Brazil—Fiscal Policy

2019: Time to Bite the Bullet

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- **In our opinion, the current heightened political uncertainty will delay the approval of social security reform. We believe this delay will act as a constraint on the fulfillment of the New Fiscal Rule (spending cap) in the upcoming years.**
- **The probable reduction in the pace of adjustment of the ceiling on primary expenditures for 2018 (the second year of implementation) leaves a tight budget in the coming years, given that the total expenditures should increase at 6% on average, according to our forecasts, while the inflation correction for the primary expenditures ceiling will be at 3% in 2018, and around 4% in the following years.**
- **According to our estimate, the decline in economic subsidy spending (around 1.8% of GDP between 2017 and 2019) will not offset the current trend of social security benefits and payroll spending, which should increase by 3.8% of GDP in the same period. Thus, we believe this gap of around 2% of GDP will demand a drastic reduction in non-mandatory spending subject to cuts (investments and other current spending) from 2019 onward.**
- **However, it would not be possible for non-mandatory spending subject to cuts (total fiscal slack) to be reduced to zero. This is because the fiscal slack concentrates a good part of the expenses with the operational cost of the federal administration, and the greatest portion of public investment.**
- **According to our exercises, in the absence of social security reform, not even an ongoing reduction in investments and other current spending, reducing them to 0% of GDP, and social security benefits and assistance social spending being adjusted only by inflation (no real increase), will be sufficient to maintain the ceiling on primary expenditures beyond 2022.**

Introduction

Following the approval of the New Fiscal Rule, our analysis showed that for the primary spending cap to be effective in the long term, a substantial amount of mandatory spending would have to decline as a percentage of GDP, which meant that additional measures would be required, such as social security reform and the delinking of social benefits from the minimum wage.

The consensus and our expectation was that these additional measures (for instance, social security reform) would start to affect the pace of mandatory spending growth within three years following their approval. This was not viewed as a problem because, in the short term, we believed the primary spending cap would be effective in cutting some non-mandatory spending. According to our calculations, the cuts in non-mandatory spending would be enough to maintain primary expenditures under the spending cap ceiling until 2019, when social security reform (which was expected to be approved in 2017) would start to reduce the pace of growth of social security benefits. (See our report *Spending Cap – The New Fiscal Regime*, October 7, 2016.)

Currently, given heightened political uncertainty, which has raised the stakes for the advance of the reform agenda in Brazil, an eventual delay in the approval of social security reform must be considered a possibility, in our view. This is mainly because mandatory spending represents about 84% of total primary expenditures, and we believe the likelihood of the approval of the most important measure to curb the pace of growth of mandatory spending toward inflation in the upcoming 18 months has declined significantly. This report presents empirical exercises regarding the execution of the New Fiscal Rule (spending cap) in the upcoming years, assuming no social security reform until 2019. We believe this is an important exercise not only to see how feasible the spending cap is under the current political scenario but also to assess the public debt dynamics.

IMPORTANT DISCLOSURES/CERTIFICATIONS ARE IN THE "IMPORTANT DISCLOSURES" SECTION OF THIS REPORT.

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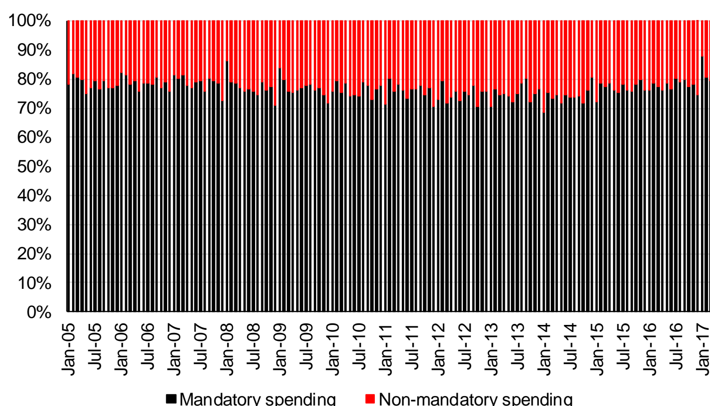
New Fiscal Rule[1] (PEC 95/2016)

This law limits the annual rise of federal expenditures to the previous year's inflation, which represents, in practice, a freeze in real terms. The primary expenditure ceiling is based on 2016 federal expenditures less some specific spending[2], and its evolution is determined by the inflation expectation in 2017 and by year-over-year inflation measured at mid-year from 2018 onward (until the 10th year of implementation of the New Fiscal Rule, when the government can propose changes to the correction method).

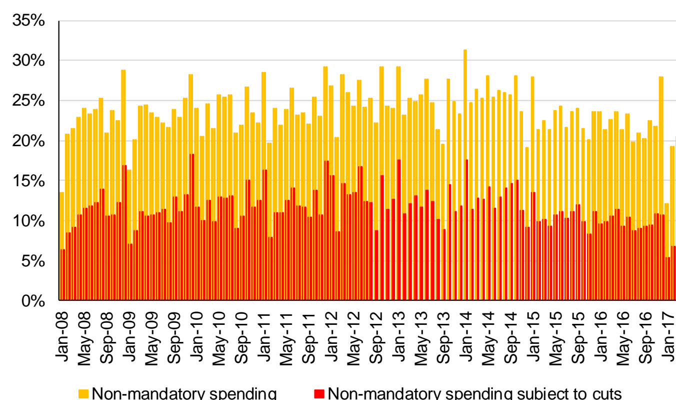
The primary expenditure ceiling was set at BRL 1.302 trillion in 2017, which is the 2016 ceiling plus inflation of 7.2%, fulfilling the rules set by the New Fiscal Regime (PEC 95/2016). According to the last "Revenues and Primary Expenditures" report published by the National Treasury in May, total expenditures will be BRL 1.290 trillion this year, which means that the total primary expenditures will be BRL 1.245 trillion – total expenditures minus some specific spending totaling BRL 44.4bn (Santander estimate). Thus, according to the National Treasury assessment, in 2017 there is a significant margin of around BRL 56bn between the primary expenditures expected and the ceiling to accommodate eventual negative surprises on the spending side. We estimate bigger primary expenditures (totaling BRL 1.256 trillion), and consequently a smaller positive margin (BRL 45.5bn) between the primary expenditures and the ceiling.

However, we see some difficulties emerging that are likely to prevent a repetition of this accomplishment in the upcoming years, such as (1) the current disinflation process, which should depress the adjustment of the 2018 primary expenditures ceiling; and (2) mandatory spending totaling 84% of total expenditures[3], while non-mandatory spending subject to cuts (investment and other current spending) represents less than 10%.

Mandatory versus Non-Mandatory Spending – % of total



Non-Mandatory Spending – % of total



Source National Treasury.

When Congress approved the spending cap in December 2016, according to our and the consensus opinion, it was believed that the principle of freezing expenditures in real terms would work in a scenario of inflation stability and economic growth. As of this writing, inflation has fallen – year-over-year inflation to May is at 3.7%, lower than the consensus forecast for annual inflation in 2017 published in the last Focus survey in 2016 – and we and consensus expect some economic growth this year; however, we have yet to see the first signs of an economic recovery. Regarding the weight of mandatory spending *versus* non-mandatory spending, it has become more important, as there is a cap for spending growth (at the rate of inflation) and the pace of mandatory spending growth hovers at 11% y/y[4].

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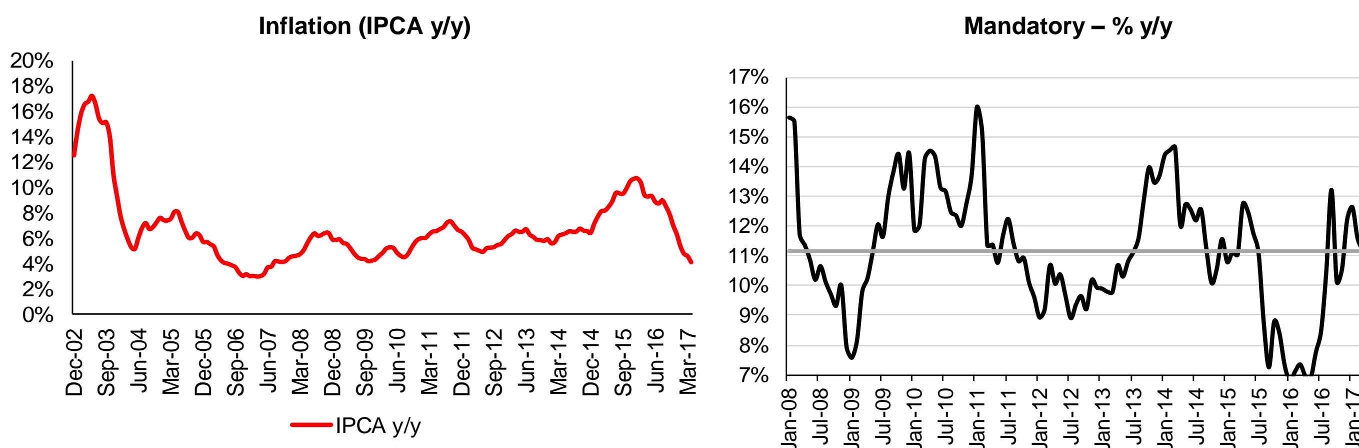
[1] The new rule is valid for a period of 20 years, and it can be changed only after the 10th year of implementation by a proposal from the president of the republic.

[2] Constitutional transfers, mandatory transfers due to earmarked revenues, nonrecurring spending (for unforeseeable and urgent situations such as weather or ecological disasters), electoral spending, and capitalization of state-owned companies are excluded. The spending excluded has hovered at under 2% of GDP.

[3] According to the 2017 budget estimated by the National Treasury.

[4] 2008 to April 2017 (latest available data) average.



Sources: IBGE and National Treasury.

In this report, we attempt to answer the main questions regarding the feasibility (or lack of feasibility) of meeting the spending cap in the upcoming years in the absence of social security reform: (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 part of non-mandatory spending that was supposed to be cut throughout 2019 in order to keep federal expenditures under the ceiling, at least until 2019?, and (3) Assuming no social security reform until 2019, what could happen to the primary expenditures dynamic in the upcoming years?

Does the current process of disinflation hinder the achievement of the spending cap in 2018 and in the following years?

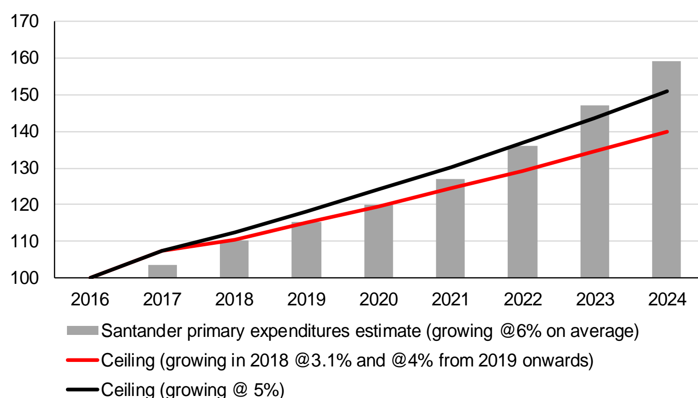
The current unexpected process of disinflation should not hinder the achievement of the spending cap in 2018, in our view. However, we think the most likely scenario is that the 2018 primary ceiling will be adjusted by only 3%, while total expenditures should increase at 6% on average, considering mandatory spending increasing at 8% and non-mandatory spending being capped at -1% (previous inflation). In our view, the achievement of the spending cap in 2018 will be possible due to the following three factors:

i) In 2017 primary expenditures will be lower than the ceiling – according to our estimate, this gap will be around BRL 45.5 billion – which allows some margin for effective 2018 primary expenditures to grow above inflation without surpassing the ceiling (i.e., expenses start growing from a base considerably lower than the ceiling, which allows for expenses to grow at a higher rate than past inflation during a short period) (see charts below).

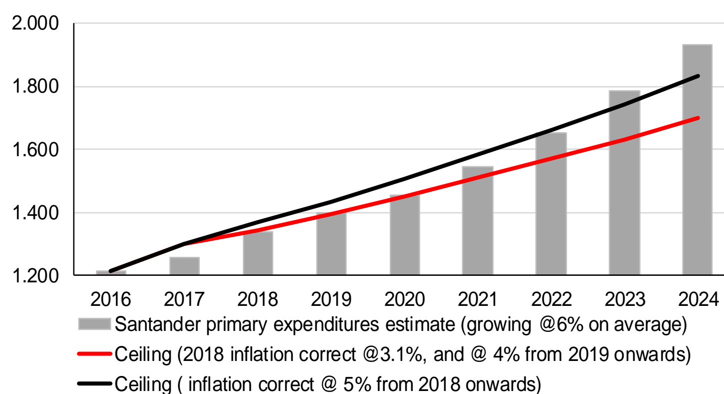
ii) The prospect of declining spending on economic subsidies (from BRL 112bn in 2015 to BRL 9bn in 2018, i.e. saving of BRL 103bn), because the 2014-15 fiscal maneuver payments are expected to end this year, and PSI loan subsidies payments are expected to end in 2018.

iii) The payment of aid to regional governments should be significantly reduced in 2018. We estimate that the aid payment will fall from BRL 13.8bn in 2017 to BRL 1.6bn in 2018 (saving of BRL 12bn).

Simulation of Primary Expenditures Growth (ceiling versus estimate) – index 2016=100



Simulation of Primary Expenditures Growth (ceiling and effective) – BRL trillion



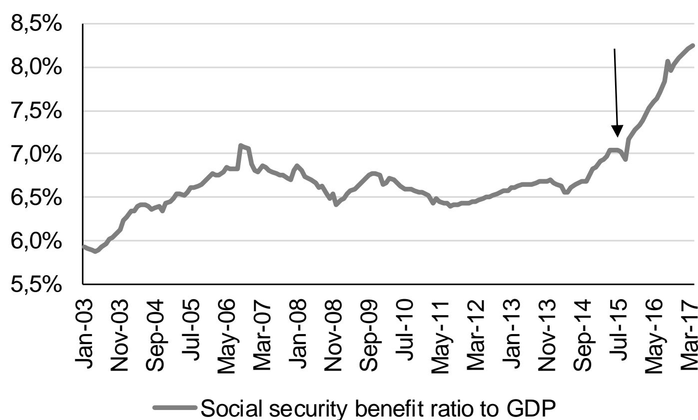
Sources: National Treasury and Santander estimate.

However, it is important to highlight that the probable reduction in the pace of adjustment of the ceiling on primary expenditures for 2018 (the second year of implementation) leaves a tight budget in the coming years (see charts above). From 2019 onward the reduction of the inflation correction means the ceiling dynamic (line red) does not reconcile with the pace of primary expenditures growth of 6% y/y. That said, the current disinflation process contributes to hindering the achievement of the spending cap from 2019 onwards. This brings us to the second question.

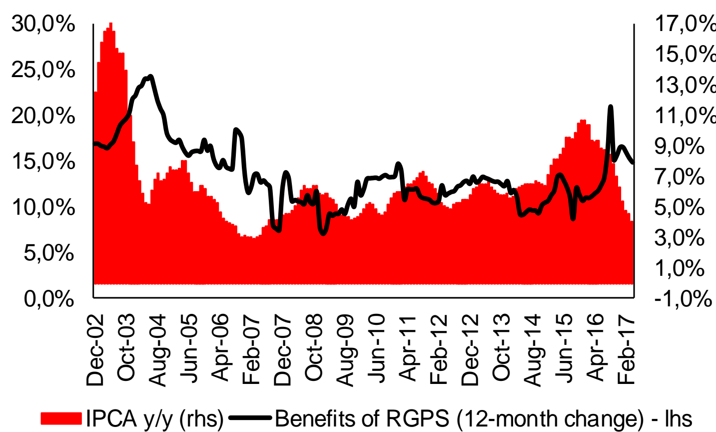
What happened with mandatory spending dynamics?

Two factors have driven the acceleration of social security benefits spending since 2015: (1) the new rule for the progressive ratio to retirement (85/95), which resulted in an early retirement age for women and men (receiving full benefits); and (2) inflation at a high level. Growth in social security benefits has always been linked to inflation, mainly because of the legal link between those benefits and the minimum wage, but the approval of the rule for a progressive ratio of 85/95 in November 2015 pushed the social security benefit's annual growth rate up to 14% y/y from 11% y/y (average in 2007-2015) (see charts below).

Social Security benefits of General Regime of Social Security – RGPS (Urban+Rural) – % of GDP



Inflation y/y versus RGPS benefits

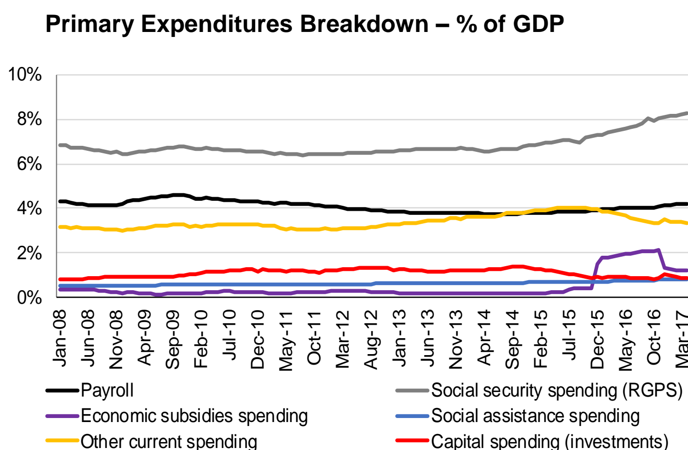


Sources: IBGE and National Treasury.

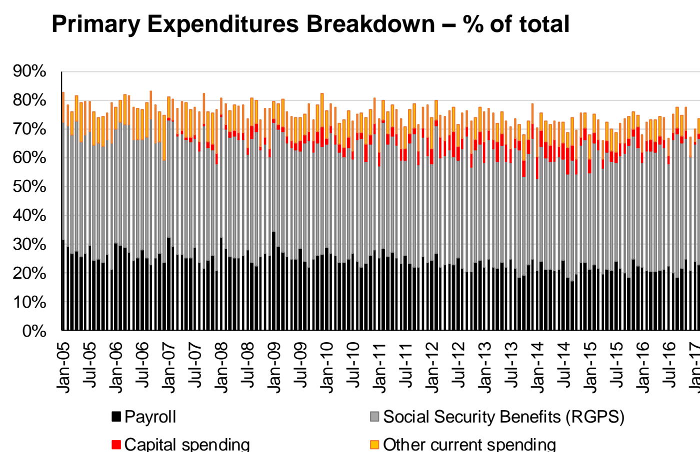
From June 2016 to April 2017, social security benefits (RGPS) increased by 0.6% of GDP (to 8.3% from 7.6%), and payroll expenses rose by 0.2% of GDP (to 4.2% from 4.0%), which consumed almost all reductions in economic subsidy spending that occurred in 2017, a drop of 0.8% of GDP (to 1.2% from 2.0%) – as well as consuming all reductions in non-mandatory spending, a fall of 0.3% of GDP (see chart below on the left). If the current growth rate for mandatory spending is maintained,

non-mandatory and economic subsidy cuts will not be sufficient to compensate, in our view.

Primary Expenditures Breakdown – % of GDP



Primary Expenditures Breakdown – % of total



Sources: IBGE and National Treasury.

According to our estimates, economic subsidies are at 1.2% of GDP and could be shrunk to 0.2% of GDP (their historical average until 2013), but this will occur throughout 2019. Between 2016 and April 2017, the economic subsidies already fell to 1.2% from 2.0% of GDP, and we believe that the government can count on 1% of GDP to cut economic subsidies from now to 2019, but it is likely that this will not be sufficient to offset social security benefits (RGPS) and payroll spending growth until the end of 2019. All in all, we estimate that economic subsidy spending will decline by 1.8% of GDP between 2017 and 2019, which will not offset the current trend of social security benefits and payroll spending, which should increase by 3.8% of GDP in the same period. In our view, this gap of around 2% of GDP will necessitate a drastic reduction in non-mandatory spending subject to cuts (investments and other current spending, which represent less than 10% of total expenditures).

Assuming no social security reform until 2019, what could happen to the primary expenditures dynamic in the upcoming years?

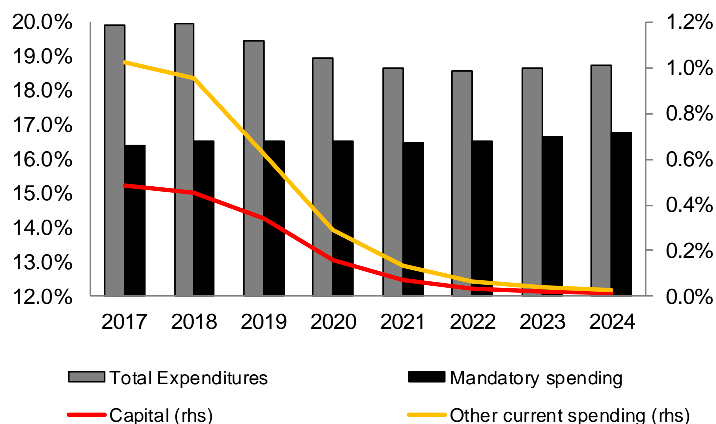
In our exercise, we assumed an inflation adjustment of the primary expenditure ceiling at 3.1%, payroll increasing 5% y/y (slightly above inflation), General Regime of Social Security (RGPS) benefits increasing at 12% y/y (growth average between 2008-April 2017), and other mandatory spending decreasing at 1% in 2018 (mainly due to the decline of economic subsidies); from 2019 onwards, payroll increasing at previous year inflation, General Regime of Social Security (RGPS) benefits increasing at 11% y/y on average (result of a combination of previous year inflation, minimum wage adjustment, and population >60 years' growth), and other mandatory spending increasing 1% y/y on average. Under these assumptions for mandatory spending, **2019 capital spending (investments) has to be 40% less than the 2016 amount, and other current spending has to be 50% less than the 2016 level, in order to maintain the primary expenditures under the ceiling until 2019 – see the chart below on the left side.**

It is important to highlight that, even under the assumption of an ongoing reduction of investments and other current spending, we believe it will not be feasible to keep the primary expenditures under the ceiling from 2020 onward due to the pace of mandatory spending growth (payroll, social security benefits, health, education and other mandatory spending) (see table below).

Exercise A: Primary Expenditures versus Ceiling on Primary Expenditures (2017-2024)

	Realized		NT's Budget		Santander (e)															
	2016		2017		2017		2018		2019		2020		2021		2022		2023		2024	
Total Expenditures	**1,242.5**	**7%**	**1,290.1**	**4%**	**1,290.1**		**1,400.5**	**9%**	**1,445.4**	**3%**	**1,506.2**	**4%**	**1,609.1**	**7%**	**1,721.1**	**7%**	**1,842.8**	**7%**	**1,992.1**	**8%**
Primary Expenditures Ceiling	**1,214.4**		**1,301.8**	**7%**	**1,301.8**	**7%**	**1,342.2**	**3%**	**1,398.5**	**4%**	**1,454.5**	**4%**	**1,512.7**	**4%**	**1,573.2**	**4%**	**1,636.1**	**4%**	**1,701.5**	**4%**
Total Expenditures (A)	**1,242.5**		**1,290.1**		**1,300.7**		**1,385.8**	**6%**	**1,445.4**	**4%**	**1,506.2**	**4%**	**1,595.2**	**6%**	**1,706.4**	**7%**	**1,842.8**	**8%**	**1,992.1**	**8%**
Mandatory Spending	**958.8**	**1%**	**1,052.1**	**10%**	**1,062.6**	**11%**	**1,149.3**	**8%**	**1,228.8**	**7%**	**1,315.2**	**7%**	**1,410.5**	**7%**	**1,518.2**	**8%**	**1,643.7**	**8%**	**1,780.5**	**8%**
Payroll	257.9	14%	283.1	10%	283.1	10%	297.3	5%	309.2	4%	321.6	4%	334.4	4%	347.8	4%	361.7	4%	376.2	4%
Social Security benefits	507.9	16%	559.8	10%	579.0	14%	648.7	12%	721.2	11%	798.6	11%	883.2	11%	976.5	11%	1,079.3	11%	1,192.5	10%
Other Mandatory Spending	193.0	-29%	209.2	8%	200.5	-4%	203.2	1%	198.3	-2%	195.1	-2%	192.9	-1%	193.9	1%	202.7	5%	211.9	5%
Non-Mandatory Spending	**283.7**	**18%**	**238.1**	**-16%**	**238.1**	**-16%**	**236.5**	**-1%**	**216.7**	**-8%**	**191.0**	**-12%**	**184.7**	**-3%**	**188.3**	**2%**	**199.0**	**6%**	**211.6**	**6%**
Capital expenditures (PAC)	42.0	-9%	31.5	-25%	31.5	-25%	31.5	0%	25.2	-20%	12.6	-50%	6.3	-50%	3.2	-50%	2.2	-30%	1.5	-30%
Other expenditures	228.4	18%	206.5	-10%	206.5	-10%	203.4	-1%	191.4	-6%	178.4	-7%	178.4	0%	185.1	4%	196.8	6%	210.0	7%
Health	99.8	17%	101.1	1%	101.1	1%	108.4	7%	115.9	7%	124.0	7%	133.3	8%	143.3	8%	154.1	8%	165.6	8%
Education	34.5	6%	25.4	-27%	25.4	-27%	27.2	7%	29.1	7%	31.1	7%	33.4	8%	36.0	8%	38.7	8%	41.6	8%
Other current expenditures	94.0	-5%	66.3	-30%	66.3	-30%	66.3	0%	46.4	-30%	23.2	-50%	11.6	-50%	5.8	-50%	4.1	-30%	2.8	-30%
Aid for Regional government + Committed investments expenses net from Foreign asset repatriation revenue	19.9		13.8	-31%	13.8	-31%	1.6	-89%												
Spending discounted (B)			**44.4**		**44.4**		**45.8**	**3%**	**47.7**	**4%**	**49.6**	**4%**	**51.6**	**4%**	**53.7**	**4%**	**55.8**	**4%**	**58.0**	**4%**
Primary Expenditures (C=A-B)	**1,214.4**		**1,245.7**	**3%**	**1,256.3**	**3%**	**1,340.0**	**7%**	**1,397.7**	**4%**	**1,456.6**	**4%**	**1,543.6**	**6%**	**1,652.7**	**7%**	**1,787.0**	**8%**	**1,934.1**	**8%**

Simulation of Primary expenditures breakdown - % of GDP



Santander's fundamental assumptions

	2018	2019-2024
IPCA	3.1	4.0
GDP (real growth)	0.7	3.3
GDP (nominal growth)	3.8	7.3
Minimum wage adjustment	4.2	6.9
Population >60 years' growth	3.4	3.3

Sources: National Treasury and Santander estimates.

In the second exercise (see table below), we raised the fiscal austerity level by: (1) changing the minimum wage rule in 2019 (to only the previous year's inflation instead of the previous year's inflation plus real GDP growth of two years ago); (2) raising the criteria for concessions of rural retirement benefits; and (3) delinking social assistance spending from the minimum wage adjustment. Using these new assessments, and maintaining the previous assumption of an ongoing reduction in investments and other current spending, primary expenditures are kept under the ceiling until 2022.

Exercise B: Primary Expenditures versus Ceiling of Primary Expenditures (2017-2024)

	Realized 2016		NT's Budget 2017		Santander (e) 2017		2018		2019		2020		2021		2022		2023		2024	
Total Expenditures	**1,242.5**	**7%**	**1,290.1**	**4%**	**1,290.1**		**1,400.5**	**9%**	**1,429.3**	**2%**	**1,470.3**	**3%**	**1,550.6**	**5%**	**1,636.8**	**6%**	**1,728.5**	**6%**	**1,844.2**	**7%**
Primary Expenditures Ceiling	**1,214.4**		**1,301.8**	**7%**	**1,301.8**	**7%**	**1,342.2**	**3%**	**1,398.5**	**4%**	**1,454.5**	**4%**	**1,512.7**	**4%**	**1,573.2**	**4%**	**1,636.1**	**4%**	**1,701.5**	**4%**
Total Expenditures			**1,290.1**		**1,300.7**		**1,385.8**	**6%**	**1,429.3**	**3%**	**1,470.3**	**3%**	**1,536.8**	**5%**	**1,622.1**	**6%**	**1,728.5**	**7%**	**1,844.2**	**7%**
Mandatory Spending	**958.8**	**1%**	**1,052.1**	**10%**	**1,062.6**		**1,149.3**	**8%**	**1,212.7**	**6%**	**1,279.3**	**5%**	**1,352.1**	**6%**	**1,433.8**	**6%**	**1,529.5**	**7%**	**1,632.6**	**7%**
Payroll	257.9	14%	283.1	10%	283.1	10%	297.3	5%	309.2	4%	321.6	4%	334.4	4%	347.8	4%	361.7	4%	376.2	4%
Social Security benefits	507.9	16%	559.8	10%	579.0	14%	648.7	12%	707.6	9%	768.3	9%	833.7	9%	904.7	9%	981.8	9%	1,065.7	9%
Urban	396.6				452.1	14%	506.6	12%	557.1	10%	609.3	9%	665.6	9%	727.0	9%	794.0	9%	867.2	9%
Rural	111.3				126.9	14%	142.2	12%	150.5	6%	159.1	6%	168.1	6%	177.7	6%	187.8	6%	198.4	6%
Other Mandatory Spending	193.0	-29%	209.2	8%	200.5	-4%	203.2	1%	195.9	-4%	189.4	-3%	183.9	-3%	181.3	-1%	185.9	3%	190.7	3%
Non-Mandatory Spending	**283.7**	**18%**	**238.1**	**-16%**	**238.1**	**-16%**	**236.5**	**-1%**	**216.7**	**-8%**	**191.0**	**-12%**	**184.7**	**-3%**	**188.3**	**2%**	**199.0**	**6%**	**211.6**	**6%**
Capital expenditures (PAC)	42.0	-9%	31.5	-25%	31.5	-25%	31.5	0%	25.2	-20%	12.6	-50%	6.3	-50%	3.2	-50%	2.2	-30%	1.5	-30%
Other curent expenditures	228.4	18%	206.5	-10%	206.5	-10%	203.4	-1%	191.4	-6%	178.4	-7%	178.4	0%	185.1	4%	196.8	6%	210.0	7%
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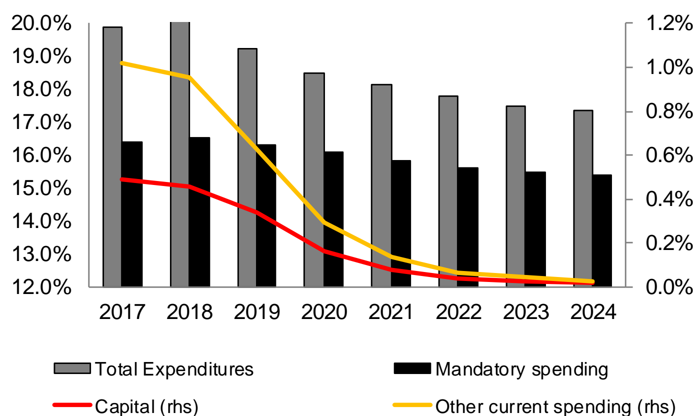
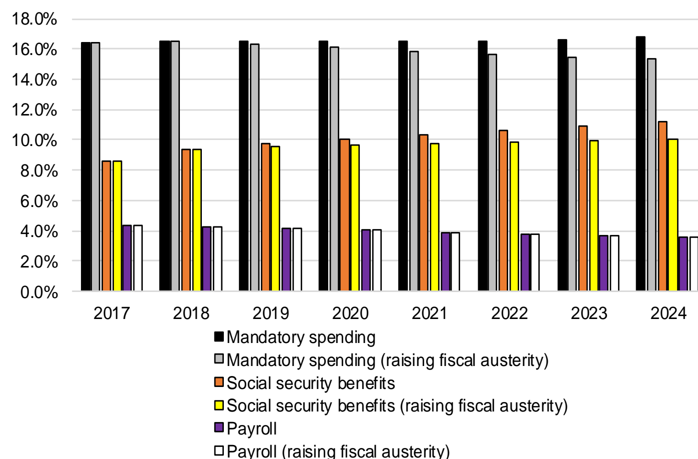
Education	34.5	6%	25.4	-27%	25.4	-27%	27.2	7%	29.1	7%	31.1	7%	33.4	8%	36.0	8%	38.7	8%	41.6	8%
Other expenditures	94.0	-5%	66.3	-30%	66.3	-30%	66.3	0%	46.4	-30%	23.2	-50%	11.6	-50%	5.8	-50%	4.1	-30%	2.8	-30%
Aid for Regional government + Committed investments expenses net from Foreign asset repatriation revenue	19.9		13.8	-31%	13.8	-31%	1.6	-89%												
Spending discounted (B)			**44.4**		**44.4**		**45.8**	**3%**	**47.7**	**4%**	**49.6**	**4%**	**51.6**	**4%**	**53.7**	**4%**	**55.8**	**4%**	**58.0**	**4%**
Primary Expenditures (C=A-B)	**1,214.4**		**1,245.7**	**3%**	**1,256.3**	**3%**	**1,340.0**	**7%**	**1,381.6**	**3%**	**1,420.7**	**3%**	**1,485.2**	**5%**	**1,568.4**	**6%**	**1,672.7**	**7%**	**1,786.1**	**7%**





Sources: National Treasury and Santander estimate.

In exercise B, the higher fiscal austerity, mainly reducing the pace of social security growth and the pace of other mandatory spending growth, it is possible to stabilize the ratio of social security benefits and other mandatory spending to GDP, resulting in a decline of the total mandatory spending ratio to GDP (see chart above on the right), which coupled with the drastic reduction in non-mandatory spending subject to cuts (investment and other current spending) maintain the primary expenditures under the ceiling until 2022.

It is worth noting that there are limits as to how much investment and, especially, other current spending can be reduced. In the case of other current spending, this is basically the operational cost of Brasilia (the political capital of the country), which means that there is a minimum financial requirement to maintain Brasilia as a working operation. Thus, it is not feasible to reduce that amount to zero. In the case of investments, part of these are parliamentary amendments – the way that representatives of the Lower House and the Senate sponsor their own projects in their respective states/cities – and part of these are federal government projects. Again, it is not feasible to reduce this amount to zero.

Conclusion

As highlighted by the exercises, significant limits on payroll spending and a change in the minimum wage rule would not be enough to curb the primary expenditures towards 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).

The fiscal slack (or fiscal margin), which is the non-mandatory spending subject to cuts (investment and other current spending), was 10% of total expenditures in December 2016 (BRL 136bn); the budget cut in 2017 is intended to reduce it by BRL 42bn (to BRL 94bn, or 7.6% of total expenditures). Additional cuts could occur in non-mandatory spending subject to cuts; however, it would not be possible for the total fiscal slack to be reduced to zero. This is because the fiscal slack concentrates a good part of the expenses with the operational cost of the federal administration, and the majority of public investment. Therefore, in this sense, the threshold for the federal government expenditures tends to occur even before 2022, a year that the fiscal slack would zero, according to our scenario without social security reform.

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