Main Challenges for Brazil's Public Finances

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Overview

Following decades during which endemic weaknesses and inadequate control of the public finances contributed importantly to macro-economic instability in Brazil, the country embarked in the late 1990s on a sustained fiscal adjustment, marked by high and rising primary surpluses of the consolidated public sector. The adjustment reflected strengthened policies; institutional improvements; and, especially since the mid-2000s, the beneficial effects on the public finances of a favorable external environment (strong external demand, high commodity prices and low international interest rates) and of increased domestic policy credibility. The resulting moderation in the public debt and the improvement in its structure allowed a strongly countercyclical response to the downturn in activity in the wake of the global financial crisis of 2008–09. As a result, the Brazilian economy emerged from the downturn with remarkable speed and relatively small economic and social costs.

Fiscal policy remained, however, strongly expansionary during the subsequent cyclical upswing, fueling an unsustainable pace of domestic demand growth, a pick-up of inflationary pressures and a significant deterioration of the external current account. Arresting and ultimately reversing these trends has become an important short-term imperative for macroeconomic, and in particular fiscal, policy in Brazil.

Moreover, the country continues to face a number of more structural challenges in its public finances: the need for substantial and long-overdue tax reforms; for related reforms in the intergovernmental fiscal arrangements; and for further reforms in the social security, civil service and health systems. It also needs to continue efforts to strengthen the tax administration and increase the cost-effectiveness of public spending at all levels of government. Newer challenges include creating fiscal space for a needed large public investment effort; ensuring a responsible management of the growing natural resource wealth; and adequately provisioning for rising fiscal risks, especially from the operations of financial and non-financial public enterprises that have been increasingly excluded from the fiscal targets.

This paper provides a compact overview of these short and medium-term challenges. Following a brief review in the second section of main historical trends in Brazil's public finances and of the country's fiscal response to the global financial crisis, the third section focuses on the current macroeconomic challenges and the role of fiscal policy in addressing them. The fourth section briefly discusses the main structural fiscal challenges mentioned above.

Background

Historical trends

During the 'lost decade' of the 1980s and the crisis-ridden early 1990s, high inflation represented the main mechanism of adjustment of the Brazilian public finances, as it eroded the real value of public expenditures, while revenues were largely protected through indexation mechanisms. The rapid decline of inflation in the wake of the implementation of the Plano Real in the mid-1990s exposed this fundamental weakness. Despite a rapid growth of revenues, boosted by the surge in demand, the primary (non-interest) balance of the consolidated public sector[1] deteriorated significantly, moving into deficit. The overall deficit narrowed initially, reflecting the sharp decline in nominal interest rates, but worsened subsequently (Figure 1). The net public debt climbed steeply (Figure 2).

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[1] The consolidated public sector is defined to include the central, state and local governments, their non-financial enterprises and the Central Bank. In recent years, the coverage of both public sector targets and data has been narrowed, to exclude two major federal companies, the petroleum *(Petrobras)* and electricity *(Eletrobras)* ones.

Figure 1

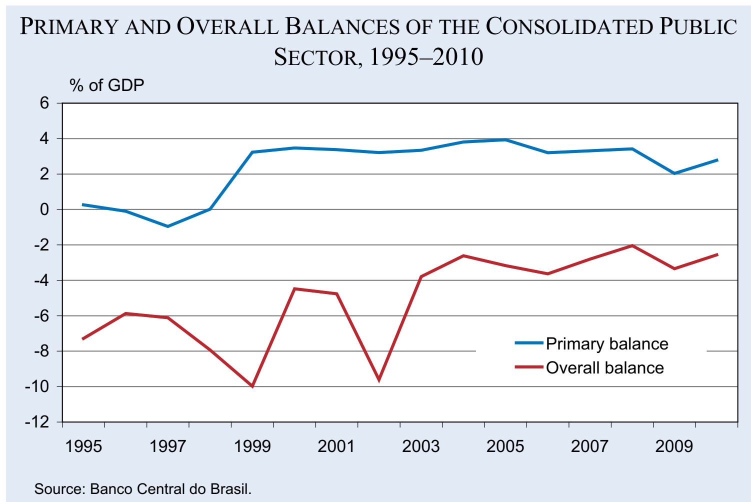
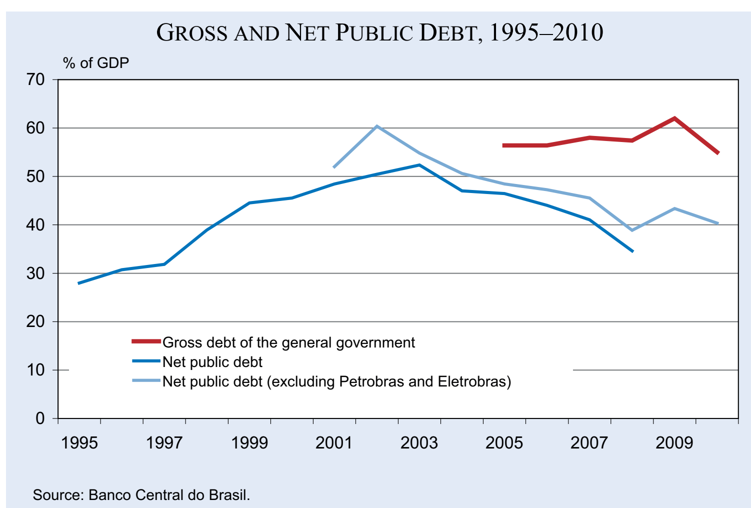


Figure 2



The fiscal weakening contributed, along with a relatively lax monetary policy and a significant real appreciation of the exchange rate, to the emergence of serious external imbalances that ultimately forced in early 1999 a strong adjustment program, supported by large external official financing. The program included: the floating of the Brazilian currency *real*; a substantial tightening of monetary policy and the adoption of inflation targeting; and a range of revenue-raising and expenditure-containment measures. A key ingredient of the fiscal adjustment was the adoption in 2000 of a Fiscal Responsibility Law that mandates the setting of three-year rolling targets for the primary surplus; stipulates limits on debt and certain types of public expenditures relative to revenues, as well as strict transparency requirements for the operations of all levels of government; and prohibits intergovernmental bailouts. Also crucial was the tightening of controls on the indebtedness of sub-national governments, whose finances had contributed importantly to the fiscal deterioration of the mid 1990s.[2]

The fiscal performance remained relatively strong during the 2000s, until the onset of the global crisis: the primary surplus fluctuated narrowly in the 3–4 percent of GDP range, and the overall balance (after a sharp but brief deterioration in 2002, reflecting the adverse impact of the depreciation of the *real* during that year) improved strongly. The net public debt also declined steadily, from a peak of nearly 60 percent of GDP in 2002 to around 40 percent of GDP in 2008. The structure of the public debt improved as well, with the share denominated in foreign currencies declining from over 20 percent at the beginning of the decade to under 2 percent in 2008, and the share at fixed rates rising from around 12 percent to over 35 percent over the same period. Moreover, the average maturity of the debt increased significantly, reducing rollover risks.

The improvement in the primary balance was wholly accounted for by a steady increase in the tax burden, as general government non-interest spending rose by the equivalent of a cumulative 4 percent or so of GDP. The rise in spending was mostly driven by transfers to households (pensions and social assistance programs, including the well publicized *Bolsa Familia*[3]), which contributed significantly to the improvement in the indicators of poverty and income inequality[4] from the beginning of the last decade to 2008.

[2] In 1997, the federal government refinanced the debt of the states and of most municipalities. In contrast to previous bailout episodes, this was accompanied by strict debt servicing requirements which, in combination with a prohibition of new borrowing, required sub-national governments to run significant primary surpluses.

[3] The *Bolsa Familia* pays poor households to keep children in school. It is one of the most successful international examples of conditional cash transfer programs.

[4] The poverty ratio fell from around 35 percent at the beginning of the 2000s to around 22 percent in 2008, and the Gini coefficient declined from around 0.6 to 0.54 over the same period.

Brazil's response to the global financial crisis

The global financial crisis of 2008–09 hit Brazil initially hard, through a sudden stop of foreign capital inflows, a significant fall in commodity prices from their mid-2008 peaks, and a sharp downturn in external demand. The ensuing credit crunch and decline in exports, together with a fall in consumer and business confidence, were reflected in a cumulative (seasonally adjusted) decline in GDP of over 6 percent between the third quarter of 2008 and the second quarter of 2009. The Brazilian authorities' response was rapid and multifaceted, including a number of measures to ease credit conditions; reduce interest rates; support the exchange rate, partly with a view to moderating foreign exchange losses for exposed domestic firms; and provide substantial fiscal and quasi-fiscal stimulus (OECD 2009).

Specifically on the fiscal front, in addition to accommodating the cyclical downturn in revenues, the federal government reduced the rates of selected indirect taxes (especially on sectors hard hit by the downturn in demand); increased the threshold and widened the brackets of the personal income tax; announced a new subsidized low-income housing program; and expanded some of the ongoing social assistance programs. This countercyclical fiscal response contrasted markedly with previous crisis episodes, when market pressures, financing constraints and sustainability concerns had forced pro-cyclical fiscal policies. The fiscal impulse to demand was reinforced by increases in current and capital spending already in the pipeline (in particular, significant adjustments in minimum wages and pensions; increases in public employment; and additional public investment under the so-called *PAC (Programa de Aceleração do Crescimento)* program.

These measures were reflected in a decline of the central government's primary surplus from the equivalent of 2.4 percent of GDP in 2008 to 1.3 percent in 2009. The decline in the primary surplus was moderated by exceptional revenues, equivalent to an estimated 2 percentage points of GDP.[5] The overall deficit widened to 3.3 percent of GDP, and the net debt of the central government interrupted the declining trend of the preceding years, rising by more than 5 percentage points of GDP. In contrast to the federal government, most states and municipalities were forced by financing constraints to cut back spending in response to the cyclical decline in own revenues and in transfers (mainly revenue sharing) from the central government. As a result, the consolidated primary surplus of the states declined only slightly in 2009, and that of the municipalities was virtually unchanged, compared to 2008 (Ter-Minassian and Fedelino 2010).

In addition to budgetary measures, the federal government provided support to demand through some quasi-fiscal operations (not reflected in the primary and overall balances and in the net debt[6]), in particular subsidized loans to public banks (the National Development Bank *BNDES* and the Housing Bank *Caixa Economica Federal*) equivalent to about 3.5 percent of GDP in 2009. These operations were reflected in a larger increase in the gross than in the net public debt (Figure 2).

Short-term challenges in fiscal macro-management

A pro-cyclical fiscal policy in 2010

The recession was short-lived in Brazil. Reflecting both favorable external developments (a rapid recovery in key emerging market partners, leading to a rebound in commodity prices; and a reflow of foreign capital, facilitated by the ample liquidity and low interest rates abroad) and the effects of the expansionary domestic policies mentioned above, GDP began to grow again already in the second quarter of 2009, and accelerated strongly in 2010, when the growth rate is estimated to have exceeded 7 percent. The recovery was clearly driven by domestic demand (both consumption and investment), as the growth of imports far outpaced that of exports. As a result, and despite a significant gain in the terms of trade, the current account of the balance of payments deteriorated from the small surplus prior to crisis to a deficit equivalent to 2.3 percent of GDP in 2010. At the same time, inflation accelerated markedly, to an average annualized rate of over 7 percent.[7]

[5] These included: the transfer to the Treasury of deposits held at the *Caixa Economica Federal* on account of taxes under judicial dispute; accelerated collection of tax debts; and a near doubling of dividends from federal enterprises.

[6] The subsidized Treasury loans to public banks are recorded below the line in the fiscal accounts and do not impact the net debt because they involve simultaneous increases in the federal government's assets and liabilities. However, the substantial difference between the rate paid by the Treasury on its market borrowing and that received on those loans is reflected over time in an increase in net interest payments and therefore in the overall deficit of the federal government.

[7] The average rate of increase of the main price indices *(IPCA, IGP-DI and IPC-FIPE)* in 2010 is estimated by the Central Bank of Brazil at 0.63 percent per month. The corresponding figure for 2009 was 0.18 percent.

Against this background of mounting domestic demand pressures, fiscal policy remained expansionary in 2010. To be sure, the recorded primary surplus of the consolidated public sector improved slightly (to 2.8 percent of GDP) and the overall deficit narrowed correspondingly (Figure 1), but the improvement was more than accounted for by the proceeds of the sale of future oil exploration rights to the national oil company *Petrobras* (which is not included in the consolidated public sector),[8] revenues that certainly did not reduce domestic demand. Federal expenditures (including the capitalization of *Petrobras*) rose by over 22 percent (compared with an estimated growth of less than 15 percent in nominal GDP) from an already high level in 2009. While most categories of expenditures rose significantly in real terms, the fastest growth was recorded in investment spending (largely under the expanded *PAC-2* program). Moreover, the federal government continued to support the expansion of subsidized lending by *BNDES* through additional loans equivalent to over 2 percent of GDP.

Rebalancing the mix of macro-economic policies in 2011

Looking ahead, there is growing recognition in Brazil of the risks (for both inflation and the external accounts) of a continuation of current macro-economic trends. The Central Bank has signaled its intention to rein back consumer price inflation towards the official 4.5 percent target, by first arresting and more recently reversing the decline in its policy *(SELIC)* interest rate; by increasing reserve requirements; and by introducing an array of macro-prudential regulations to moderate credit growth. However, the tightening of monetary conditions is likely to stimulate further capital inflows (which so far do not appear to have responded much to a progressive tightening of capital controls in recent months), and to put further upward pressures on the exchange rate (which is estimated to have appreciated by nearly 30 percent in real effective terms over the last 4 years, to a level broadly comparable to that prevailing just before the 1998–99 crisis).

A significant tightening of fiscal policy would help rebalance the macro-economic policy mix, moderating the need for monetary restraint and possibly the pressures on the exchange rate. This is increasingly being recognized by the fiscal authorities, who are targeting for 2011 a primary surplus target equivalent to 3 percent of GDP. Albeit only marginally higher than the 2.8 percent of GDP recorded in 2010, the 2011 target would require a significant expenditure containment effort, since revenues will not benefit this year from the one-off receipts from the sale of the future oil rights mentioned above.

Towards this objective, the authorities have recently announced a cut of 50 billion *real* (about 1.2 percent of GDP) in the federal budget expenditures approved by the Congress for 2011. While this is an appropriate signal in the current circumstances, it appears that, even if implemented in full, these cuts would still allow an increase in actual spending of nearly 10 percent (nearly 4 percent in real terms) from the high level of 2010. Moreover, given the rigidities in many categories of expenditures (see discussion below) and the government's commitment to safeguard certain types of discretionary spending, there are concerns that the proposed cuts may not be realized in full, or may end up being partly reversed in subsequent years. On a more positive note, the government has succeeded in moderating substantially the adjustment of the minimum wage for 2011, which is essential to contain the growth in real terms of social security benefits.

Main medium-term structural fiscal challenges

Ensuring a sustainable and transparent framework for fiscal policies

As indicated in the second section above, with the enactment of its Fiscal Responsibility Law (FRL) in 2000, Brazil adopted a comprehensive and transparent framework for fiscal management, appropriately blending rules and flexibility.[9] Although the experience to date with the implementation of the law has been in general better than in many other countries, some important mandates of it (in particular the definition of the ceiling on the federal debt and the creation of an intergovernmental Fiscal Management Council) have not been put in practice. Moreover, in the more recent years the coverage of the target variable (the primary surplus of the consolidated public sector) has been reduced through the exclusion of

[8] The federal government sold *Petrobras* the rights to 5 billion barrels from deep-sea (the so-called *Pre-sal*) fields (not expected to come into production for several years), and used the proceeds in part to capitalize the company, to enable it to raise additional funds for its massive investment programs. The remaining 32 billion Brazilian *real* (equivalent to about 0.9 percent of GDP) were used to fund (as revenues above the line) budgetary spending in 2010.

[9] See Corbacho and Schwartz (2006), and Ter-Minassian (2010) for discussions of the Brazilian FRL in an international perspective.

some key public enterprises and of a progressively expanding set of budgetary investments. Also, the meaningfulness of the primary balance as an indicator of the fiscal policy stance has been weakened by a significant use of one-off revenues and quasi-fiscal operations.

The medium-term sustainability and international credibility of Brazil's fiscal policy could be strengthened by the following steps:

- announcement by the government of its commitment to declining target paths for both the gross and the net public debt over the medium term, and to primary surplus targets consistent *ex-ante* with such paths, with a simultaneous commitment to revisit each year (and adjust as needed) the primary surplus targets to ensure compliance with the debt targets. This would represent a strong signal of commitment to medium-term fiscal sustainability;
- calculation and publication of cyclically adjusted budget balances as indicators of the fiscal stance, to guide, along with the sustainability considerations mentioned above, the choice of the primary balance targets over the cycle. The timely calculation of a cyclically adjusted balance for 2010 would have helped alert to the pro-cyclical nature of fiscal policy during that year;
- clarification in the budget document of the nature and amount of quasi-fiscal operations (such as funding of financial and non-financial public enterprises not included in the budget; and private-public partnerships), with a systematic and transparent analysis of their future costs and risks for the public finances;
- refraining from (or at a minimum transparently disclosing) one-off revenues and/or anticipations of receipts and delays in expenditures that distort the assessment of the budget stance; and
- creation of an independent fiscal watchdog responsible for vetting budgetary projections and publicly reporting on a timely basis on the consistency of budgetary developments with the fiscal targets.

Generating adequate public savings to finance needed investment in infrastructure

Although it is notoriously difficult to reliably calculate infrastructure needs and gaps, there is broad consensus among observers of the Brazilian economy that, despite the strong increase in the last couple of years, infrastructure bottlenecks remain substantial in the country, particularly as concerns roads, railroads, ports and urban sanitation facilities. Infrastructure investment needs will be compounded in the next few years by the fact that Brazil will host major international sporting events (the World Cup and the Olympic Games). Moreover, the relevant federal enterprises *(Petrobras and Eletrobras)* will be substantially ramping up investments in the energy sector (in particular oil exploration and electricity generation).

How much of the increased investment can be responsibly financed through debt, as opposed to higher public savings, depends on a number of considerations, including careful (and duly cautious) comparisons of the projected streams of costs of the additional borrowing and of fiscal returns on the investments; and assessments of conditions in domestic and external markets. Such considerations should inform the choice of the target paths of the public debt and primary balances mentioned above, as well as the specific choices of investment projects and their pace of executions, to be reflected in the next four-year Plan for 2012–15.

The need to increase public savings to fund in part the higher public investment is reinforced by the consideration that private investment will also need to rise as a ratio to GDP in the years ahead, to boost the potential growth rate of the economy and to promote adequate gains in productivity and international competitiveness (which has been significantly eroded by the appreciation of the exchange rate). The scope to increase the resort to foreign savings to finance the increased national investment effort is likely to be limited, as the current account deficit is already approaching 3 percent of GDP. Thus, a failure to raise significantly public savings in the years ahead would likely put further upward pressure on domestic interest rates, stifling private investment and hindering the needed recovery of competitiveness.

Over the longer term, a particular challenge will be posed by the management of a growing stream of fiscal revenues from the exploration of the deep-sea oil fields. A recently approved law envisages a shift from the current concession regime to a production-sharing arrangement (PSA) for the exploration of such fields. The PSA regime is expected to increase significantly the federal government's take of oil revenues. The resources so obtained will be used to constitute a savings-type sovereign wealth fund (the *Fundo Social*).

The law mandates that the returns on the investments of this fund be used for education, health and other social programs. While the constitution of such a fund is theoretically sound and in line with international best practice, significant doubts remain at this point on how the fund will operate in practice, given the large degree of discretionality afforded by the law to the government in its implementation.

Main tax reform needs

At over 35 percent of GDP, the tax burden in Brazil is already the highest in Latin America, and one of the highest among emerging market countries. Therefore, tax reform efforts should focus, rather than on further increasing the tax ratio, on addressing the main distortions and inequities created by the current tax systems, and on simplifying it, with a view to reducing compliance costs for taxpayers, which rank as the highest in the world in a World Bank index.[10] Rapid progress in such reforms would make an important contribution towards increasing potential growth and strengthening international competitiveness.

The area in greatest need of reform is undoubtedly indirect taxation. In contrast with widespread international practice, the main form of indirect taxation in Brazil is state-level VAT *(ICMS)* levied on intra- and inter-state sales of goods and selected services, on a mixed origin and destination basis. It is complemented by a municipal-level tax on other services *(ISS)*. The federal government also levies selective excises *(IPI)*, and so-called contributions *(PIS and COFINS)* based on enterprises' turnover, and earmarked for the financing of social security. It has relied increasingly on these contributions in the last decade, since their revenue is not shared with the sub-national governments.

The *ICMS* (which currently raises the equivalent of nearly 8 percent of GDP) suffers from a number of serious shortcomings that include:

- *de facto* incomplete crediting of exports and capital goods purchases;
- use of the tax for predatory competition by the states in attracting investment;
- huge dispersion in rates on intra-state transactions and in administration procedures, raising sharply compliance costs, especially for enterprises operating in multiple states; and
- the fact that it does not cover most services and it is levied at very high rates on a few services (e.g. electricity and telecommunications) which represent key inputs into production processes.

The federal contributions are also quite distortive because (despite recent reforms) they maintain a significant degree of cumulativity which impacts differently enterprises in the same sector, depending on their degree of vertical integration.

The need for reform in these areas has long been recognized by the Brazilian authorities and by economic opinion-makers, as witnessed by the numerous reform proposals put forward in recent years. However, past reform efforts have been stymied by strong opposition of those states and municipalities most likely to be negatively affected by the proposed changes. The prospects for reform may be enhanced, over the next year or so, by the increased urgency of addressing the deteriorating competitiveness of Brazilian industry, on the one hand; and by the scope that scheduled reforms of the intergovernmental transfer system (discussed below) may create for compensating at least in part sub-national losses entailed by the tax reform, on the other.

A desirable reform of the indirect tax system would involve the replacement of the *ICMS, ISS, IPI, COFINS* and *PIS* with a dual (federal and state) VAT, complemented by federal and state excises, and by a municipal retail sales tax. The dual VAT should be of the consumption type (with full credit for both exports and purchases of capital goods); have a very small number of rates that could be allowed to vary across states within a nationwide band;[11] and be collected on an origin basis, to facilitate enforcement, but with the revenue redistributed on a destination basis through a clearing house mechanism, to avoid incentives to predatory tax competition. The introduction of the dual VAT should be accompanied by steps to harmonize collection and enforcement procedures across the national territory. This would contribute to both making the administration of the tax more effective, and reducing compliance costs.

Another area of the tax system in need of reform is labor taxation. According to OECD (2009) calcula-

[10] A compact and up-to-date overview of the Brazilian tax system can be found in Afonso and Barroso (2008). See also OECD (2009) and Rezende (2010) for more comprehensive discussions of tax reform needs.

[11] There is broad consensus in the literature that redistributive objectives should be pursued through expenditure policies, rather than through a proliferation of VAT rates. A degree of differentiation among states may be necessary to allow adequate play to the historically well entrenched autonomy of the states in this area.

tions, the combined burden of employer and employee contributions to the social security system (pensions and unemployment insurance) and assorted other levies on payroll can exceed 50 percent, dampening demand especially for low-skilled labor and creating a significant incentive to informality. Given however the precarious current state of the social security finances, the scope for a significant reduction of this burden hinges largely on simultaneous reforms of social security benefits (see also discussion below). In the short term, reform efforts could focus on a rationalization of the payroll levies to finance training and other labor services (the so-called S system).

Finally, reforms in both taxation areas should be accompanied by a review and narrowing of the scope of the simplified system for taxation of small and medium enterprises (the so-called *SIMPLES*), which, by providing a substantial tax preference to enterprises with turnover below a (too high) ceiling, significantly erodes the tax base and constitutes a disincentive to enterprise growth beyond that ceiling.

Reforming intergovernmental transfers

A further priority area for reform (and one that is closely linked with tax reform) is the system of intergovernmental transfers (including revenue-sharing). The current system is characterized by:

- low discretionality of the transfers (most of which are mandated, and defined in considerable detail, by laws, or even by the Constitution). This imparts to the system relatively high degrees of transparency, predictability, and immunity from continuous political bargaining, but also of cyclical volatility and inflexibility in the face of changing economic, social and demographic trends;
- the fact that a significant portion of the revenue sharing arrangements is based on derivation (geographic origin of the revenue) criteria, thus compounding the already substantial differences in revenue capacities that characterize sub-national own taxes. The (also derivation-based) sharing of natural resource rents further aggravates these differences, as such resources are concentrated in relatively few states and municipalities;
- a relatively high degree of fragmentation of the sharing arrangements, as regards the purpose of the different regimes, the definition of their bases (with resulting distortive incentives for upper level governments to exploit non-shared taxes), and their distribution formulas. This complicates the assessment of the allocative and distributional effects of the overall revenue sharing system; and finally
- lack of a comprehensive and well-designed equalization transfer system. While existing studies suggest that some of the existing transfers have a (more or less significant) progressive redistributive impact, they fall well short of an equalization system.

A reform of the main revenue-sharing mechanisms (*the Fundo de Participação dos Estados (FPE)* and *the Fundo de Participação dos Municípios (FPM)*) has been mandated in 2010 by the Constitutional Court, which found the current criteria for horizontal distribution of the transfers unconstitutional.

The reform of the system should be guided by the objectives of simplifying it, making its effects more transparent, reducing its sensitivity to the cycle, and especially making it more equitable. As the international experience shows, however, there are likely to be trade-offs between some of these objectives, and careful choices would need to be made in the design of a reformed system. To maximize the chances of political acceptability of proposed reforms, a further objective should be the broad maintenance of the vertical distribution of the total transfers among the three levels of government.

As regards the more complex issue of the horizontal distribution of the transfers, a theoretical first best would be the implementation of a full-fledged equalization system combining both revenue capacities and spending needs equalization criteria. As the experience of Australia shows, however, such a system would be so demanding in terms of data requirements and resources for its effective implementation that it does not appear to be a practical option for the foreseeable future in Brazil. A more manageable alternative would appear to be the implementation of a system to equalize revenue capacities (such as e.g. the Canadian one), which could be developed initially only for the state level, given the more limited number of entities involved.

Expenditure reform needs

The need to maintain, for macro-economic stability and longer-term fiscal sustainability reasons, significant (2–3 percent of GDP on average over the cycle) primary surpluses, and the already high level of the tax burden highlight the need to arrest the relentless

increase in the size of the public sector over the last decade. Indeed, Brazil could benefit from adopting at all levels of government expenditure rules consistent with this aim. Moreover, as indicated above, there is a clear need to reduce current spending as a ratio to GDP, to create fiscal space for the needed increase in public investment.

Unfortunately, these are likely to prove difficult tasks, requiring fundamental changes in the legal (in some cases constitutional) frameworks for major spending categories, and therefore a strong government commitment to building the necessary broad base of political and social support for such changes. The difficulty reflects a number of factors, in particular:

- pervasive rigidities in the main public expenditure programs, ranging from extensive earmarking provisions,[12] to selective indexation requirements,[13] and to strict tenure provisions for civil servants; and
- mounting pressures on spending on pensions and health, due to ongoing demographic changes that are leading to population aging at a faster pace than in most advanced and emerging market countries.

Space limitations prevent a comprehensive analysis in this paper[14] of needed expenditure reforms in the health, education, public administration and social security systems, as well as of ongoing and further desirable reform efforts in public expenditure management systems, aimed at improving the cost-effectiveness of existing spending programs. Because of their importance, however, reform needs in the pension system are briefly discussed in what follows.

The public component of the pension system in Brazil includes separate regimes for private and public employees. Expenditures of the former *(Regime Geral da Previdência Social, RGPS)* (with over 23 million beneficiaries) amount to over 7 percent of GDP; those of the latter *(Regime da Previdência dos Servidores Públicos, RPPS)* (with about 3 million beneficiaries) to around 2 percent of GDP. Both are defined-benefit, pay-as-you-go systems, currently running primary deficits in excess of 1 percent of GDP each, despite the above-mentioned relatively high levels of social security contributions. There is also a growing network of private (open or closed) pension funds, operating mostly on a defined contribution basis, and participation in which is voluntary.

The *RGPS* suffers from a number of significant weaknesses that are largely responsible for the relatively high (in an international perspective) level of its expenditure:

- indexation of its minimum benefits (about 40 percent of total benefits) to the minimum wage (which rose by over 120 percent in real terms over the last 15 years);
- absence of a minimum retirement age requirement after 35 years of contributory service;
- a relatively low minimum retirement age for women (60 years, or less after 30 years of service); and
- excessively generous survivor benefits.

The *RPPS* is widely recognized to suffer from excessive generosity in both the retirement age and determination of benefits provision.

Previous reform efforts (in 1998 and 2003) included the introduction of a formula *(fator previdenciário)* to link the level of benefits under the *RGPS* to recipients' life expectancy, and to modify the *RPPS* for new public employees.[15] These reforms moderated significantly the growth of the *RPPS* benefits, but had a limited impact on the expenditures of the *RGPS*, that have been boosted strongly by the above-mentioned growth of the minimum wage.

Looking forward, a comprehensive reform of the pension system, aimed at ensuring its longer term financial viability during the coming demographic changes, would need to include:

- indexing benefits to prices, rather than the minimum wage;
- introducing a unified minimum retirement age requirement for all pensioners, linked to the rising average life expectancy;

[12] These provisions include the earmarking of federal contributions on payroll, turnover, and company profits to fund social security expenditures; a constitutional requirement to devote 25 percent of total primary spending to education; and an (also constitutional) mandate to increase health spending at least in line with nominal GDP.

[13] For example, the minimum pension and social assistance benefits are indexed to the minimum wage, which is in turn indexed to price (with a one-year lag) and real GDP growth (with a two-year lag).

[14] Selective references to detailed studies of needed expenditure reforms (in particular in the social security, health, and civil service systems; and in expenditure management systems) are provided in the bibliography attached.

[15] The 2003 reform envisaged the introduction of a ceiling (the same as under the *RGPS*) for the pension benefits under the *RPPS*. This was to occur simultaneously with the creation of a complementary mandatory defined-contribution regime for new public employees. Both reforms have not been implemented to date.

- implementing the ceiling on pension benefits and introducing a complementary mandatory defined-contribution regime for public employees, as envisaged by the 2003 reform; and
- tightening eligibility requirements for survivors' pensions.

To facilitate their social acceptance, most of these reforms should be adequately phased-in, and existing pensioners should be grandfathered.

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