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Brazil—Fiscal Policy

2019: Time to Bite the Bullet II

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- **According to our analysis presented in the previous report, not even an ongoing reduction in investments and other current spending, combined with social security benefits and assistance social spending being adjusted only by inflation (no real increase), would be sufficient to maintain primary expenditures below the ceiling beyond 2022. Please see our report on fiscal policy, *2019: Time to Bite the Bullet,* published on June 27, 2017.**
- **The non-fulfillment of the New Fiscal Regime leads to the application of penalties, which, according to the law, must be applied in the year of non-fulfillment. All penalties are intended to control payroll spending and social security benefits.**
- **Among several options to avoid the non-fulfillment of the New Fiscal Regime, in our opinion, there are two possible courses of action for the newly elected government that represent the best- and the worst-case scenarios, in our opinion: (1) approving social security reform; or (2) changing (or even undoing) the New Fiscal Regime (i.e., removing the spending cap).**
- **In order to approve social security reforms or change/undo the New Fiscal Regime, a Constitutional amendment is needed, which requires a supermajority of votes in both houses (Lower House and Senate) – 308 votes in the Lower House and 41 votes in the Senate – in two rounds of voting in both houses.**
- **Among several options between the best- and the worst-case scenarios are some solutions cogitated by the government's economic team; however, those proposals could prove to be also unpopular, in our opinion.**
- **We believe that the inexorable budget constraints will ultimately prevail and fiscal adjustment will be undertaken before 2022.**

Introduction

This is our second and final report regarding the constraints of the New Fiscal Regime (spending cap) for federal expenditures. **In this report, we discuss the penalties associated with non-fulfillment of the New Fiscal Regime and the possible solutions for the new government elected in 2019.**

In our previous report we focused on **the feasibility (or lack of feasibility) of meeting the spending cap in the upcoming years, addressing the following questions: (1) Does the current process of disinflation hinder the achievement of the spending cap in 2018 and in the following years? (2) What have the dynamics been for mandatory spending, which consumed a significant portion of non-mandatory spending that was supposed to be cut throughout 2019 in order to maintain federal expenditures under the ceiling, at least until 2019? (3) Assuming no social security reform until 2019, what could happen to the primary expenditures dynamic in the upcoming years?**

(1) The current disinflationary process depresses the adjustment of the 2018 primary expenditures ceiling – the 2018 ceiling will be adjusted by only 3%. This unexpected process of disinflation will not hinder the achievement of the spending cap in 2018, in our view. However, it leaves a tight budget in the coming years.

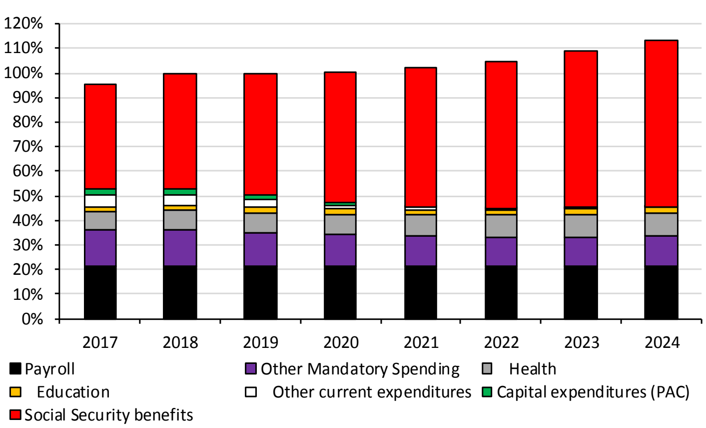
(2) The fast pace of social security benefits and the federal Government's payroll spending growth (representing more than 60% of total expenditures) consumed almost all reductions in economic subsidy spending and in non-mandatory spending that occurred in 2017. If the current growth rate for mandatory spending is maintained, total expenditures would grow at 6% y/y, on average, in the coming years, while the inflation correction of the primary expenditure ceiling would be 3% in 2018 and about 4% in the following years.

(3) Therefore, according to our analysis presented in the previous report, in the absence of social security reform, not even an ongoing reduction in investments and other current spending combined with social security benefits and assistance social spending being adjusted only by inflation (no real increase) would be sufficient to maintain primary expenditures below the ceiling beyond 2022. This perspective will negatively affect the assessment of the primary balance and public debt dynamics. Please see our report on fiscal policy, 2019: Time to Bite the Bullet, published on June 27, 2017.

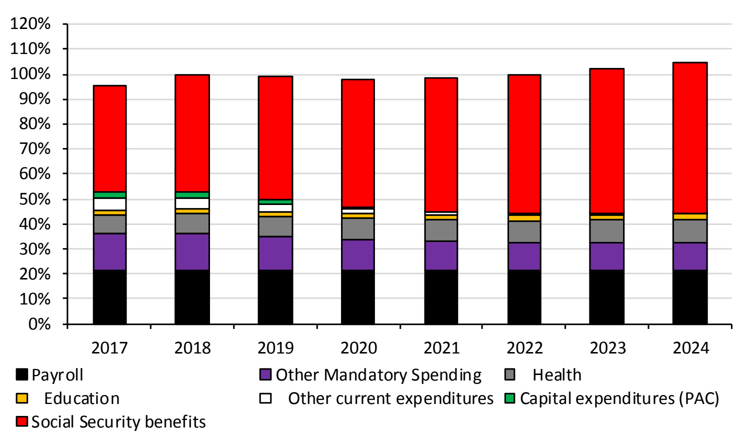
In the charts below, we compare the evolution of primary expenditures with the primary expenditures ceiling. The ceiling increases by 3% in 2018 and about 4% in the following years. In exercise A, primary expenditures increases by 6% y/y on average – assuming payroll increasing at the rate of the previous year's inflation; the general regime of social security (RGPS) benefits increasing at 11% y/y on average (the result of a combination of the previous year's inflation rate, minimum wage adjustment, and population >60 years' growth); and a drastic cut in investments and other current spending occurs (40%-50% below the 2016 level). In exercise B, primary expenditures increase by 5% y/y on average, assuming social security benefits and social assistance spending being adjusted only by inflation (no real increase) and population >60 years' growth from 2019 onward, and a drastic cut in investments and other current spending occurs. Both exercises assume the absence of social security reform.

The charts below provide a breakdown of federal expenditures as a percentage of the primary expenditures ceiling. **The chart on the left represents the evolution of expenses in exercise A, and indicates that social security benefits would drag all cuts in non-mandatory spending, and surpass the primary ceiling in 2019.** The social security benefits ratio to primary expenditures increases from 43% in 2017 to 68% in 2024, while other mandatory spending (payroll, health, education and other mandatory spending) maintains its ratio at 45%, as stipulated by the Constitution. **The chart on the right represents the evolution of expenses in exercise B, and shows that primary expenditures could remain below the ceiling until 2022 if social security benefits and social assistance spending are adjusted only by inflation plus population >60 years' growth from 2019 onward (applying one of the penalties provided for in the New Fiscal Regime law, which we will discuss in the next session).**

Exercise A: Primary Expenditures Breakdown - % of primary expenditures ceiling



Exercise B: Primary Expenditures Breakdown - % of primary expenditures ceiling



Sources: National Treasury and Santander estimates.

(4) What are the penalties for non-fulfillment of the New Fiscal Rule (spending cap)?

The non-fulfillment of the New Fiscal Regime would lead to the application of penalties, which, according to the law, must be applied in the year of non-fulfillment, and not in the following year. This means that additional budget cuts could be recurrent in the last quarter of a given year, in order to curb the primary expenditures towards the ceiling, and help the government to avoid non-fulfillment of the spending cap. The following penalties apply:

I - no increase or adjustment in the salaries of civil servants and employees, except those derived from a final judicial decision or from a legal determination;

II – no creation of a position, job, or function that would result in higher payroll expenses;

III – no change in the career staffing structure that would result in higher payroll expenses;

IV – no hiring of personnel, except for the replacement of chief supervisory positions that do not entail an increase in payroll expenses;

V – no public tendering , except for vacancy replacements;

VI – no creation or increase of aid, advantages, bonuses, or benefits for civil servants, military personnel, and employees;

VII – no creation of mandatory spending; and

VIII – no readjustment of mandatory spending above inflation.

The majority of these items are intended to control payroll spending, which represents 22% of primary expenditures in the 2017 budget. The last item (item VIII) is intended to control the growth of social security benefits (46% of primary expenditures in the 2017 budget), social assistance spending, and any other spending growth linked to the minimum wage adjustment.

This implies that, in the case of the non-achievement of the spending cap, the minimum wage rule[1] adjustment of social security and other social assistance spending would automatically change for the next year, in the case of the non-fulfillment of the spending cap. This works in favor of the spending cap, as we highlighted above, as in our view, the changing of the minimum wage rule would be the most important measure in order to extend the period of when the spending cap can be achieved.

However, also as highlighted in exercises A and B, a significant limit on payroll spending and a change in the minimum wage rule would not be enough to curb primary expenditures toward the ceiling much beyond 2022, which implies, in our opinion, that it will not be possible to postpone the approval of social security reform (changes in the retirement rules for the private and public sectors) for another 20 years, nor even beyond 2019 (when the next government is elected).

(5) What are the possible solutions for the non-fulfillment of the New Fiscal Regime?

Here we enter the realm of conjecture. Among several options, there are two possible courses of action for the newly-elected government that represent the best- and the worst-case scenarios, in our opinion: (1) approving social security reform (which sets a minimum age for retirement in line with Brazilian life expectancy, equal for both genders, with restricted transition rules, and which equalizes the benefits between private and public sectors); or (2) to changing (or even undoing) the New Fiscal Regime (i.e., removing the spending cap).

In order to approve social security reform, a Constitutional amendment is needed, which requires a supermajority of votes in both houses (Lower House and Senate) – 308 votes in the Lower House and 41 votes in the Senate – in two rounds of voting in both houses.

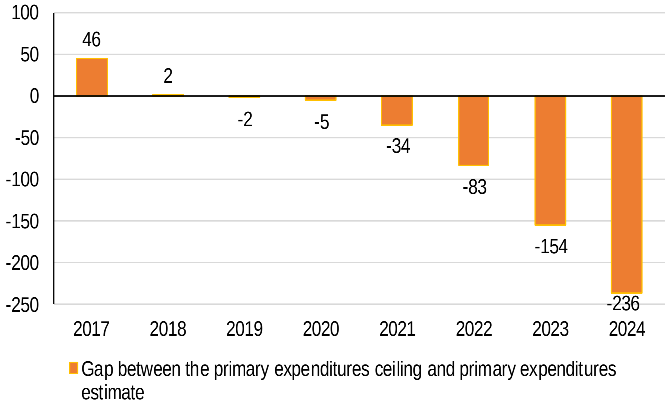
It is important to highlight that (i) raising the minimum age for retirement (in the private sector); (ii) implementing a charge on rural retirement benefits; (iii) delinking benefits and social assistance from the minimum wage; and (iv) making public sector retirement rules equivalent to those of the private sector rules can only be accomplished by a Constitutional amendment. According to our estimate, the minimum age for retirement represents around 50% of total potential savings from the reform proposed by the government (for more details, see our *Report on the Social Security Reform Proposal: A Risky Strategy*, published on April 20, 2017). Transition rules, rules for survivor pensions, and rules to calculate retirement benefits can be made through ordinary law, which requires a simple majority in both houses. However, according to our estimates, these changes would represent less than 30% of the total potential savings from the reform proposed by the government.

In order to change, or even undo, the New Fiscal Regime, a Constitutional amendment is needed as well (using the same procedures and vote majorities cited above). For instance, the most relevant mandatory spending could be excluded from the primary expenditures ceiling (social security benefits, health and education mandatory spending). These maneuvers would make it feasible to achieve the spending cap, given that it is easier to keep other mandatory and non-mandatory spending increasing in line with or below inflation. However, these maneuvers would not allow for the achievement of the goals of the spending cap target – curbing the federal spending to GDP ratio, producing fiscal primary surpluses, and stabilizing the public debt to GDP ratio, mainly because these maneuvers (representing almost 50% of total spending) would maintain the total federal spending to GDP ratio in an upward trend.

In order to simplify the rational arguments we could choose to restrict the options in these two scenarios, and to assess the best- and the worst-case scenarios, in our opinion. However, we think it is important to discuss **some solutions cogitated by the government's economic team** that are between the two possible courses of action mentioned above.

[1] Minimum wage is adjusted once a year in January.

Gap between primary ceiling and primary expenditures (exercise A estimate) – BRL billion



Possible cuts in mandatory spending (% of GDP)

	Now	Potential change	Savings	Implementation
Unemployment insurance	Needs 12 months working for 1st request (9 months for the 2nd request and 6 months for the 3rd)	Needs 18 months working for 1st request (12 months for the 2nd request and 6 months for the 3rd one)	**0.10%**	Simple Majority (if via "MP"/ dateline: 120 days to be voted)
Wage bonus	Needs 6 months working	End of this social programm	**0.28%**	Simple Majority
Unemployment insurance to fishermen	When it is not fishing season	3yrs as fisherman needed and cannot receive this benefit if receives another (as illness assistance)	**0.02%**	Simple Majority (if via "MP"/ dateline: 120 days to be voted)
Sick leave	as of 15 days out of work due to illness	as of 30 days out of work due to illness	**0.18%**	Simple Majority (if via "MP"/ dateline: 120 days to be voted)

Sources: Finance Ministry and Santander estimate.

In the chart above on the left, we present our estimate of the gap between the primary expenditures ceiling and our primary expenditures estimate – where we assume primary expenditures increase by 6% y/y on average between 2017 and 2024. In the table on the right, we outline some possible cuts to mandatory spending – most of which have already been cogitated by the government. If these changes were implemented in the short run, the savings would be sufficient to maintain primary expenditures below the primary ceiling until 2021. According to our estimate, the gap between the primary ceiling and primary expenditures in 2022 would be BRL83 billion, which is more than the potential savings.

That said, even with severe measures (all of them are unpopular), this solution would merely result in buying time; the cuts on mandatory spending would not be sufficient to keep primary expenditures below the ceiling beyond 2022. It could be argued that the need for fiscal structural reforms is not urgent, and could be postponed to 2022, which "theoretically" seems to be true. However, we believe that the inexorable budget constraints will ultimately prevail and fiscal adjustment will be undertaken before 2022.

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