Brazil's Argentina moment

By Filipe Campante and Dani Rodrik
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Brazil's economy has been in free fall, a casualty of years of economic mismanagement and the vast corruption scandal that has engulfed the country's political and business establishment – and which now threatens to bring down the second president in as many years. It may seem hard to focus on policy developments amid the political and economic turmoil, but the fact remains that Brazil must overcome fundamental challenges if it is to lay the groundwork for sustainable growth. Few loom as large as the country's fiscal woes.

There is a strong argument that Brazil's overstretched government finances have long held back the economy. At 36%, the ratio of government spending to GDP is one of the highest among countries at a similar income level. Years of fiscal laxity, mounting social security obligations, and low commodity prices have greatly magnified concerns – now compounded by the political crisis – about the government's debt burden, which now stands at about 70% of GDP. The high interest rates required to finance the perilous fiscal position aggravates it further: higher interest payments account for much of the difference in spending between Brazil and peer countries.

Against this background, Brazil's National Congress, seeking to regain market confidence, approved an unprecedented constitutional amendment last December that imposes a ceiling on non-interest government expenditures, indexed to the previous year's inflation rate, for a period of at least ten years. As long as it holds, the spending cap ensures that the size of the government (excluding interest payments) will shrink as a share of national income in every year that the economy experiences real growth. The International Monetary Fund enthusiastically endorsed it at the time, calling it a potential fiscal "game changer."

But is it? Taken at face value, the economic justification for a spending cap is surprisingly weak. Nothing in economic theory supports keeping real government spending constant over a period as long as a decade. As large as the size of Brazil's government is, there is no magic ratio of spending to GDP that would ensure sustained growth. Furthermore, the ceiling does not distinguish between government consumption and investment. And, in practice, it is likely to become more of a target than a ceiling, thereby removing room for countercyclical fiscal policy during a future downturn.

Even as a signal for market confidence, the idea of a cap on future spending has important weaknesses. As long as the economy contracts, a spending cap in fact does not impart much discipline; it does not force the government to shrink in step with the economy. Fiscal contraction is, in Augustinian fashion, deferred to the future – not exactly a confidence booster. Indeed, the IMF, arguing that the spending cap is inadequate, has pushed for additional frontloaded fiscal adjustment.

Perhaps desperate times call for desperate measures. Brazil's move resembles Argentina's convertibility plan of 1991, which abolished all currency controls and pegged the Argentine peso to the US dollar. Facing hyperinflation and a complete loss of market confidence, the government sought to buy credibility by placing monetary policy on automatic pilot. Argentina's message to markets was, "look, we have no discretion over monetary policy." Similarly, Brazil is telling markets it will shrink the government (as long as the economy is growing). In both cases, the promises are backed up by legal or even constitutional changes.

When credibility becomes the binding constraint on economic recovery, measures such as these may make sense – as long as they have the intended effect on market confidence. In fact, long-term interest rates on Brazilian government bonds have come down significantly since the amendment was passed (though it is hard to pinpoint the causal impact of the rule itself), and remain well below pre-amendment levels, despite the short-lived spike that followed the release of a recording of President Michel Temer allegedly authorizing illegal payments to a jailed congressman.

But as Argentina found out several years down the line, binding fiscal legislation can itself become a powerful constraint on economic recovery. By the late 1990s, Argentina's overwhelming problem had become an overvalued currency. Successive governments stuck with the convertibility law for fear of losing credibility, but aggravated the economy's competitiveness crisis as a result. Eventually, amid street riots and political mayhem, Argentina abandoned the currency peg in 2002.

Viewed with Argentina's experience in mind, Brazil's spending cap looks problematic – all the more so against a backdrop of political turmoil that is set to continue for the foreseeable future. The cap will likely become even more politically controversial once Brazil recovers, as it will. It is not hard to imagine the next administration – whenever it comes about – perceiving the cap as an obstacle to faster economic growth. The cap's defenders will sound unconvincing, because the economic case for it is weak in the absence of extreme credibility problems.

Indeed, the cap will undermine itself to the extent that it succeeds in addressing the credibility issue. Brazil could become a prisoner of the policy's totemic value as a commitment device, even as it outlives its usefulness as such. The irony will not be lost on investors or Argentines: countries that can write a spending cap into the Constitution on short notice are also those where it could be just as easily removed.

There are good reasons why democracies sometimes tie their hands or delegate decision-making. Independent central banks or fiscal commissions, for example, can help governments overcome the temptation of short-term manipulation of the economy at longer-term cost. But Brazil's spending cap does not look like a sustainable solution. While born of a real sense of fiscal urgency, the biggest risk is that it will eventually fuel political conflict around the ceiling itself, rather than foster deliberation about the difficult fiscal choices that must be made.

Filipe Campante is Associate Professor of Public Policy at Harvard University's John F. Kennedy School of Government. Dani Rodrik is Professor of International Political Economy at Harvard University's John F. Kennedy School of Government.