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SUSTAINABLY FINANCING DEVELOPMENT

BRAZIL POLICY NOTES

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A Delicate Balance

1 As the incoming authorities seek to fulfil commitments and securing the recovery, it will be **essential to situate these efforts within a sound medium-term fiscal plan** that carves out space for priority development needs while shoring up the credibility of the fiscal framework.

2 The main challenge facing Brazilian fiscal policy today is navigating the delicate balance between **promoting growth, inclusion and climate resilience through the budget and maintaining fiscal discipline.**

3 **Key elements of such a plan include:**

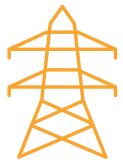
I. maintaining a credible fiscal anchor;

II. making social transfers and taxation more efficient and progressive; and,

III. containing public sector renumeration.

Development needs are high as Brazil pursues a recovery in social and economic outcomes

Poverty and disparities remain prominent in the lives of many Brazilians. Deep shocks widened existing gaps and losses in learning during the pandemic were high, calling for increased investment in service delivery and growth enhancing programs.



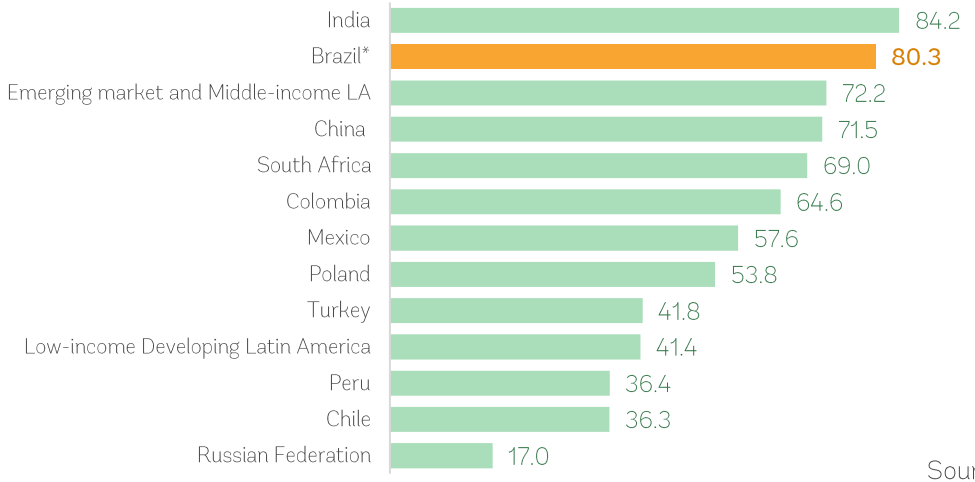
The decline in infrastructure spending is also of particular concern, having fallen dramatically from about 4.8 percent of GDP in the 1980s to merely 1.7 percent in 2021, it is no longer sufficient to replace depreciating capital, let alone expand the infrastructure stock.

The investment needs of the climate transition are sizeable. Brazil's climate action estimates set the investment needs between 2022–2030 at 0.8 percent of projected GDP, and over the 2022–2050 period, around 1.2 percent.

Yet, Brazil's public finances are on a fragile footing.

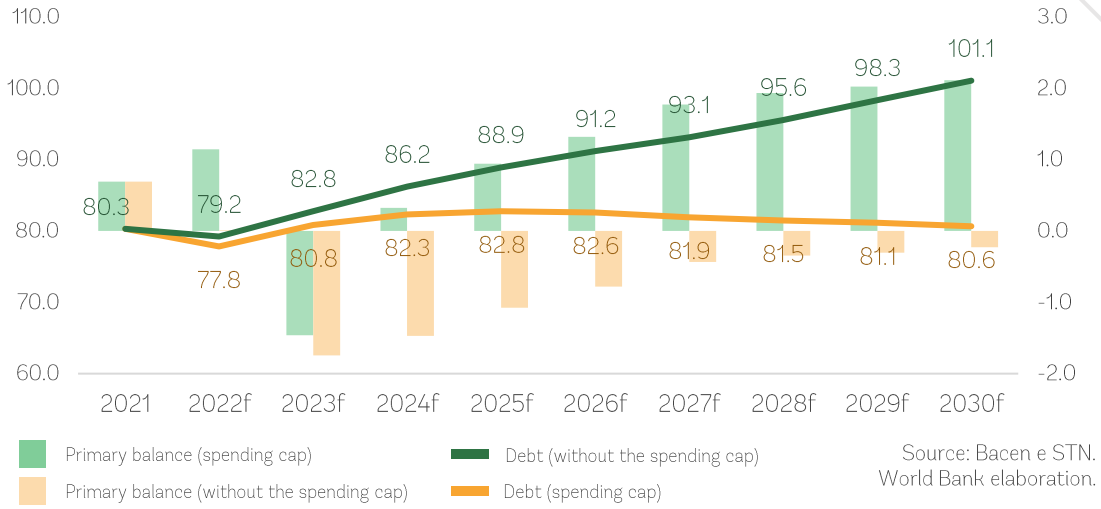
Fiscal projections indicate that, in the absence of the federal spending ceiling rule, Brazil's public debt would be on an unsustainable fiscal path. Weakening fiscal discipline would increase debt costs, and fuel inflation – making it difficult to normalize interest rates at an incipient stage of the economic recovery.

Gross debt in comparison with peers in 2021 (% of GDP)



Source: IMF Fiscal Monitor.

Debt and deficits with and without spending controls



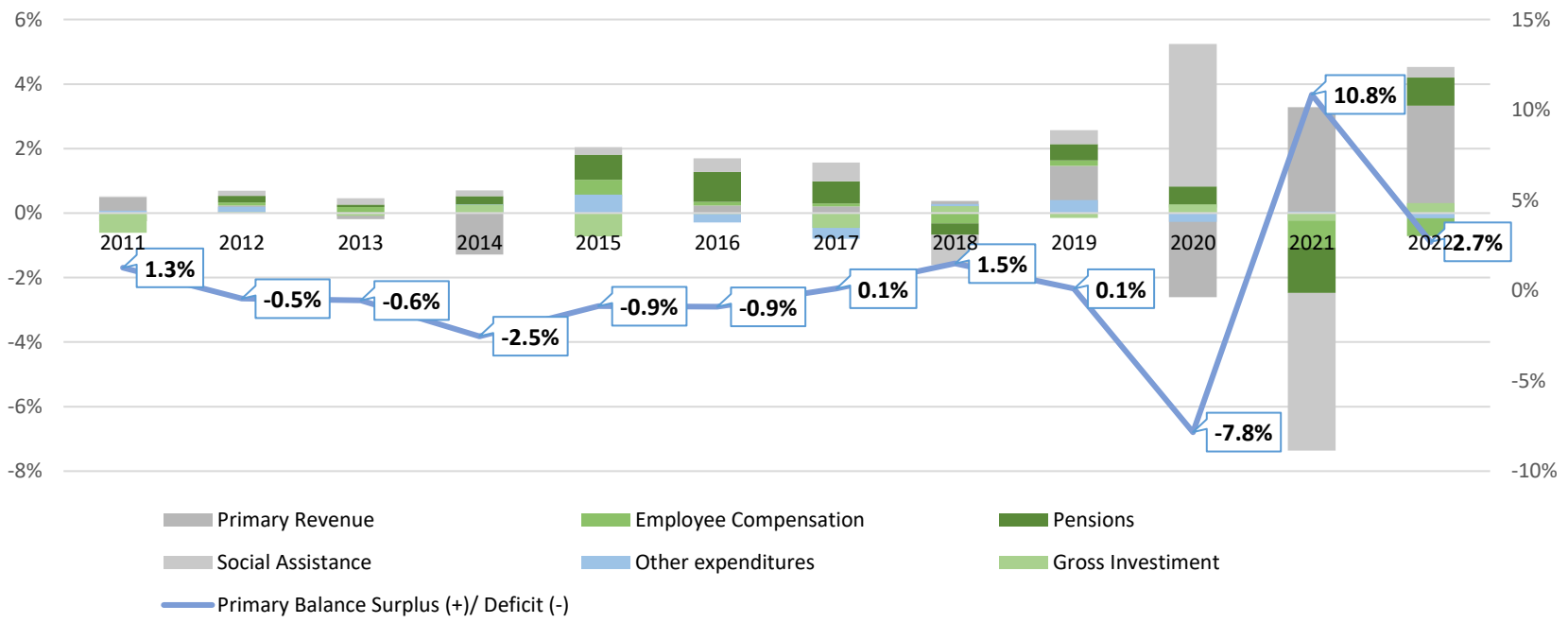
Source: Bacen e STN. World Bank elaboration.

And spending pressures are persistent

The structural spending pressures that inflated the recurrent budget and raised debt over the past 15 years persist today, further stressing the need to anchor public finances.

Contribution of primary expenditure and revenue items to the primary balance (annual change in p.p.)

Source: National Treasury Secretary. World Bank elaboration.



How can Brazil finance development needs while maintaining fiscal sustainability?

- Maintaining a credible fiscal anchor
- Controlling public sector pay and pensions
- Rationalizing regressive social transfers
- Making taxation more progressive

Maintaining a credible fiscal anchor

As the country engages in debate around ways to finetune its fiscal rules, we highlight four important best-practice principles for consideration for any new arrangement:

1. Fiscal rules for sustainability whilst avoiding procyclicality

Fiscal projections under a business-as-usual scenario indicate a return to rising debt in the absence of strong fiscal anchor. Maintain a credible fiscal rule is necessary. A combination of debt rules with expenditure or budget balance rules, for example, could favor debt sustainability while reducing the procyclicality of government spending.

2. Simple and transparent fiscal rules to support communication and broad-based buy-in

Fiscal rules represent a pact between the state and its citizens that involves tradeoffs and even sacrifices in pursuit of macroeconomic stability. For this reason, fiscal rules should be transparent, simple, monitorable and easy to communicate.

3. Well defined "escape clauses" to deal with shocks

To be resilient and credible, a rules-based fiscal framework must be sufficiently flexible, but this flexibility must come primarily in the form of well-designed escape clauses with defined scope for governmental discretion in triggering them and a clear resumption path.

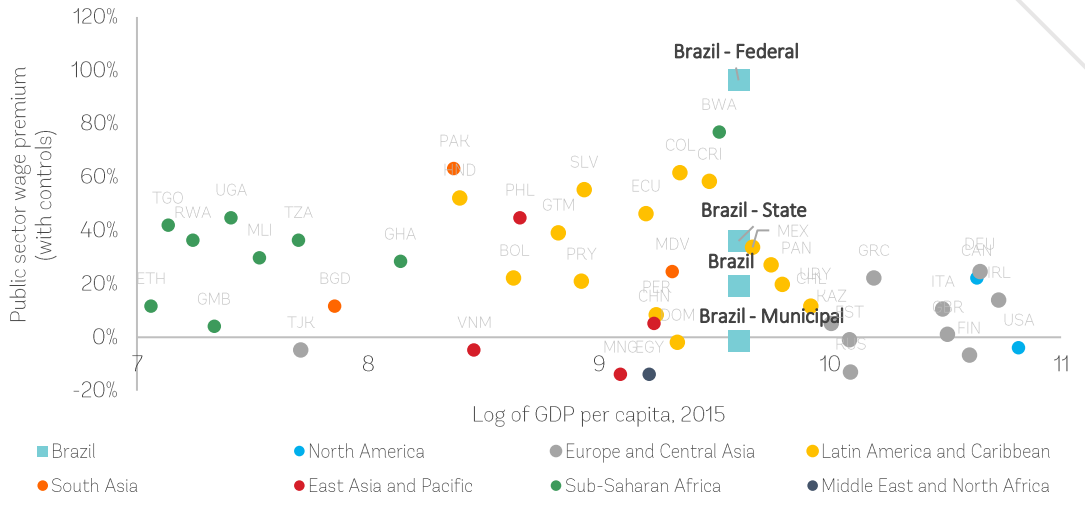
4. Progress in implementing structural fiscal reforms to support the fiscal rule

A fiscal rule is not a standalone tool. It works best when part of an integrated fiscal program of reforms that tackles the underlying sources of budgetary pressure such as the administrative reform to control the public sector wage bill, the wider roll-out of pension reform to States and reducing built-in momentum from earmarking and indexation.

Controlling public sector pay

While the size of the Brazilian civil service is not large by international standards, the federal government wage premium is an important source of pressure on wage bill growth. Implementing an administrative reform to reduce the wage premium and improve human resource management is therefore a priority reform.

Public sector wage premium: Comparing Brazil



Source: World Bureaucracy Indicators (World Bank, 2019)

Policy options to reduce the wage premium over time include:

I **Restricting wage increases** and entry level salaries to reduce the wage premiums over time;

II **Career reforms such** that the interval for progressions increases while the wage adjustment between progressions decreases;

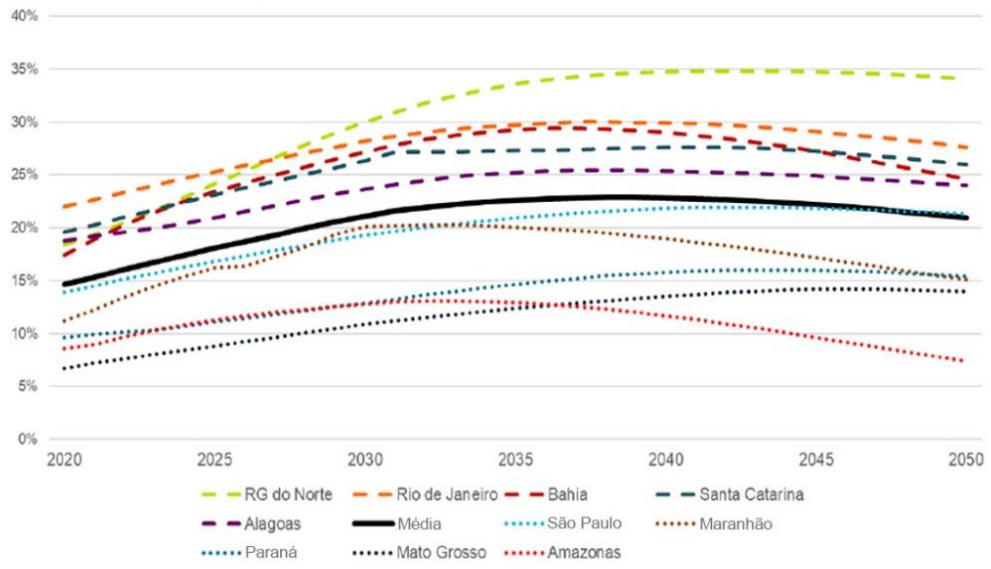
III **Decreasing replacement** rates depending on the sector; and

IV **The introduction** of more rigorous performance evaluation would link salary increases to gains in performance.

Controlling public sector pensions

The fiscal sustainability of subnational systems remains the main concern of the overall pension system in the near term.

Projected pension deficit as a share of revenues – selected states



Source: World Bank projections, using data provided by state governments.

Policy focus should be on advancing the pace and depth of subnational pension reforms initiated at the federal level in 2019, given the uneven pace and breadth of their adoption by States and municipalities to date:

I **Increasing the number** of States and municipalities that adopt a comprehensive pension reform;

II **Consolidating the management** of pensions from all State government branches into a single management unit, as mandated by 2019 federal reform; and

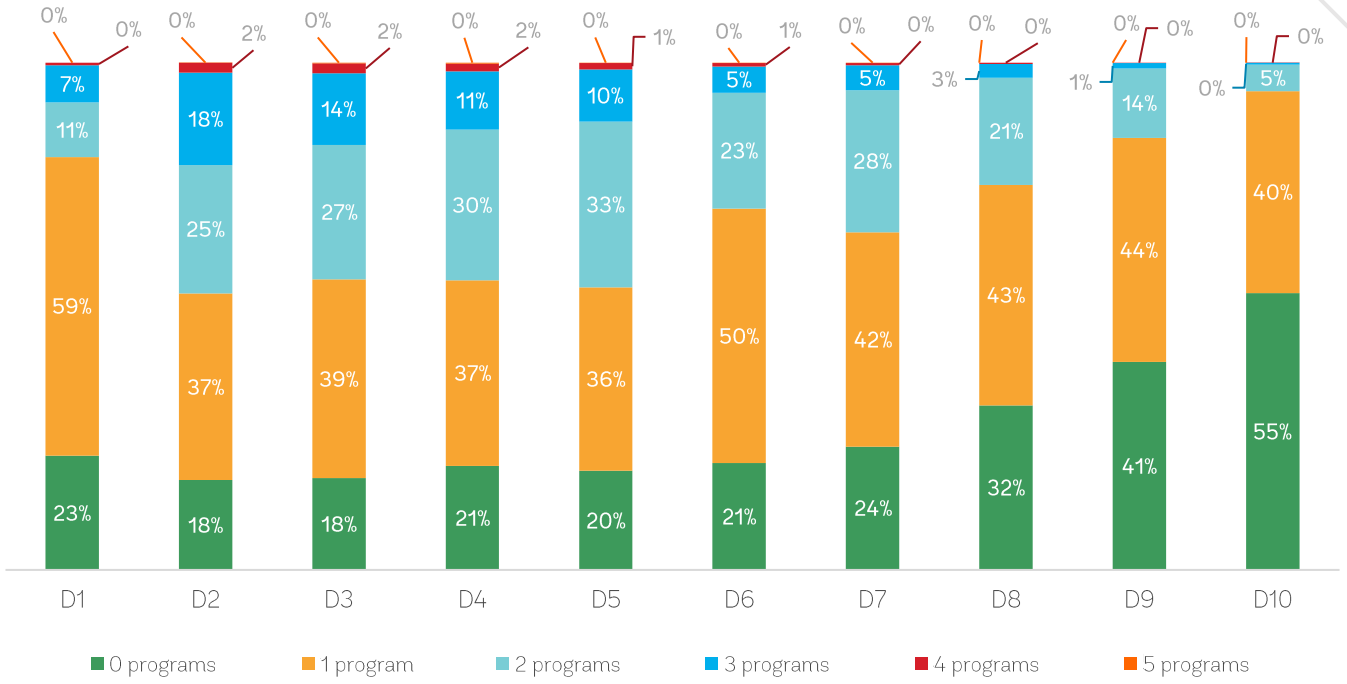
III **The integration** of human resource and pension systems' IT systems.

Making social transfers more efficient and progressive

Inefficiencies and overlaps in Brazil's numerous social assistance programs offer opportunities to consolidate the various schemes and to sharpen their impact on inequality: **about 40 percent of households in income deciles 2 to 5 receive two or three benefits often due to the poor targeting of the programs.**

Consolidating the various social protection programs is a policy agenda that would both enhance the performance of the social protection system, whilst also offering efficiency gains.

Share of the population in each decile, according to the number of benefits received by their households



Source: World Bank (2018), using data from PNAD Continuous

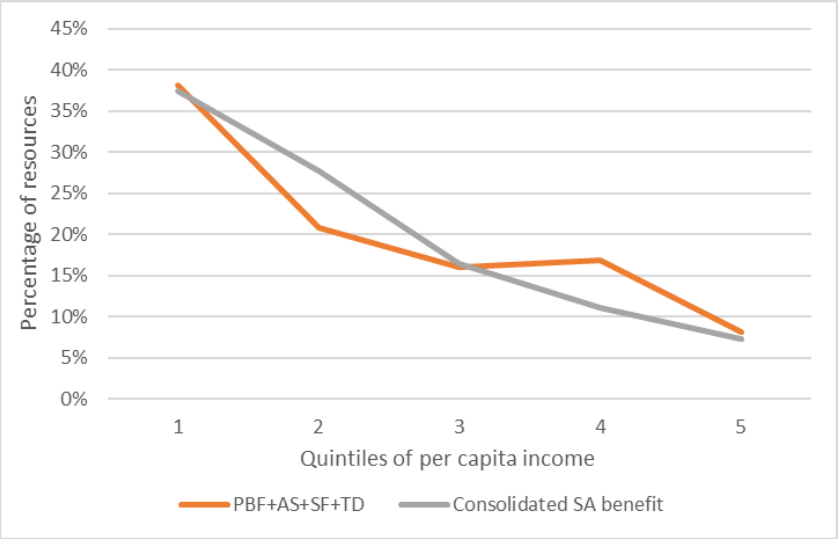
Making social transfers more efficient and progressive

A more progressive and affordable Auxilio Brasil/Bolsa Familia

In the near term, the design of Auxilio Brasil/Bolsa Familia could be finetuned to offer a more fair and efficient use of resources. An important policy option for consideration in the near term is to adjust the conditional cash transfer program so that it provides benefits to individuals, as opposed to a flat benefit amount per family. This approach would be more progressive, further improve poverty outcomes since poorer households tend to be larger in size and would offer savings.

In the medium term, Brazil has the opportunity to consolidate several social assistance programs into a single social transfer that refocuses around the needs of the most vulnerable Brazilians and saves costs. A policy option that Brazil could consider in the medium-term is to adopt a single social transfer that combines a universal flat benefit for children with a broadly targeted means-tested benefit to poor households, a "consolidated social assistance benefit.". The are several advantages to this approach. It would prevent overlaps between the various programs and better align benefits with needs.

Distribution of benefits by income level: the current system vs. a consolidated social assistance benefit



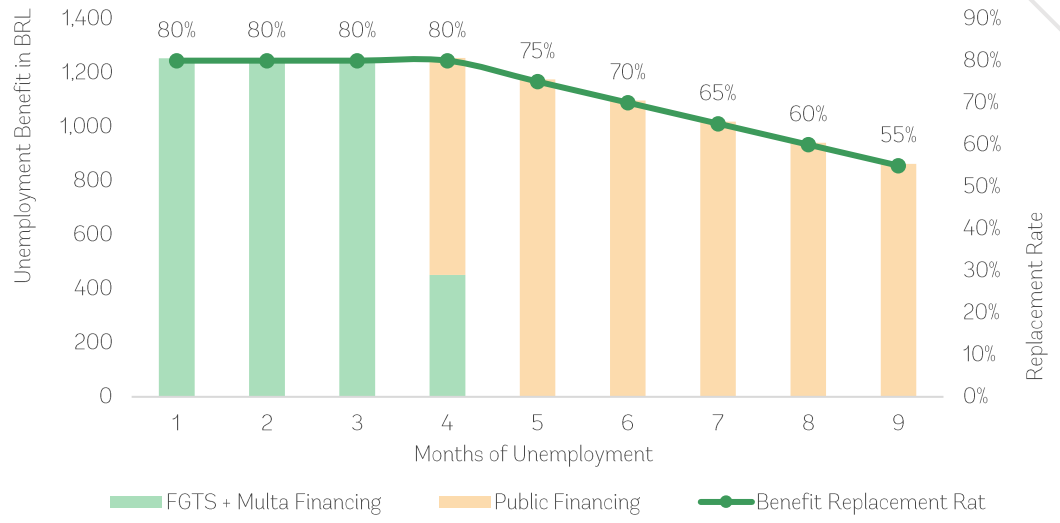
Source: World Bank – Social Protection for the Future Brazil. (forthcoming).

Making social transfers more efficient and progressive

Optimizing unemployment insurance schemes

To increase the efficiency of unemployment protection programs, unemployment insurance (*Seguro Desemprego*) and individual unemployment insurance savings accounts ("*Fundo de Garantia do Tempo de Serviço*" - FGTS) should be coordinated with each other and with other services.

Unemployment payouts if unemployment insurance and individual savings accounts were coordinated



Source: World Bank – Social Protection for the Future Brazil. (forthcoming).

Policy Option

A policy option is to enable individual savings accumulated in the FGTS to be used as the first line of financing for unemployment claims. Only once the worker's funds in the FGTS are exhausted would the worker receive funds from unemployment insurance. In this way, workers would receive less than they earned while working (thus removing perverse incentives), payout periods would be extended, and individual savings would be used up before any payouts would be given from the public risk pool.

This reform could result in fiscal savings whilst providing improved protection to workers.

Making social transfers more efficient and progressive

Social pension reform

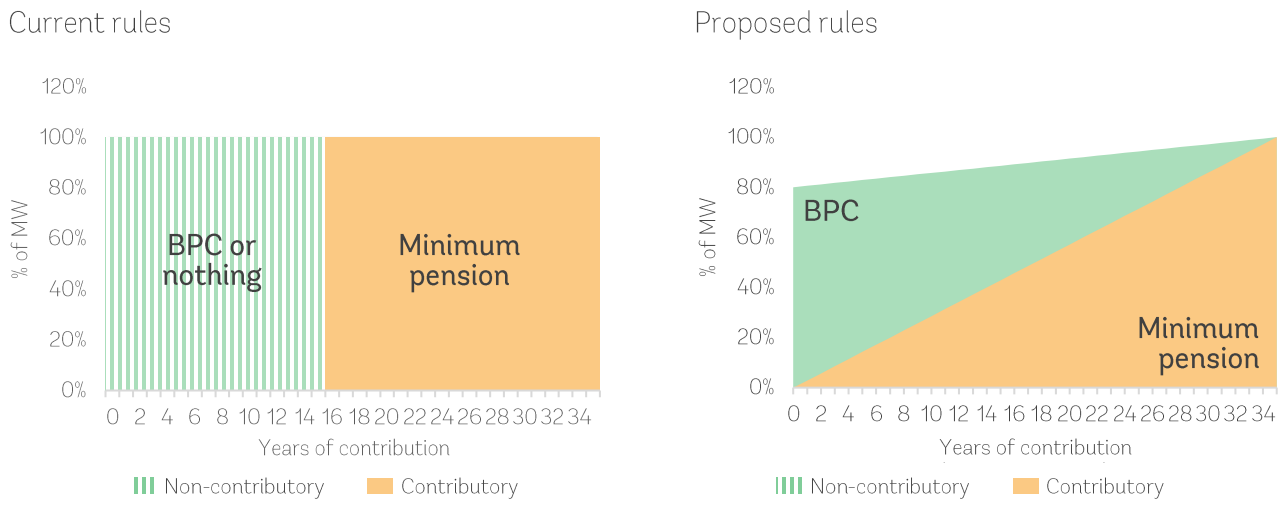
Considering the large fiscal costs and the major sustainability challenges facing the private pension system, reform of the minimum pension benefit will be vital, coupled with compensating measures in the provision of social pensions.

Policy Option

- **Minimum pension:** remove the 15-year minimum contribution to not penalize those with shorter work histories and implement a pro-rate years of contribution benefit. For those who don't qualify for full pension, BPC could be used to close the income gap resulting in savings for the BPC. For people with no contributory pension, BPC would be paid in full.
- **BPC:** BPC could be gradually reduced in real terms to become lower than the minimum contributory pension by decoupling its indexation from the minimum wage.

This reform could result in 0.9 percent of GDP in annual fiscal savings whilst keeping minimum old age protection universal.

Consolidating the components of old-age pensions (BPC and rural pension) and the prorated minimum contributory pension guarantee



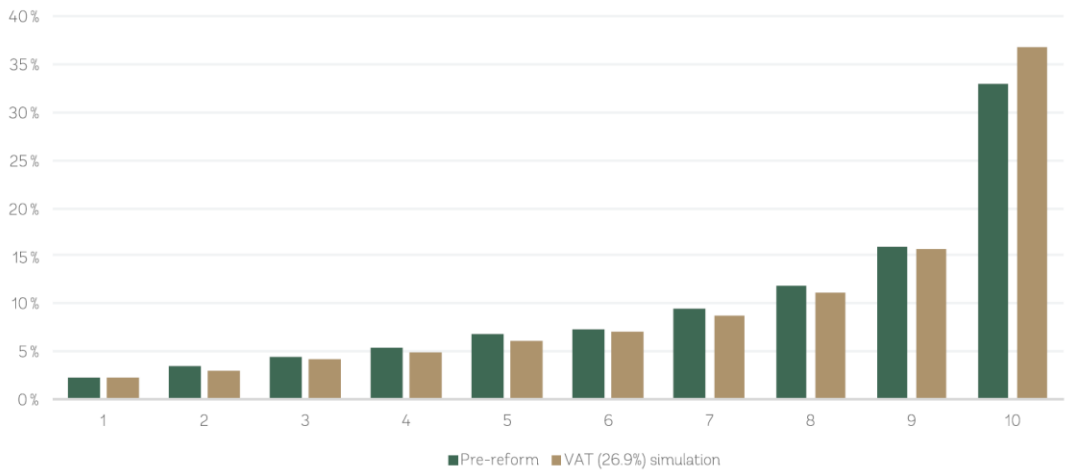
Source: World Bank – Social Protection for the Future Brazil. (forthcoming).

Making taxation more progressive

Brazil's tax burden departs from international standards with its regressive structure.

- Income taxation is only 8 percent of total tax revenue, which is relatively low when compared to OECD average.
- The country's tax revenue is heavily concentrated on taxes on goods and services and on payroll, which respectively account for 43 and 24 percent of the tax burden.
- Special tax regimes such as SIMPLES for small firms and for MEI independent workers help high-earners to avoid taxes by shifting income from the personal to the corporate tax base. This phenomenon, called "*pejotização*" (from "PJ", or *Pessoa Jurídica*), not only harms the ability of the system to fight inequality, but also reduces the size of the tax base.

Share of Total Indirect Taxes Paid by each Income Decile – Status Quo versus VAT Simulation



Source: World Bank Poverty and Equity Assessment (2022)..

Making taxation more progressive

As the country engages in debate around ways to finetune its fiscal rules, we highlight four important best-practice principles for consideration for any new arrangement:

1. Mitigating the "pejotizacao" phenomenon

Reducing the difference in the costs of procuring labor from a dependent wage employee vs self-employed.

2. Removing the current exemptions for dividends and financial investments

Dividends distributed to individual shareholders and financial incomes are exempt from income taxes, which is a global anomaly. This further incentivizes individuals to incorporate as firms. Taxing dividends would harmonize income taxation across different tax bases – personal, capital and corporate income – to avoid income shifting and increase the progressivity of income taxes and align Brazil with global standards.

3. Removing the remaining exemptions on incomes from pensions

An Income tax exemptions on a portion of the income from pensions currently costs the government more than 70 billion Reais per year. Removing this exemption would raise revenues and increase progressivity given the higher income levels of contributory pension beneficiaries.

4. Making indirect taxation more progressive through VAT reform

Further gains in fiscal progressivity can be made through reforms that consolidate and simplify indirect taxation. Adopting a flat VAT rate would make taxation more progressive since these taxes take up between 23 and 45 percent of the income of the poorest.

5. More progressive personal income taxation

By charging higher rates for higher incomes and reducing exemptions and deductions (for example, deductions linked to private health and education services).

What has the World Bank been doing?

Analytical Studies

01

Brazil 2042

It supports a conversation in Brazil about how to overcome its external and internal growth challenges, considering various "alternative futures".

02

Social Protection for Future Brazil : A 2040 Outlook

To inform the renewal of Brazil's social protection system, in light of the challenges of the next two decades.

03

Subnational Civil Servant pension schemes in Brazil

It presents an integrated view of RPPS pension schemes and provides lessons and policy recommendations for the future of pension schemes in Brazil.

04

FPE Reform Proposal

It provides an analysis of the Brazilian intergovernmental fiscal transfer system, and presents reform options for a new FPE design.

05

Wage Bill Study

It provides policy options for carrying out administrative reforms in Brazil, with significant fiscal gains both in the federal government and in states.

Projects

01

First Amazonas Fiscal and Environmental Sustainability DPF

To support fiscal discipline, climate-informed decision making, and an integrated approach to forest conservation and development in the state of Amazonas.

02

State of Goias Sustainable Recovery DPF

The objective is to (i) improve fiscal sustainability; and (ii) adopt climate-smart, resilient, and inclusive policies for its agricultural sector.

03

Rio de Janeiro Adjustment and Sustainable DPL

To support the Municipality of Rio de Janeiro in: (i) strengthening fiscal management to improve medium-term fiscal sustainability; and (ii) accelerating the transition towards a low-carbon, resilient and inclusive urban development.

04

Progestão Alagoas

To improve efficiency in public resource management in selected departments of the State of Alagoas.

05

Progestão Mato Grosso

To improve efficiency in public resource management in selected departments of the State of Mato Grosso.

Thank you!

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