

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Brazil, in the period after the great financial crisis of 2007–2008, presents a compelling case study of the interactions between fiscal policy and business cycles. The country is noteworthy not only for being one of the very few that dealt relatively well with the most acute stage of the crisis, maintaining its dynamism throughout most of the 2007–2010 period, but also for the speed of its economic and fiscal deterioration during the 2011–2014 economic slowdown, and the subsequent 2015–2016 recession. The contrast in performance is stark when one observes the decrease in growth of the country's gross domestic product (GDP), which halved from 4.6 per cent per year during 2007–2010—which placed Brazil close to the top third of countries with the best global performance—to 2.3 per cent per year during 2011–2014, which placed the country among the bottom third of countries, and finally culminating in an accumulated collapse of -7.2 per cent of GDP during 2015–2016, the worst recession in the country's history.

How to explain both the extraordinary performance and the gravity of its subsequent deterioration? It is not a simple phenomenon. However, the central hypothesis of the *Working Paper Brazilian Fiscal Policy in Perspective: From Expansion to Austerity* (Orair and Gobetti 2017) is that the inflexions in the composition and orientation of fiscal policy are crucial elements to understand the performance of the Brazilian economy.

The paper focuses on three recent periods. The first was a sub-period characterised by fiscal expansion (2005–2010), whose fiscal space was channelled mainly towards public investment, in addition to redistributive transfers. It was marked by extraordinary economic performance. During the second sub-period (2011–2014), subsidies played a central role in the fiscal expansion, along with tax cuts on the revenue side. This new fiscal policy mix proved ineffective in preventing the economy from entering a downturn.

The third sub-period is characterised by the radical shift in fiscal policy, now driven by the hypothesis of expansionist austerity, and by the worst recession ever recorded in the country's history. This shift towards austerity started with the fiscal adjustment of 2015, which was coupled in the following year with an expectation that investors' confidence and economic growth would be regained with further liberal structural reforms.

The agenda of structural reforms is associated with a set of legislative and constitutional changes that cannot be easily reversed, and which implicitly tend to lead to a long-lasting period of fiscal austerity. The main example is the target of the 'new fiscal regime', instituted in 2016 through a constitutional amendment to freeze public expenditure ceilings, in real terms, for at least 10 years.

There is no question that the mounting public debt and control over expenditures are real problems that Brazil must face head-on.

However, the concrete manifestation of fiscal austerity might introduce unnecessary risks. First, because there is great uncertainty towards the capacity of fiscal austerity—by itself—to promote growth, as has been demonstrated by international debate. In the Brazilian case, fiscal austerity is being implemented during the worst recession in the country's history, coinciding with a period of dire political crisis. This scenario is compounded by high credit leveraging by enterprises and consumers, and the expected prolonged international recession, all of which hinder economic recovery driven by private demand.

Given this situation, it does not seem wise to adopt a fiscal regime that greatly restricts fiscal policy, instead of prioritising mid-term fiscal consolidation and supporting short-term demand. It would be more reasonable to permit, as in the main foreign experiences, some real increase in expenditure, periodic reviews of the expenditure legislation and special treatment to public investment and other social expenses.

The success of the 'new fiscal regime' will depend on the approval of a set of structural reforms, interrupting the trajectory of social expenditure—which implies a series of social risks. These reforms began with changes to the constitutional minimum spending on health care and education and an ambitious project for reforming social security. These strict reviews are not likely to end there, given the target of freezing public expenditure in a country undergoing a rapid demographic transition, which imposes pressures on pension benefits.

Therefore, there is a real risk that these reforms will interrupt the late consolidation of a social welfare state in Brazil. This consolidation has been accomplished through a systematic increase in social spending—at a real rate of 4.2 per cent per year over the past two decades—and, despite a series of inefficiencies and distortions, it has enabled the construction of a wide range of social benefits and services that have an enormous positive impact on the well-being of the population, especially those who are most vulnerable.

Of course, it is unreasonable to expect that these same rates of expansion could be maintained indefinitely, but this does not imply the need to abruptly tether it to the rate of inflation. There are many alternatives for the gradual control of expenditures, while the government gains time to promote wider discussions and evaluations about the structure of the budget. Such as it is now, the new fiscal regime signals a move towards a rupture with the social welfare state, instead of towards making it financially sustainable.

Reference:

Orair, R., and S. Gobetti. 2017. "Brazilian Fiscal Policy in Perspective: From Expansion to Austerity." *Working Paper* No. 160. Brasília: International Policy Centre for Inclusive Growth.