Budget, Institutions and Fiscal Policy*

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*Paper written for presentation at "Fiscal Policy Meeting 2014", Ministry of Finance and Getulio Vargas Foundation, Sao Paulo, SP, Brazil, November 7, 2014.

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Introduction

The topic that I was asked to address at this conference –*Budget, Institutions and Fiscal Policy* – is broad and covers wide areas of economics. Inevitably decisions had to be made on what to cover. The paper will discuss the role that the "public budget" plays or should play, as a key policy instrument that governments use to promote their economic and social objectives. In democratic societies, as Brazil is today, it is assumed that the objectives followed by governments reflect, or should reflect, those of the population, or at least of the voters, and not just those of the political leaders. This assumption, of course, can be easily questioned, because different pressure groups and the political or economic interests of the policymakers often end up influencing the decisions that governments make.

The paper starts with a historical survey of how the goals that governments are expected to promote, through their public budgets and other policy instruments, changed over the years, especially during the second half of the 20th century. As happened with other countries, and especially with European countries, with which Brazil has had continuous contacts, the Brazilian governments were influenced by similar intellectual and political winds and by pressures coming from those winds. Consequently, they required progressively more public resources to finance their growing spending needs.

Over the years the democratization of political decisions shifted the political power from relatively few individuals, as it had been in the past, to progressively larger shares of the populations that demanded more and better public services and a broader economic role of the state. See Tanzi, 2011.

The historical section, helpful in understanding the longer terms developments in Brazil, will be followed by one focused directly on Brazil's developments in more recent decades, especially those connected with taxes and public spending. A third section will raise some questions about the meaning of the estimated Gini coefficients, which receive a lot of attention. A fourth section will address some broader aspects of fiscal policy and related institutional issues. A final, brief section will draw some general conclusions.

I. Historical Background on the Economic Role of the State

A century ago there was no "fiscal policy" or "public economics" in the modern sense of these terms. There was "public finance" that, as the term implies, or should imply, dealt mainly with ways to *finance* public spending. Throughout the 19th century the economic role of the state had been limited to financing essential "public goods" needed by a community to be a community. These "public goods" were broadly defense, personal protection, justice, a few schools, some administrative services and minimal, essential infrastructures.

At that time the public budget did not include *social* programs and did not intentionally attempt to change the income distribution. These functions were delegated to religious groups, charitable institutions and extended families. The public budget made no provision for stabilization policies but dealt almost exclusively with aspects related to what economists now call *the allocation of resources*. In government documents, in public discussions, or in economic books, there was no mention of "fiscal policy".

It may seem strange to individuals living in our time, that the term "fiscal policy" originated only about a century ago when a famous German economist, Adolf Wagner, advocated in his writings, the use of taxes and public spending to promote some redistribution of wealth in a market economy. Ignoring the calls to abolish private property (and, for some, also the free market) that had started to come from socialist writers, such as Karl Marx, Saint-Simon and others, this seems to have been the first time that governments were asked by a major economist to play a role in redistributing wealth or income in a market economy.

Edwin Seligman, an American economist who, at that time, was a professor of "public finance" at Columbia University in New York, took issue with Wagner's view in advocating what Seligman ironically defined "fiscal policy". Thus, the term "fiscal policy" was born in connection with a potential, government role in *income redistribution* and not in stabilization. During the years of the Keynesian Revolution", in the 1940s and 1950s, the meaning of "fiscal policy" underwent a change and came to be associated with a still newer government role: that of trying to *stabilize the economy*, by manipulating aggregate demand.

It is an interesting and ironical historical twist that in recent decades fiscal tools were increasingly called upon to promote better income distributions, thus, returning the term "fiscal policy" close to its original meaning. Perhaps as a coincidence, or reflecting growing general worries, at about the time when the exchange between Wagner and Seligman was taking place, in 1912, the Italian statistician (Corrado Gini) developed the now popular statistics, the Gini coefficient, for measuring the income distribution in an economy. Obviously the distribution of wealth and income had started to become an issue.

At that time the public institutions that would have been necessary to promote a modern "fiscal policy", one that would have promoted both income distribution and stabilization, did not exist, or existed only in a very rudimentary form. They would be created in later decades and would require the hiring of thousands of public employees (including many economists) and the creation of new institutions (treasuries, budget offices, accountability offices, offices to make macroeconomic projections, offices to make payments and receive revenue, offices to manage public debts, and so on). For example, the New Deal in the USA in the decade of the 1930s required the hiring of thousands of new public employees. Being an economist ceased to be a hobby and became a profession. Without these new institutions, governments could not have promoted modern day "fiscal policy", even if they had wanted to.

The promotion of modern "fiscal policy" cannot be separated from the historical developments that pushed for it, and also from the creation of the essential institutions that were needed by it. With the passing of time, these would make the public budget a potentially valuable tool for promoting old and new goals that societies wanted to promote, through their governments and their public sectors. What happened in Brazil in pat decades was consistent with what had happened or was happening in advanced countries.

We shall start with a brief description of some intellectual developments, going back a couple centuries, and follow with a description of recent statistical development related to the public budgets of Brazil.

Two 19th century developments had an impact on public budgets. They were: the growing popularity of political constitutions, that changed "subjects" into "citizens", reduced the absolute power of rulers, and separated the personal budgets of rulers from those of the country; and the increasing participations of citizens, with their votes, into the political decisions.

The revolution of 1848 the so-called "revolution of that intellectuals", that swept much of Europe, had had as one of its fundamental goals the push for constitutional governments. See Namier, 1964. Constitutional governments led to widening political participations. These, in turn, and with the passing of time, would have a growing impact on the size and the structure of public budgets and, of course, on the level of taxation.

The Constitutions generally affirmed the principles of *equality* and *liberty* for all citizens: equality before the law and liberty to enjoy various personal rights, including the use of one's wealth. There were, of course, limitations to the pursuit of these two principles and, with time, the limitations would become more constraining.

For much of the 19th century the prevailing economic philosophy, in spite of the increasing challenges from "socialists" and "communists", had been "laissez-faire", the economic doctrine generally associated with Adam Smith's <u>The Wealth of Nations</u>. This "laissez-faire" philosophy had relatively little to say about the distribution of income and wealth. "Laissez-faire" maintained that the pursuit of personal interest would help make *everyone* better off and would make some accumulate wealth. At that time the economic role of the state was limited. It required little public spending and low tax levels, generally less than ten percent of national income. See Tanzi, 2011.

"Laissez-faire" accepted the existing, distribution of wealth (and of income and consumption) as the result of natural forces. The ownership of wealth was seen as a kind of entitlement for those who possessed it. It was a right not to be challenged, because it was seen as the cornerstone of a stable society and of a market economy. Even Pope Leone XIII, in his <u>Rerum Novarum</u>-- the social encyclical issued on the 15th of May 1891—had stated that: "private property is a natural right" because "the goal of work…is private property". People work with the objective of accumulating property. The property or the wealth of a family was thus seen as arising directly from work effort. At that time there was still little distinction between the wealth of an individual and that of his/her family; and between the effort of the individual and that of his/her present or past family.

As the 19th century followed its course and the industrial revolution started to shake the structure and the foundation of traditional societies-- changing economic relations and separating an increasing number of workers from their extended families and from the communities where they had been brought up-- and as "wealth", created by the industrial revolution and accumulated in a few hands increasingly "aided by the *monopoly* of production and trade", see Leone XIII, p. 25, italic added—views about the role of the state and the natural right to property started to change to be challenged, even among those who had confidence in the market economy and accepted the role of private property in that economy. There was preoccupation about the living conditions of the workers, who were increasingly exploited by unscrupulous employers at a time when they had little social protection.

A view that started to emerge was that governments should play *some* role in the economy, but not the role that socialists wanted it to play, which was to reduce or eliminate the role of the market and to abolish property rights. The government role had to be a limited one, one that would promote better living conditions for "workers" and their families. This was in line with the writing of Wagner who had recommended a government role in the redistribution of wealth. It was also the time when Bismarck introduced, in Germany, his landmark social legislation, aimed at providing some protection *for workers*. This legislation established, perhaps for the first time, the radical principle that the state could intervene in the economy, beyond the provision of basic public goods and the establishment of essential rules. See Tanzi, 2011.

A growing concern on the part of laissez-faire economists was the conflict that was developing, and that was likely to become sharper with time, between the increasing democratization of political power (due to growing voter participation, which had started to include individuals who did not own property, did not pay taxes, and included even women) and the existing, highly concentrated distribution of wealth. As Pope Leone XIII had recognized, in 1891, and as Pikketty, 2014, would remind current economists, wealth was highly concentrated and it was wealth and not income that attracted attention.

The democratization of political power would inevitably lead to pressures on governments, by the voting populations, to play a role in redistributing wealth, or income. However, if, as laissez-faire economists had believed, property rights were the cornerstone of market economies, there was a fear that this redistribution would damage economic performance and slow down economic progress. There was strong and obvious resistance from traditional forces to this change in the role of the state. The world would have to wait for the Great Depression and for the Second World War to witness the beginning of major policy changes.

The more democratic governments became, the more they were pressured to "equalize the conditions" among citizens, as de Tocqueville had predicted that would happen much earlier, after his visit to America. This was especially true when the "initial conditions" of the populations had been made unequal by inherited wealth, as had been the case in traditional societies, or by monopolies and abuses by "robber barons" as had become common during the industrial revolution.

The recognition of the role that inherited wealth played in the distribution of income, over the years had started to make some economists, even some conservative ones, to support the use of inheritance or wealth taxes. Of course, the higher taxes become, the more they restrict, in some political sense, the economic freedom of the individuals who pay them. In the view of "classical liberals" and economic conservatives the pursuit of equality, promoted by governments through high (and especially high <u>and</u> progressive) taxes, inevitably collides with and reduce the economic liberty of the taxed individuals.

As demands for equalizing the *conditions* and the *outcomes* for citizens become stronger in democratic countries while the income and wealth distributions remain highly concentrated, high incomes and large wealth inevitably come under attacks. These attacks, if enacted on, can reduce the economic liberty of those who pay the taxes, while they improve the income distribution.

Among classical liberals and conservative economists, Hayek, 1944, stressed that a society that promotes significant equality of outcomes through the use of high taxes and public spending (and also through economic regulations), becomes one that, in his view, inevitably ends up limiting the economic liberty and the incentives of individuals. This view came to be widely endorsed by conservatives. Naturally, a society that gives a vote to each citizen is likely to become one that pushes for more equality. Thus, in principle, democracy could pave the way to socialism and could end up limiting the economic liberty, first, of *some* individuals and then, when the distributive policies are pushed far, or when the means of production are nationalized, the liberty of *all* individuals.

Hayek, however, was not against the provision of an income that would guarantee a *minimum* of food, housing and clothing for all citizens in a market economy. He was also not against a system of social insurance against common life risks. What he was against was the nationalization of the means of production and the guarantee of a standard of living for all citizens that depended on *relative* incomes. He probably would not have opposed the "Bolsa Familia" program or a minimum provision of health and education for all citizens in Brazil.

The arguments against high taxes and government -promoted redistribution can be political (because "they reduce economic liberty") or economic (because "they affect negatively incentives and end up reducing economic growth"). The *political* arguments have been challenged by some economists, especially by Amartya Sen, who has pointed out that well-thought out, redistribution policies *increase* the economic liberty of those who benefit from the policies, who are at the lower end of the income distributions. The *economic* arguments have been questioned, or dismissed, by other economists, earlier by Paul Samuelson and more recently by Tony Atkinson among others. However they have continued to be stressed by conservative economists, such as the late Milton Friedman and James Buchanan and by many others associated with the Chicago School and, from the more political side, by Tea Party members in the USA.

Recent statistical evidence has indicated that for the past several decades all the growth in income has gone to individuals at the top one percent of the income distribution, in the USA and in some other rich countries. Thus, definitively, growth has not "lifted all boats" as it was claimed that it would. It has lifted a few boats a great deal while leaving many boats where they were.

If there is considerable social mobility in a country, so that everyone has some reasonable chance of moving up in the income distribution, an uneven income distribution might be more easily tolerated, because those at the top will keep changing and many would have *some* chance of getting to the top. In such a country there would be more equality of *opportunities*, if not necessarily of *outcomes*. This argument was believed to be relevant for the United States in the past as compared with Europe, where social mobility was assumed to be limited. Social mobility was an important element of the "American dream". There are now doubts that this is still the case, except for a few exceptional or lucky individuals. There are also doubts that social mobility is a characteristic of Brazil.

Recent data on the distribution of income and on the increasing stratification of social classes have led to skepticism about the relevance of the social mobility argument in many countries. The commercial success of the Pikketty's book, on both sides of the Atlantic, has indicated that the differences between the USA and Europe no longer exists; or, if they still exist, that they have become less significant.

In theory there could be a difference between inequality attributed to <u>hereditary</u> <u>factors</u> (not just wealth) and inequality attributed to <u>personal effort</u>, ability, and luck for individuals who operate in a market economy. Thus, a distinction could be made between <u>inherited inequality</u> (that could, in part, be reduced by inheritance taxes) and <u>market-generated inequality</u> (that could be more easily tolerated and, if necessary, could be reduced by progressive income taxes).

In practice, it is difficult to distinguish between the two kinds of inequality. Once created, inequality is likely to influence the present and the future income distribution, because the children of today's rich will inherit more wealth (and not just more *real* wealth) than the children of the poor. In addition to property, they will often inherit more human capital, more valuable social connections and, during their young ages, the financial means that allow them to attend better schools and to get more valuable education. Often, as was the case in the traditional, aristocratic societies of the past, they will end up marrying the children of individuals with similar background, thus forming a new social class. See Tanzi, 2000.

The following sections move from the general historical background to a discussion focused on Brazil's developments and policies.

II. On Brazil's Budgetary Developments

As had happened elsewhere, the change from an authoritarian (military) governments to democratic governments, in the 1980s accelerated the public pressures on the Brazilian governments to change the economic role of the state, to increase *social* spending and to make public spending more citizen friendly. The Brazilian Federal Constitution was changed in 1988 to assure that this happened and to create specific guidelines for future governments to follow. The main objective was to promote *universal* programs of assistance, similar to some of those that had been introduced by the European "welfare states" in the decades after World War Two.

The programs aimed at establishing a comprehensive *safety net,* mostly for the highly urbanized, Brazilian population. The consequences would be higher tax and spending levels and the progressive reduction in the *discretion* that governments had had over the allocation of public spending. Increasing shares of public revenue would be pre -assigned to particular social programs and especially to those for social security (mostly public pensions), health and education. In the years that followed, social spending would grow regardless of the government in power. Between 1991and 2013 total social spending of the general government would increase by about 6 percent of GDP. The increase would accelerate after 2003 and in the most recent years total social spending would reach 24 percent of GDP.

The pre-assigned spending would progressively absorb much of the revenue available to the government and would reduce the government's ability to allocate public resources to other areas and especially to functions directly related to economic development. With the passing of time this reduction in the government's budgetary flexibility would force the government to rely on less orthodox policies to promote some of its objectives and especially the development objective.

The developmental role of the state can be followed either (in an orthodox manner) by using current public saving that is generated by the public budget, while investing that saving in essential and, hopefully, growth -related activities; or by relying on (less orthodox) "quasi" or "shadow" fiscal policy that uses instruments other than current public saving, and especially various forms of regulations and controls. See Tanzi, 1988.These less orthodox policies aim at promoting traditional objectives and not just economic development with non -orthodox instruments. They may include price controls, regulations, control of the operations of public enterprises and public banks (including the control of some activities of the central bank). We shall return to this issue in a later section.

Social spending as a share of GDP increased from 17.6 percent in 1990, and from much lower levels in earlier years, to around 24-25 percent, in 2008 and later years. More than half of this spending and about 70 percent of its growth went to "social security", mostly pensions and related entitlements that, in large part, were received by former public sector employees and by their families. The social spending accounted by other specific cash programs, introduced after 1995, increased by a little over one percent of GDP, much of it in the period after 2003.

Governmental intervention in the economy had not been absent in Brazil in the past. See Tanzi, 2010. Especially in the 1970s, in its attempt to force a fast economic growth, the military government had generated a current account saving of up to 7 percent of GDP, which it had allocated to the promotion of economic growth. The “structuralist school” which had been popular in Brazil at that time and in earlier decades, of which Celso Furtado had been a major exponent, had also favored (or would have favored, if its components had been in power) state intervention in economic decision, because of the belief that such intervention could accelerate the rate of growth and the development of the country.

Both the military and the “structuralists” had shared the belief that faster growth would act like a tidal wave, which would “lift all boats” making everyone better off. Of course, the members of the “structuralist school” would have paid more attention to equity, than the militaries, in the choice of economic policies. They would have favored a land reform (at that time a much -discussed policy) to promote a better utilization of land and a redistribution of wealth.

The 1988 Constitution set guidelines for the allocation of budgetary revenue. In the second half of the 1990s and in the first decade of the new century, the Brazilian governments had reduced their interference in the market, giving more scope to market forces and relying more on orthodox economic policies, while they had continued to increase public spending and had created some new social programs. Focused cash programs were created especially after 2003 aimed at helping specific and often poorer people. They required additional public spending but their claims on the budget remained relatively modest. They accounted for a very small share of GDP or also of the income received by the richest one percent of the income distribution.

In the current decade there has been some return to the “developmental” or “interventionist” role of the state and to less orthodox policies. These policies have been associated with increased, political interference in the operations of the central bank, of public banks, public enterprises (especially Petrobras and Electrobras) and with the control of some prices.. These recent policies have implicitly transferred some policy objectives from the budget to other institutions, or to other instruments inevitably reducing the transparency of fiscal and economic policy. One consequence has been that, between 2007 and 2013, the combined gross debt of the public banks and of the national treasury has been estimated to have increased by about 10 percent of GDP.

Over the years the estimated, *official* measures of the main fiscal variables (tax level and public spending) have grown. See Appendix Table. Unfunded mandates, moral hazards, price controls on some products and services, and growing contingent liabilities, created by recent interventionist policies and other actions of the government, have created some fog in the fiscal situation and have made it more difficult to assess the longer-run dynamics of that policy, while they have created concerns on the part of some observers. Some public debt has been shifted to public banks so that official data on gross public debt do not show much increase.

The experience of various countries also indicates that, over longer periods attempts to stabilize the economy, during economic slowdowns, contribute to the increase in public spending because countercyclical fiscal policy is rarely symmetrical, or neutral, in its long run effects. Governments tend to spend more during periods of economic slowdown, in their attempts to sustain economic activity, but do not reduce spending sufficiently during good times, when funds become more abundant while pressures to spend do not abate, as happened during the commodity boom of recent years in Brazil. The net consequence is a sustained, long run, increase in the share of public spending into GDP.

The share of taxes into GDP for the general government (that includes all levels) increased significantly, over the decades. In the most recent years, it reached levels that one would not have expected to find in a country at Brazil's level of per capita income. These increases have mimicked those of several European countries. Brazil's levels of taxes and public spending now exceed those of the United States, a country with a per capita income several times higher than Brazil's, and exceed also by significant margins, those of all the other BRICS.

In 1950 the average tax level of Brazil was 15 percent of GDP, the same level that Sweden had had in 1940 and higher than the level (10 percent of GDP) that the United States had had in the 1930s. The tax level of Brazil rose to 17 percent by 1960 and continued to rise in the following years reaching 30 percent of GDP, in the 1980-2000 period. By 2013-2014 it had reached an estimated 38 percent of GDP. Public spending experienced similar or faster increases. In 2014 it reached an estimated 42 percent of GDP, creating a significant fiscal deficit. See the Appendix Table.

The large increase in social spending over recent decades and the creation of several federal programs focused mainly on poorer people (Bolsa Familia, Renda Mensal Vitalizia e Beneficio de Prestacao Continuada, Minha Casa, Minha Vida, PRONAF, FIES and some others) in the last two decades have been credited with having contributed to a significant reduction in the "measured" estimate of the income distribution (the Gini coefficient). About a third of the citizens of Brazil (about 80 million) now get some support from the targeted programs. These programs have so far been much less expensive than the social security program (public pensions and other benefits) and have contributed significantly to the incomes of many of the poorer individuals who have benefited from them. A larger share of the population benefits from the general social programs (social security, public health and public education) of which pensions are the other cash program.

Over the years Brazil had been notorious for having one of the most uneven income distributions in the world. According to estimates from various sources, while still highly uneven, the income distribution has become significantly less so in recent years. Recent estimates, reported by WIDER, have reported (market) Gini coefficients of: 0.58 in 1970, 0.60 in 1980, 0.63 in 1990, 0.64 in 2000 and 0.56 in 2010. There was thus a sharp fall in the Gini coefficient between 2000 and 2010. A study by IPEA, 2011, which has taken into account all the fiscal action of the government (direct cash benefits to families, direct and indirect taxes, and the *monetary* value of health and public education) has estimated that that action had reduced the Gini coefficient from 0.548 in 2003 to 0.496 in 2009. A study by Higgins et al. (2014) reports a Gini as low as 0,43 in 2009.

The share of total income received by the top "decile" in the income distribution was estimated to have fallen significantly, between 2000 and 2010, and the share of the population living below the poverty line to have fallen from 48.0 percent in 1990 to 24.9 in 2010. If the above estimates report correctly what happened, it should be concluded that, during the first decade of the new century there was a significant improvement in the Brazilian income distribution. Much of the improvement has been attributed to the cash programs directed to the poorer families and to the *monetary* value (to the beneficiaries) of health and public education spending.

Sources other than WIDER concur that, in the first decade of the new millennium, there was a major improvement in the income distribution. According to CEPAL, the share of total personal income going to the top decide fell from 53 to 45 percent. The share of the population below the poverty line fell from 31.5 to 24.9. The large increase in social spending was credited for the change.

It should be noted that different sources provide different estimates of the Gini coefficient so that the correct situation is a bit difficult to determine. However they all agree that there has been significant progress toward a more even distribution of income, and that it took place especially during the last decade.

A most recent study has indicated that the Gini coefficient was reduced from 0.577 in 1995 to 0.522 in 2011, a significant reduction even though, at 0.522, the Gini would still remain one of the highest in the world. See Azevedo et al., 2014. Some Brazilian experts have questioned the direct impact of public spending on the above-mentioned reductions in the Gini coefficient, because of recent demographic changes that have increased the average number of workers per households, combined with the low recent unemployment rate. These factors must have contributed to the reduction in the Gini coefficient. See Azevedo et al. 2014, and other studies cited in that paper.

Before discussing the above estimates, an observation that is worth making is that the "spatial" income inequality within Brazil's vast geographic area has remained high in spite of efforts by the most recent governments to bring people from poor areas of the country, especially those located in distant and not easily accessible rural areas, within the reach of the "bolsa familia" and of the other such programs. See Reis, 2014. There is evidence that the percentage of the population registered for the "Cadastro Unico", that entitles households to receive the benefits from the targeted programs is particularly high in the poorer states of the North and of the Northeast of Brazil. In some of those states it reaches 60 percent. Therefore these programs are succeeding in promoting a better income distribution.

It is inevitable, however, that especially for a country such as Brazil, the social policies pursued *with universal and not targeted programs,* which are still those that absorb a large share of the social spending, have an urban bias. Schools, hospitals and government pensions tend to benefit more those who live in cities and especially in larger cities. Those who live outside the cities, especially those who live in far –away, rural areas, tend to benefit less and often much less, from these universal programs.

The above raises the question of how much weight a national government should give to the objective of creating a more harmonious spatial income distribution within a country, and also to the objective of developing the whole country. The pursuit of this particular objective would require policies and public spending different (or additional to the one) that have been followed and especially more investment in particular kinds of infrastructures. Over the longer run this must also be an important objective for a country. The pursuit of this spatial objective would avoid that social programs focused on people who live in (especially large) urban areas, become a magnet that attracts to those areas peoples from other areas, making more difficult to develop the latter. It should also prevent that those who live in the poorer, far away areas become dependent on the targeted programs.

III. Some Comments on the Gini Coefficients and their Changes

The estimates of the Gini coefficient mentioned above and the policies credited with having reduced them deserve some specific comments, because they tend to be taken at face value and to be given more weight than, perhaps, they should receive. We shall start by discussing the potential impact of fiscal policies on the income distribution by comparing two countries: Denmark and Brazil. This comparison will help in the discussion of some of the policies credited to have reduced the Gini coefficients in Brazil.

In 2004 Denmark had a market distribution of income, as measured by the Gini coefficient, *before* the impact of fiscal policy, of 0.419, a relatively low, but not excessively low, Gini coefficient. It also had a fairly homogenous population (apart from immigrants) and a government credited with using public resources efficiently. Its index of corruption was one of the lowest in the world. A low Gini coefficient indicates that the *taxable capacity* of the population is broadly distributed, so that almost all citizens can contribute to the payment of taxes, to finance public spending. In such a country the tax system need not be significantly progressive for the government to collect a high tax level and collecting a high tax level while providing generous public services *to everyone* can achieve much in redistributing income.

In Denmark public spending financed by taxes amounted to 54.4 percent of GDP and the redistributive impact of its fiscal policy, as measured by the change in the Gini coefficient, was equivalent to 0.191. Therefore, fiscal policy reduced the (before -fiscal policy) Gini coefficient from 0.419 to a remarkably low 0.228, indeed a very even income distribution for a market economy. Of the total impact of fiscal policy on the Gini coefficient, 78.0 percent came from the (universally distributed) public services and only 22.0 percent came from the *progressivity* of the tax system. In other words given the *initial* situation of Denmark, taxes did not need be very progressive to raise the revenue needed to finance the public spending that would make the income distribution significantly more even. Even proportional taxes could have been used to reduce the Gini, as long as the spending was universally distributed so that every income level benefited from it.

The *initial* situation in Brazil was different. To make our main point, we shall use the data from a study by IPEA, 2011. The initial Gini coefficient in Brazil, before any fiscal action, was around 0.64, or 0.22 above Denmark's. This meant that a great deal of the *taxable capacity* was concentrated in the upper part of the income distribution. Given this situation, to get a high tax level, without excessively reducing the after-tax income of the lower income groups, it would have been necessary to have a *progressive* tax system. A high tax level not collected progressively would reduce excessively the after -tax income of those at the lower end of the income distribution, the poorer part of the population. Also to make fiscal policy significantly redistributive it would be necessary to make the public spending *very* pro poor. Also Brazil's population is less homogeneous and less geographically concentrated than Denmark's and its public money is spent significantly less efficiently than Denmark's.

Given the above differences, the tax system in Brazil would need to play a far larger role than in Denmark and to collect *progressive* taxes to achieve a significant *and genuine* reduction in the Gini coefficient. Keeping the above comparison in mind, we look more closely at the Brazilian data.

The impact that fiscal policy in general has on the income distribution depends on several factors among which taxes are important. If taxes are not progressive and if the tax system is complex, a larger budget, even if it contained more spending directed at the poor, than does the Brazilian budget, might not be as beneficial on the poor as indicated by the reported decrease in the measured estimate of the income distribution. We address these issues below.

There is considerable evidence that the Brazilian tax system is <u>not</u> progressive; furthermore it <u>is</u> very complex. Brazil has been more successful over the years in raising taxes to European levels than in introducing European (or American) tax structures. Personal income taxes are collected from few and are collected with low rates. As a consequence, they produce little revenue and contribute little to making the tax system progressive. Brazil relies on complex and inefficient value added taxes and other indirect taxes to raise its current, relatively high -tax level. As a whole the tax system is regressive and its burden is heavy on the low -income classes, significantly reducing their disposable incomes. This means that the low -income groups end up losing (to taxes payments) larger shares of their before-tax incomes than the better to do, even though, of course, the latter pay much of the total taxes, because of their high incomes and high spending.

Given the relatively high tax level of Brazil (now about 37 percent of GDP), the reduction in disposable income, due to the payment of taxes, must be large for the low-income groups. In some estimates of the Gini coefficient, the pre-tax Gini, has been reported to be significantly lower than the post-tax Gini (before taking into consideration the impact of public spending). See Rossignolo, 2012; and IPEA, 2011. The *personal income tax,* the tax than should make the tax system progressive and the Gini coefficient more even, plays a very marginal role.

A recent study (see Afonso, 2014), that uses official tax data published by Receita Federal (based on incomes in 2010), has reported that, in 2011, there were only 24 million tax declarations in Brazil. Three -fourth of the declarations reported incomes below the exempt limit. Of the remaining 6.4 millions, few faced the highest marginal tax rate, of 27.5 percent. Many of those with high incomes (most of the rich) declared themselves as juridical persons. As such they were subject to a fix tax rate of 15 percent, or to rates between 15 and 22,5 percent. The share of wages and salaries in national income is low in Brazil, as in most Latin American countries (it is a little over 40 percent of GDP) and the personal income taxes paid are only about two percent of GDP. Capital income has been growing faster than wages and salaries in recent years and is concentrated among the high -income individuals.

While personal income taxes are low, indirect taxes, especially value added taxes, and social security taxes on wages are very high. For all social security taxes, that include unemployment and social assistance to workers in the formal economy, the total taxes on wages and salaries are 37.65 percent. Of these 30 are paid by employers and 7.65 paid by the workers. These are the highest in Latin America. Only Colombia has similar rates, but Colombia has a much lower tax level. However, it is difficult to determine the final incidence of these taxes, whether it falls on the workers, the consumers, or the owners of the enterprises.

The above results indicate that the positive impact of social programs, financed by proportional or regressive taxes, on the income distribution, ought to be very high to compensate the lower income groups for the share of their income that they lose to the taxes that they pay.

The collection of taxes is not costless, for both the government (due to "administrative costs") and the taxpayers (due to "compliance costs"). The government net revenue, from taxes collected, is reduced by administrative costs while the burden of the payment of taxes for taxpayers is often increased by compliance costs. These costs are especially high when a tax system is complex, and the Brazilian tax system is rated as one of the most, if not the most, complex in the World. See IFC, at the World Bank, and IDB, 2013, p. 32. Furthermore, "compliance costs" tend to be regressive. See Tanzi, 2013, and also Afonso, 2014, p. 26. They tend to be higher for lower income taxpayers, making the net impact of the tax system even more regressive, than shown by the tax payments.

Let us now consider the expenditure side of the budget. The negative impact of the tax payments on those with low incomes could, in principle, be compensated by the positive impact that public spending can have on them. For example a poor household may pay R100 in taxes and may receive benefits, in cash or in the form of health, educational or other services, valued at more than R$100, thus improving its standard of living. This is the reason why social spending is praised and why the estimated Gini coefficents are reported to be lower after that public spending is taken into account.

If public spending programs are efficient; if they are sufficiently focused on the neediest citizens; if they do not create "poverty traps" and other permanent dependency on the programs; if the services provided by the programs match exactly those that the citizens, and especially the poorer citizens, want; and, if they do not require public resources at levels that can create macro-economic difficulties for a country; then the spending programs can make the income distribution more even, can reduce the poverty rates and, as in Denmark, can increase public welfare, without creating macroeconomic difficulties. The question is the extent to which these conditions are satisfied in Brazil's case.

The above questions do not have easy answers. The best that an observer can do is speculate. We shall start with some issues related to the *efficiency* of the public spending and follow with some observations related to taxes. We shall ignore issues related to the creation of dependency, by those who receive government's benefits. These issues can be important, especially for the long run, but the author does not have information lo allow an informed opinion on these issues. It can be observed, however, that a large share of the beneficiaries from some *cash* programs (say "Bolsa Familia") is made up of younger people (generally people under 18 years of age). As they get older, they lose the benefits from programs. For programs not tied to young age, concerns about dependency become more significant.

Studies that assess the impact of the budget on the income distribution by estimating Gini coefficients, routinely assign the full, monetary, amount of the budgetary spending as a benefit received by the intended beneficiaries of the programs, say the students in schools, the patients in hospital using health services, and so on. The higher the spending, the higher are the assumed benefits received. This is done for both the spending in "cash" (as with "Bolsa Familia" or public pensions) and in real services (public health and education services). For cash benefits, the households that receive the cash are clearly better off, financially, by the full amount of the cash received. For this spending a question that could be raised is whether the distribution of the benefits *among* the individual components of the households is fair and whether all the members benefit equally.

For money that is spent on the provision of real services delivered by government employees, or by contractors on its behalf, the issues can get more complicate. For a much earlier discussions of these issues see, Tanzi, 1974 and, later, Tanzi 2008. These issues have not attracted the attention by experts that they should have attracted. The basic question is the equivalence, assumed by those who make the estimates, between the money spent by the budget and the value of the benefits received by the beneficiaries of the services.

The problem is that this kind of spending can be diverted, or hijacked, in various ways, by those who administer the programs or deliver the services, so that the beneficiaries may not get services equivalent in value to the money spent in the budget. Beside the intended beneficiaries others who, in various ways, may also derive some benefits from the spending are: the administrators, the teachers, the doctors, the nurses, and other individuals who, in various ways, participate in the delivery of the public services. The diversion or leakages may be large or small and may be due to: frequent absences from work, during working hours, by the public employees, while they continue receiving the full stipends (ghost workers and job shirkers); laziness during work; getting positions and salaries not justified by their competence; acts of corruption, including pilfering of supplies; and other similar actions or problems.

When some of the above circumstances are present (and to different degrees they always are) the legal beneficiaries (school children, patients, etc.) get allocated to their "income" the full amount of the budgetary spending, even when the real value to them of what they have received may be low. This is what is routinely done by the studies that estimate Gini coefficients, before and after public spending. See, for examples, the studies made by the "Commitment to Equity" project, by Tulane University and the Inter-American Dialogue. The IPEA, 2011, study, estimated that the Gini coefficient, after taxes but before public spending, in 2009 in Brazil, was 0.598. After adding, to the incomes of the intended beneficiaries, the monetary value of health and public education the Gini coefficient was reduced to 0.496, clearly an important reduction.

Reports for Brazil and for some other countries suggest that the leakages may be large. These leakages often lead to complaints by the citizens who use the services, even when the spending to finance these public services has increased, as it has in Brazil. A recent announcement for a seminar on the governance and administration of public hospitals in Brazil points to the basic issue. As the announcement put it:" Dentro da rede hospitalar, desperdicios de recursos e ineficiencias de diversa naturaleza coexisten com problema de governance, carencia de incentivos, ausencia de informacoes e falta de instrumentos de gestao." See, seminario "Governanca e Gestao dos Hospitais de Atendimento Publico no Brazil".

Cash programs suffer less from these problems. This may explain the popularity of the "bolsa familia" and other such programs. For these programs, beside the issue mentioned earlier related to the allocation of the use of the cash received within the households, the main problem may be the correct identification of the individuals who are entitled to receive the cash. The information needed may not be available to the government agencies, or it may be deficient or distorted by corruption on the part of those who administer the programs, or by cheating by those who submit claims. Therefore, *some undeserving* individuals may end up receiving the cash benefits. This must happen to some extent with some of the Brazilian cash programs. In several countries, this problem has been common for disability pensions where fake "disables" have ended up receiving these pensions.

In some cases, the problems with benefits provided in cash may be political. In Brazil, public pensions may be received by individuals (or by relatives of individuals) who, during their working years, did not contribute sufficiently to the financing of the pensions, to justify the pensions that they receive. This problem has contributed to make the Brazilian social security program a very expensive one. It now absorbs about a third of all the Brazilian public spending and those who receive these pensions are not among the lowest income percentiles. Pension spending is not likely to make the income distribution more even.

Similar observations could be raised when (not necessarily in Brazil) cash payments go to agricultural producers, to energy companies, to airlines and to other similar programs. A significant part of the *total* social spending does not go to individuals who are at the lower end of the income distribution. For example spending for tertiary education benefits mostly those in the highest income percentiles. See Tanzi, 2008.

Another point that could be raised is whether the priorities, established by the government in the allocation of redistributive programs directed to the poor in the form of real services, reflect closely those of the intended beneficiaries. These programs have the interest of particular groups as their goals, but largely reflect the paternalistic views of those who make the policy decisions. Given the choice, the poor might have chosen different ways of spending the public money if they had received it in cash. A well-known result of economic theory is that R$100 gift received *in cash* is often more valuable to the person who receives it than R$100 value received as a *specific gift* selected by the giver, that cost R$100. The beneficiaries of several non -cash programs might have preferred to receive *in cash* the money spent by the program. This might explain why “bolsa familia” is so popular, in spite of its limited spending; it might also explain the complaints by citizens about the real services, in spite of the higher spending that they have required.

Finally there could also be a question of *horizontal equity,* one rarely raised. Some programs, as for example health benefits, are in substance, though not in intention, selective in the benefits that they provide to citizens, while the taxes that finance these programs, especially the value added taxes, are much less so. These programs operate in the same way as insurances but, unlike insurances, they are not voluntary. Therefore, those who actually end up using the services benefit more from these programs than those, in their same economic income groups, who have paid equivalent taxes but have not used, or have used less, the services. The latter individuals lose from the governmental action of taxing and spending for these programs. The *option* available to them, to use the facilities if and when they may need them, may not have enough value to compensate them for the taxes that they pay.

The bottom line is that caution should be exercised in the interpretation of the estimated Gini coefficients; or of the changes in those coefficients. They may contain less information than is generally assumed.

Although the *personal* distribution of income and the creation of a national safety net are obviously important objectives to promote for a budget and for fiscal policy in general, they cannot become the sole objective. The allocation of resources to *essential public goods* and to the pursuit of growth with reasonable stability must also remain important objectives. Excessive preoccupation with the creation of a safety net and with the redistribution of income can easily distract policymakers from the pursuit of these equally important objectives. Some brief attention to this issue may be justified in a paper on fiscal policy.

Evidence from various countries suggests that when governments significantly increase social spending, as happened in Brazil in recent decades, they often end up using, for this purpose, much or all of the *fiscal space* available. In particular, spending for financing "pure" public goods tends to be reduced. In several countries, as social spending claimed increasing shares of the budget, public spending for the financing of infrastructure and of other "essential" public goods was reduced. This clearly happened in the United States, where there is growing worry about an "infrastructure crisis", but also in Europe, where the share of public investment in GDP was much reduced over the years and there is now a plan being considered to spend 300 billion euro of borrowed money for this purpose. In various countries badly needed infrastructures were not built and the existing infrastructures did not receive the required *operations and maintenance* spending necessary to keep them in good working conditions. This result contrasts with what has happened in several Asian countries, including China, where social spending has been low but spending on infrastructure has been very high.

Brazil seems to have had an experience similar to that of the advanced countries. Public spending for better and quicker justice, for increasing the protection of individuals against crime, and especially for increasing their *spatial* mobility was squeezed over the years to accommodate the higher social spending. The physical movement of goods and people within Brazil has continued to be slowed down by the notoriously high “Brazil cost”. In spite of government efforts in more recent years, large areas of the country have continued to have little access to clean water and to good sewer facilities for the people who live in those areas, even though clean water and better hygienic facilities, when combined with *basic* public health services (vaccination for children, assistance to pregnant women, medication for infectious diseases and similar) might do more for life expectancy and for the quality of life than spending for rich countries’ diseases and for modern hospitals, which often are located in large cities. Fear of crime and diseases that can be easily cured can significantly reduce the liberty that many individuals should have to operate and move freely in the areas in which they live.

The lack or the reduction in this kind of public spending has important consequences for the quality of life of those who occupy the lower end of the income distribution, and especially for those who do not live in large, urban areas, where the good hospitals and the better schools are often located. This spending may also be important for the long run, economic development of Brazil. While the estimated Gini coefficients have fallen in Brazil, *spatial inequality* (that among the average incomes of individuals who live in different parts of the country) is likely to have changed less than it could have (in spite of recent efforts) with policies that over the longer run would have put more emphasis on the building of essential infrastructure and on the provision of the basic public goods.

The divide between the rich Southeast and the poor North has remained large and the "Brazil cost", so important for *global* competitiveness, has remained high. Many large parts of Brazil are still little linked with the rest of Brazil and, consequently, with the rest of the world. Brazil has remained a closer economy than it should have become by this time. This economic closeness must have reduced its growth potential. It should be recalled that the United States did not become an economic power until its coastal areas were connected with its potentially rich interior. That connection transformed it from a minor into a major economic power. So far, this has happened to a much lesser extent in Brazil.

The two measures of inequality – *personal* and *spatial*--respond differently to the size and the structure of the budget. The first is more likely to be reduced by social spending that may make the income distribution more even but might also create some disincentives and some possible dependencies, on the specific social policies, on the part of some citizens. The second is more influenced by investments in transport and in other infrastructure, that facilitate the movement of goods and people, and by other kinds of spending, that improve the quality of life in distant and isolated places, increasing the incentives for people and for economic activities to move to, or to remain into, those areas. Both of these inequalities merit equal attention.

Surveys conducted annually by a Chilean institution (Latinobarometro) in several Latin American countries have reported that the citizens of these countries are as much worried by crime and by the lack of mobility, that restrict their freedom, as they are by economic difficulties. The Latinobarometro of 2012 reported that 96 percent of the Brazilian respondents thought that taxes were either high or very high, as they certainly are for many people. For sure, they must not have been speaking of the personal income taxes that few Brazilians pay. Many of the respondents were not satisfied with the quality of the health system and their worries were probably not directed at the absence of expensive medical treatments in modern hospitals.

The above worries tend to create the presumption that more spending is required *in the existing programs*, even when spending in those programs has been growing rapidly. They create pressures for governments to further increase the already high public spending on the same programs, requiring higher taxes. They create the classic situation of the customer who, after a meal in a restaurant, complained about the small portions and the bad food. The current political debate in Brazil indicates that pressures for increasing social spending is likely to continue. If not resisted these pressures may contribute to the return of some of the macroeconomic difficulties that had been common in Brazil in the 1980s and in the first half of the 1990s.

Some attention must be paid to macroeconomic aspects of fiscal policy in this paper. The next section will address briefly this issue.

IV. Orthodoxy and Shadow Fiscal Policy and Macroeconomic Issues

The academic, orthodox view of fiscal policy is that: it should be pursued through *fiscal* instruments (taxes, public spending and public debt); it must be outlined in official policy documents (budgets and others), which provide the necessary information; and it must adhere to clearly defined macroeconomic requirements. An ideal budget document would need to be comprehensive and economically significant. It should tell about the fiscal actions and plans of the government, how much it intends to spend, for what purpose, when the spending would take place, where the revenue would come from, and when its effect on the economy and on the financial market would be felt. From this document it should be possible for experts to analyze the impact of the fiscal policy on the allocation of resources, on economic activity, on income distribution and on other policy objectives, to express expert judgments about the government policy.

Of course, there is no document capable of doing all that and it is doubtful that one could exist. Real life budgets documents are often more narrowly oriented and less useful in providing the information that economists would like to have. Public budgets are generally not comprehensive (they cover only part of the public sector); do not measure the public spending at the time when it will have its major impact on the economy; generally, are focused on the time when the cash payments for the spending are made, rather than when the commitments are entered into; and they suffer from other deficiencies.

Budgets also suffer from shortcomings due to various forms of financial engineering, or creative accounting, that most governments use, to convey a better impression of the fiscal situation of the country. Being essentially *plans* for spending and (to a lesser extent) taxing for the fiscal year, budgets may be made less relevant by unanticipated events, such as economic fluctuations, natural catastrophes, wars, etc. Furthermore much public spending is on self -pilot having been determined by past laws or even constitutional directives. The more budgets gets away from some conception of a totally discretionary, ideal budget, the more difficult the interpretation of a country's fiscal developments becomes.

A useful budget: should embrace much or the whole of the public sector (including sub-national governments and off budget spending), not just parts of it; it should facilitate the understanding of the extent to which the government is promoting its stated goals; and it should cover all the fiscal actions of the state even when those actions are not pursued with fiscal instruments. Policy objectives that can be promoted by fiscal tools should not be delegated to other instruments. Such a useful, or even ideal, budget does not exist and, perhaps, it cannot exist.

To varying degrees, most governments rely on tools, such as regulations and other *quasi-fiscal instruments,* to promote their goals, even when those goals could be promoted with orthodox fiscal tools. See Tanzi, 2011, Chapter 10, and Tanzi, 1998. This may be done for political expediency; or because at times it may seem more convenient to the government or may even be considered more efficient, to use these other instruments. For example a country whose central bank has accumulated large foreign exchanges, which are invested at very low interest rates in the bonds of the US or some other governments, while the country's own government must pay high interest rates for its own borrowing, may consider efficient to have its central bank hold some of the country's own public debt. There are also cases when public enterprises can borrow abroad more cheaply than the national government.

Brazil has thousands of budgets, between the budget of the federal government and those of the states and the municipalities. The sub-national governments account for about 30 percent of total public spending and social security for a further quarter of total spending. Therefore, the federal budget is far from providing a full picture of the operations of the public sector. Furthermore and generally, no budget is best at indicating all the goals that governments want to pursue. A budget that gives the most useful information on the stabilizing role of fiscal policy may not be useful in assessing its impact on the financial market. For these reasons different budgets, such as cash budgets, accrued budgets, or even documents that measure the net worth of public sectors and other documents may be needed and are used by some countries.

At times a government commits spending but the payment for that spending is made much later. Therefore known or unknown arrears, or hidden debts, build up. The immediate effect on the economic activity of the country, that comes from the commitment, may be felt at a different time from when the payment is made and from when the impact on the public debt and on interest rates may be registered or felt. At times the payments for work done by private enterprises for the government are made much later than they should have been made, creating liabilities for the government, which may or may not be recorded, and financial difficulties for the private enterprises. At other times the budget may assume implicit responsibilities for possible *future* payments for which no assets are set aside and no estimates are entered in the budget. This happens in several areas, including that of unfunded pension obligations, in public private partnerships, in financial commitments to public or also private banks and public enterprises, and also when unavoidable repairs to public infrastructures are delayed. All these may create discrepancies between the long-run sustainable fiscal situation and the one revealed by the official statistics.

In periods of increasing financial difficulties governments are tempted to pursue what could be called a “shadow fiscal policy”. This shadow fiscal policy, that does not show in the official budget documents, is pursued through the use of regulations, unfunded mandates, implicit assumption of contingent liabilities, creation of “moral hazards”, controls over some of the actions of the central bank, impositions on, or constraints over, the actions of public enterprises and public banks, and other forms of creative accounting.

“Shadow fiscal policy” can become important at particular times but is more difficult to fully understand than fiscal policy pursued through orthodox fiscal instruments. Its economic effects are certainly more difficult to quantify and assess. While the problems created by “shadow banking” have been attracting increasing attention in recent years, those created by “shadow fiscal policy” have attracted less attention, especially by economists who have continued to rely on the official fiscal deficits for their analyses and conclusions. For example, “shadow fiscal policy” played a major role in the 2008 financial crisis that hit the advanced countries. See Tanzi, 2013.

In Brazil "shadow fiscal policy" had been much used some decades ago, and especially in the 1980s and the early part of the 1990s. Its role had been reduced for some years in the second half of the 1990s and in the first decade of the new century. Recent indications and media reports suggest that shadow fiscal policy has become again important, raising concerns among Brazilian and foreign experts. See The Economist, October 18th, 2014 and various recent articles in the Financial Times.

Governments may engage in "shadow fiscal policy" because of lack of economic sophistication; because of short run electoral or political considerations; because more orthodox fiscal policy has run into political or economic headwinds; or because there is a conviction that less orthodox tools may be more efficient or politically easier to use in achieving particular objectives. For example a government may consider easier to assist poorer people, or to reduce the inflation rate, by freezing the prices of some important goods and services, such as energy prices, rather than by directly subsidizing the consumers or the producers though the budget. In this case the regulation to freeze the price becomes equivalent to an implicit subsidy to the consumers of the good and service and a tax on the enterprise that must provide the service. See Tanzi, 1998. This may also create an implicit obligation on the part of the government to assist the enterprise that may encounter difficulties. These policies can become very expensive, either for the enterprises or eventually for the budget.

Growing reliance on "shadow fiscal policy" is often interpreted as an indication of growing fiscal stress. When there is fiscal stress, public enterprises, central banks, public banks or even private enterprises may be subjected to increasing interferences and regulations that would have been absent in more normal times. Shadow fiscal tools progressively replace orthodox fiscal tools.

An assessment of the role of "shadow fiscal policy" in today's Brazil would require a lot more detailed information that the author of this paper has. The impression that has been created by recent writing on Brazil is that the use of "shadow fiscal policy" has grown recently and may have created "a deficit of macroeconomic discipline…" and…."a surplus of macroeconomic meddling", in the words of The Economist, of October 18th, 2014, p. 26. There have been reports about governmental actions that have reduced the autonomy of the central bank and about controls on energy prices, to implicitly subsidize consumers while presenting a better inflation face. These actions have reportedly created large losses and other difficulties for Petrobras and for Electrobras. BNDES has been required to increase its holding of public bonds by significant amounts (to a reported R$ 78 by 2014); some payments due have been postponed; and there have been other such actions.

Some of these actions have created contingent liabilities for future budgets and growing current problems for some public enterprises and public banks. They have also raised questions about the sustainability of current policies. How significant or damaging these actions have been, it is difficult for this writer to assess. However, the gap between the recent actions of the government and those that should be followed by a rational, orthodox, and transparent fiscal policy seems to have grown and it is creating worries for investors and some potential future problems. These inevitably affect economic performance. In spite of these actions the officially measured nominal fiscal deficit has increased, reaching about four percent of Brazil's GDP, the inflation rate has also reached a high levels, while the economy has stopped growing.

Political controls or influence on public enterprises and public banks (including the central bank) often lead to, or encourage, acts of corruption, inefficient use of public resources, fiscal and economic problems, including low growth, high inflation and other difficulties. Brazilian policymakers should address these problems and prevent them from becoming grave. It would be a pity if the achievement of Brazil in past years were to become compromised. Until recently there had been a feeling that the future had finally arrived in Brazil, and that it was a good future. Now some clouds have begun to question the validity of that feeling.

V. Concluding Remarks

This paper has dealt with several issues related with the economic role of the state in a market economy as exercised through the use of fiscal instruments, such as taxes, public spending and public debt. The paper has recognized that the economic role of the state can also be played with the use of non -orthodox instruments, of which regulations are the most important. However, in most cases, though perhaps not always, the orthodox instruments are preferable, in part because their use is more transparent and they lend themselves less to potential abuses.

Of course, a rational and orthodox fiscal policy needs to have in place efficient institutions and to have a budget that is fairly comprehensive of the spending activity of the state and flexible. When the budgetary action is too fragmented and the spending and taxing become inflexible, an orthodox fiscal policy becomes more difficult to promote and the temptation to follow a shadow fiscal policy increases.

This paper started with a brief survey of how the economic role of the state changed over the 20th Century, in Western countries. Brazil was inevitably influenced by these developments. In recent decades it attempted to introduce policies similar to those introduced by European countries. It created a broad safety net made up of universal social programs for health, education and pensions and, in more recent decades, cash programs focused on low -income groups. Unfortunately, while it significantly increased its public revenue to almost advanced countries' levels, it continued to rely on indirect taxes, in a country with a very uneven income distribution and with much of the taxable capacity located in the upper end of the income distribution. This imposed a very heavy tax burden on lower income groups, which neutralized to a significant extent the re-distributional impact of the social spending.

There are indications that, perhaps because of its inability to make the tax system more progressive while the pressures to assist lower and median income groups have continued, in the most recent years, the government seems to have deviated from its previous reliance on orthodox fiscal policies and, to some extent, to have adopted a more interventionist policies using less orthodox policy instruments. This path can lead to difficulties, both macroeconomic and institutional. It would be wise for the coming governments to reconsider these policies and to attempt to return to a more orthodox policy path.

The targeted cash programs seem to have been effective in helping selected groups of citizens in need of public help. So far the cost of these programs has modest although it has come on top of existing costly traditional social programs. It would have been preferable if the financing of these programs had come from reducing other costs, such as those for pensions, or from higher personal income taxes, collected from individuals high up in the income distribution. The income loss to these high-income individuals would have been modest, while the benefits to those who receive these cash transfers were significant.

Naturally, it is important that these cash programs are not allowed to grow excessively. It is also important to realize that the longer these programs remain in existence and the more generous they become, the more the potential problem of dependency may become important.

Appendix Table
Basic Fiscal Data for Brazil
Selected Years and Percentages of GDP- General Governments

	Public Revenue	Public Spending	Fiscal Balances	Government* Gross Debt	Government Net Debt	Primary Balance
2002						
2003						
2004						
2005						
2006	34.4	38.0	-3.6	67.0	47.3	3.2
2007	35.6	38.4	-2.8	65.2	45.1	3.3
2008	36.7	38.3	-1.6	63.5	38.0	3.9
2009	34.8	38.1	-3.3	66.8	41.5	2.0
2010	37.1	39.9	-2.8	65.0	39.1	2.4
2011	37.0	39.6	-2.6	64.7	36.4	3.1
2012	38.1	40.9	-2.8	68.2	35.3	2.1
2013	37.9	41.1	-3.3	66.2	33.6	1.9
2014**	38,2	42.1	-3.9	65.8	33.7	1.3

*Gross debt refers to non -financial public sector, excluding Electrobras and Petrobras. It includes sovereign debt held on the balance sheet of the Central Bank.
**Forecast
Source: IMF Fiscal Monitor, October, 2014.

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