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Brazil— Structural Reforms

Closed for Renovation: The Challenging Reform Agenda

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- **President Michel Temer has set an ambitious goal for his rather short term in office: to approve a series of reforms, targeted at ensuring fiscal balance and improving the business environment, in order to recreate conditions for stronger and sustainable potential growth in Brazil.**
- **President Temer seems to have built a strong government coalition, controlling nearly 70% of the votes in the Lower House and over 75% in the Senate. The first votes carried out during his interim presidency suggest that he can rely on votes from his coalition: average adherence to the government orientation has been very high even among those parties not represented in the cabinet.**
- **Such a congressional base will be put to the test from October on, with the kick-off of the main fiscal reforms. Ahead of these votes, we look at the reform initiatives that have been proposed so far, commenting on the key ideas, the likely timing of their vote and the odds of approval.**

Figure 1 – The Reform Agenda (So Far): A Summary

Topic	Legal instrument	Current status	Expected conclusion date	Odds of approval
Changes in Brazilian Pre-Salt Law	Ordinary Law	Approved by the Lower House Awaiting a final vote by the Lower House	**LH:** Oct 2016 **Senate**: concluded	High, unchanged from Senate's version
States' debt renegotiation	Complementary Law	Approved in the Lower House Debates initiated in the Senate	**LH**: concluded **Senate**: Nov 2016	High, unchanged from LH's version
New Fiscal Regime (spending freeze in real terms)	Constitutional Amendment	Debates initiated in the Lower House	**LH**: Oct 2016 **Senate**: Dec 2016-Mar 2017	High, with shorter validity and milder constraints
Social Security Reform	Constitutional Amendment	Still to be sent to Congress	**LH**: Jun 2017 **Senate**: Dec 2017	Moderate to high, with negotiated conditions
Regulatory Agencies Law	Ordinary Law	Approved at the Senate's Commission	**Senate**: Oct 2016 **LH**: end-2016	High
Labor Reform	Different pieces of legislation	Outsourcing: approved by the Lower House Negotiated > Law: to be sent to Congress	No timeline yet	Moderate
Tax Reform	Different pieces of legislation	Unification PIS-Cofins: to be sent to Congress Unification ICMS: debates frozen	No timeline yet	PIS-Cofins: Moderate ICMS: Low

Requirements for approval: Constitutional amendment – 60% majority (308 votes in the Lower House and 49 votes in Senate, regardless of quorum) in two rounds of voting in each House; Complementary Law – absolute majority (257 votes in the Lower House and 41 in the Senate, regardless of quorum) in one round of voting in each House; Ordinary Law – simple majority (50% + 1 of representatives attending the session, provided a minimum quorum) in one round of voting in each House. Source: Santander.

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Can the government rely on Congress for reforms?

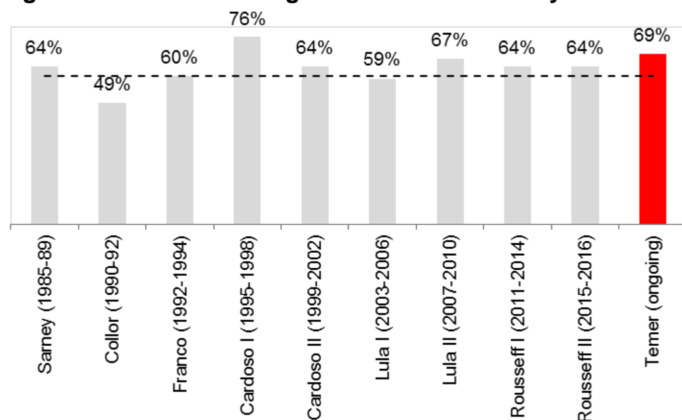
President Michel Temer has set for himself an ambitious goal: to move forward with a challenging reform agenda, aimed at ensuring medium- to long-term fiscal sustainability and creating an environment conducive to stronger, more sustainable growth in the coming years. If the width and depth of the agenda were not challenging enough, he faces an additional difficulty: he will have to do so within a shortened term in office, less than 2 and a half years. In fact, due to the electoral dynamics, approving reforms tends to be politically unfeasible in the year leading up to the Presidential elections (to be held in October 2018), which means that, in practice, the government has a little more than one year to obtain approval of the bulk of reforms.

How feasible is this task? While the short time poses a severe constraint, President Temer has two factors in favor of his odds of delivering such reforms. First and foremost, **the economic team is comprised of individuals who possess not only a strong academic background but also (and perhaps more importantly) years of experience in analyzing the public sector and its interplay with the country's efficiency, with most of them having had previous experience in the public administration and being knowledgeable about the legislation and the legislative process.** This is crucial in that it enables them to provide a prompt diagnosis of the problems, and to deliver sound reform proposals to address such problems within a relatively short period of time. The proposal of the New Fiscal Regime (see page 6 of this document) provides a good example: the rough guidelines of the proposal were announced to the press on May 24th – a mere 12 days after Temer took office as interim President in the aftermath of the Senate's acceptance of the impeachment process; on June 15th (shortly after completing one month in office), Temer's administration sent a detailed proposal for Congressional appraisal.

Second, and just as important, President Temer has built what could be called a "parliamentary cabinet", resulting in one of the largest coalitions in Brazil's recent history, second only to that led by President Cardoso in his first term (Figure 2). **The 11 parties represented (by some of their key members) in President Temer's cabinet have 355 representatives and 62 senators, which equates to 69% of the Lower House and 77% of the Senate** (Figure 3). This is well in excess of the votes required for approving the most challenging legislative pieces, such as Complementary laws (257 votes in the Lower House and 41 in the Senate) and constitutional amendments (308 in the Lower House and 49 in the Senate).

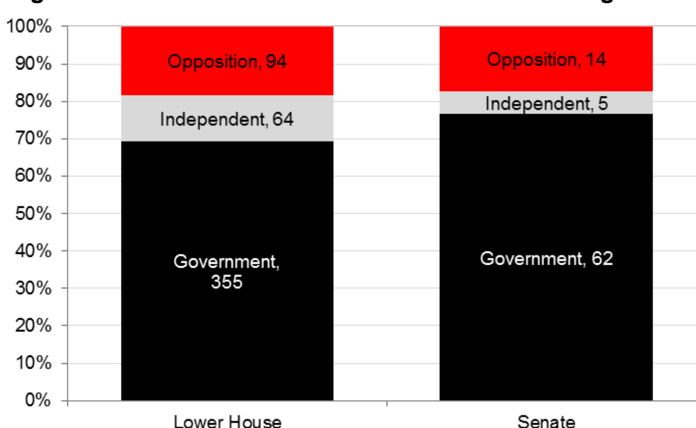
One fair question, however, is whether such a wide coalition is to be trusted. Indeed, President Rousseff's formal coalition held more than 60% of the votes in both her first and second term, yet this did not help her to secure a solid Congressional base. An analysis of voting patterns in the Lower House between 2011 and 2014 indicate that, when it came to actual votes, members of parties in her coalition did not always vote in line with the government's interests: in fact, in the final year of President Rousseff's first term (2014), these parties only voted in a manner aligned with the government 66% of the time, on average (Figure 4), as a result, the government could only effectively rely on votes from roughly 40% of the Lower House in most of the legislative discussions. Congressional support declined even further during her second term and later on, with the departure of some parties from her coalition, President Rousseff had a mere 137 votes (27%) in her favor during the critical impeachment vote at the Lower House.

Figure 2 – Size of formal government coalition by President



Formal coalition = parties with seats in the cabinet. Considers party representation in the Lower House. The dotted line represents the percentage of support required for approving constitutional reforms.
Source: MCM Consultores (based on Cebrap data) and Santander.

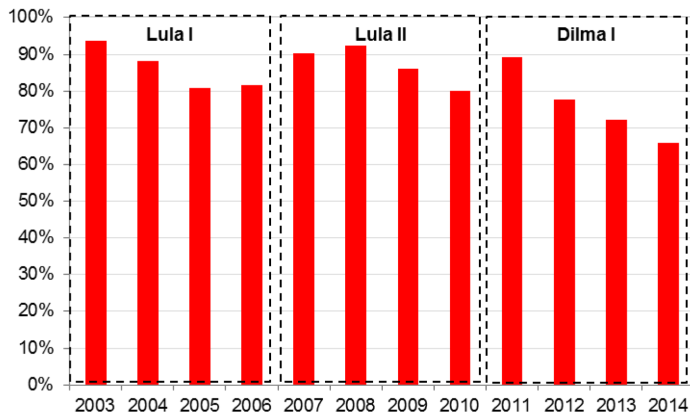
Figure 3 – President Temer's coalition: seats in Congress



Coalition comprised of the following parties, all of them with members at President Temer's cabinet: PMDB, PSDB, PP, PR, PSD, PSB, DEM, PRB, PTB, PV and PPS. Opposition: PT, PDT, PC do B and PSOL. All those parties are considered independent, for the purpose of this study.
Sources: Lower House, Senate, Federal Government and Santander.

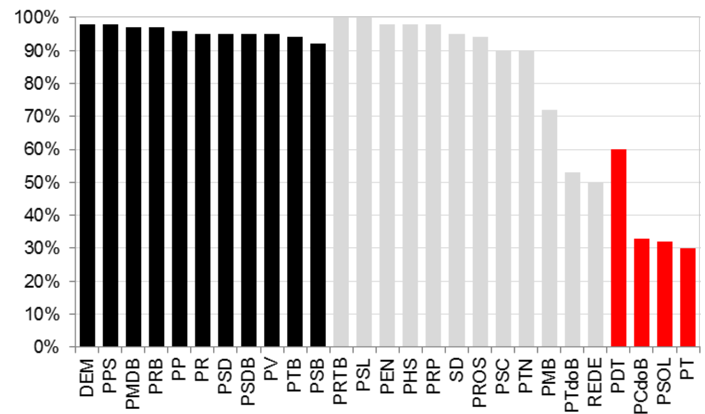
Should President Temer expect more or less loyalty from his coalition base? An analysis of 74 votes held at the Lower House during the period in which Temer was interim President (mid-May to end-August)[1] indicates a very high adherence to the government orientation from his coalition: all 11 parties represented in the cabinet had their average representative[2] voting in line with the government an average 96% of the times (Figure 5). The same analysis shows that "independent" parties – that is, parties neither represented in the cabinet nor in open opposition to the government – also contributed toward approving the government's interests, with their average representative voting most times in line with the official orientation; some of these independent parties have displayed an average adherence even higher than that of parties represented in the cabinet. Taking into account also the few, but existing, aligned votes coming from opposition parties, we find that President Temer has enjoyed an average adherence of 84% in the Lower House during that period.

Figure 4 – Loyalty index in congressional votes



Average frequency with which representatives from parties within the government coalition voted in line with the government orientation.
Source: MCM Consultores (based on Cebrap data).

Figure 5 – Average adherence to gov't orientation



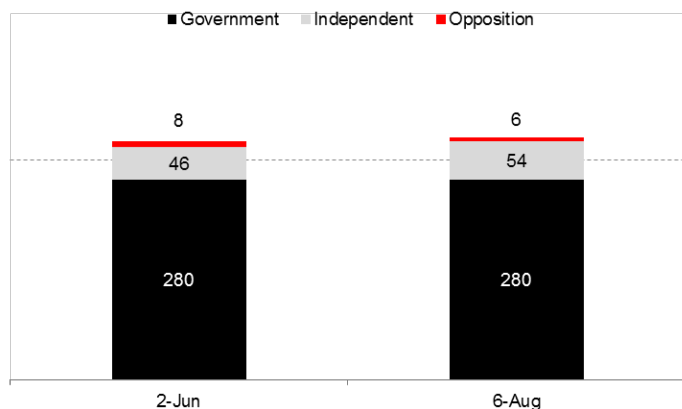
Represents the percentage of times that Lower House representatives of each party attending voting sessions voted in line with the government orientation (for each party, it is shown the average adherence of its representatives). Analysis based on 74 votes from May 18th and Aug 30th, 2016 (Temer's interim administration).Bar color indicates party block – black: coalition, grey: independent, red: opposition.
Sources: MCM Consultores (based on Estadão) and Santander.

A final argument could be made that what matters most is how these parties vote specifically in key, difficult votes (as is the case for most reforms). In order to assess this issue, it is useful to look at how parties voted during the debates on the so-called Desvinculação de Recursos da União (DRU), a constitutional amendment approved in late August that reduces federal budget rigidity (the recently approved DRU is valid through 2023). As a constitutional amendment, it required a minimum 308 votes in each of two rounds in the Lower House, and 49 votes in each of two rounds in the Senate, corresponding to 60% of the total Congressmen, regardless of how many of them attend the voting sessions. In this case, effective support requires both showing up and voting according to the government orientation. Coalition parties alone delivered 280 votes in each of the two floor votes at the Lower House, representing an effective support from 79% of their representatives, whereas independent parties accounted for 46 votes in the first and 54 votes in the second round at the Lower House (effective support of 72% and 84%, respectively), totaling 326 and 334 votes from these groups in each round – well in excess of the required 308. In Senate, coalition parties contributed with 50 votes in the first and 46 in the second round, and independent parties with 3 votes in each round, adding 53 and 49 votes, sufficient for approval (effective support of 81% and 74%, respectively, from coalition parties and 60% in both rounds from independent parties). The bill received a few but meaningful votes from opposition parties, most of them from PDT (PT, PSOL and PCdoB oppose the government more fiercely and tend to never vote aligned with the administration's interests in matters like this). In sum, **even when deducting abstentions and absences, the government coalition and the independent parties seem reliable enough**. It seems fair to assume that, should the government perceive a high risk of losing at any of these key votes, either it would have coordinated for more coalition representatives to show up, or worked out a way to postpone the vote to a less risky moment.

[1] Considers votes on bills but also on urgency requests, on changes in voting orders, and similar situations. Although the latter may seem less important, adhering to government orientation in such votes is also relevant in that these votes may critically affect both the timing and the odds of approval of some bills.

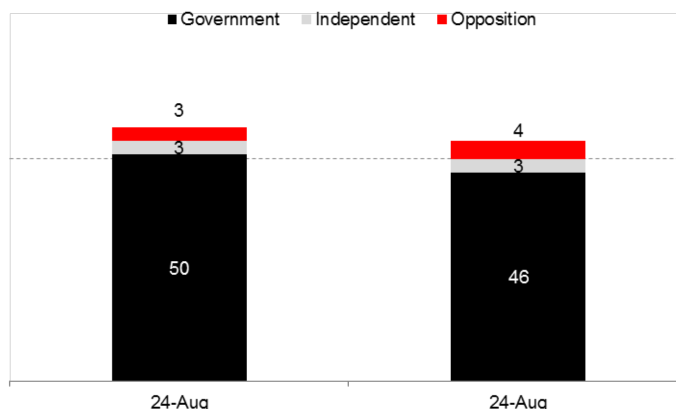
[2] The measure of average adherence to government orientation is built as follows: for each of the total 513 representative, the adherence is given by the percentage of times the Representative voted aligned with the government orientation (considering only the sessions which the representative attended). The adherence of each party is given by the average of its representatives' adherence. Aggregate measures for "Congress", "government coalition", "independent" and "opposition" correspond to the average of the parties that comprise each group, weighted by the number of representatives in each party.

Figure 6 – DRU: key votes at the Lower House



Votes in favor of the DRU constitutional amendment from each party block, in the floor votes at the Lower House (first round: June 2nd, second round: August 6th). Dotted line represents the minimum votes required for approval (308, 60% of the total 513 Lower House members).
Sources: Lower House and Santander.

Figure 7 – DRU: key votes at the Senate



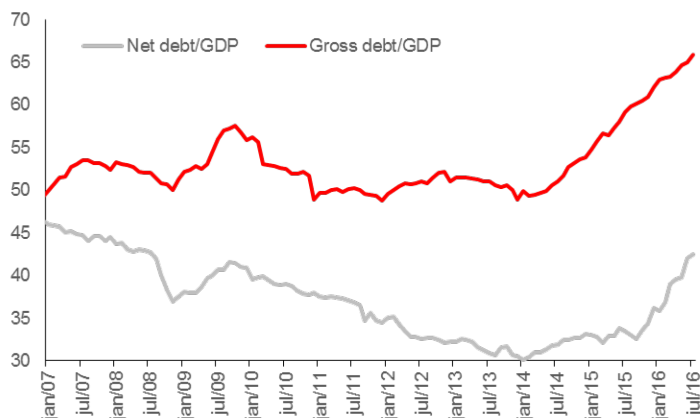
Votes in favor of the DRU constitutional amendment from each party block, in the floor votes at the Senate (both the first and the second round votes were held at August 24th). Dotted line represents the minimum votes required for approval (49, 60% of the total 81 senators).
Sources: Senate and Santander.

Reforming the country for balanced growth: a challenging agenda

Brazil faces significant challenges on two fronts: it needs to ensure fiscal sustainability over time, and it needs to improve the competitiveness of its economy. Both fronts are important, but fiscal sustainability is a sine qua non condition: without it, real interest rates will remain high and the decision horizons will become shorter, two conditions that jeopardize balanced growth in the medium to long run. Competitiveness reforms, in turn, could significantly improve potential output and also reduce the exchange rate required to produce a sustainable external deficit, leading to higher purchasing power. They are crucial to overcoming the so-called middle income trap.

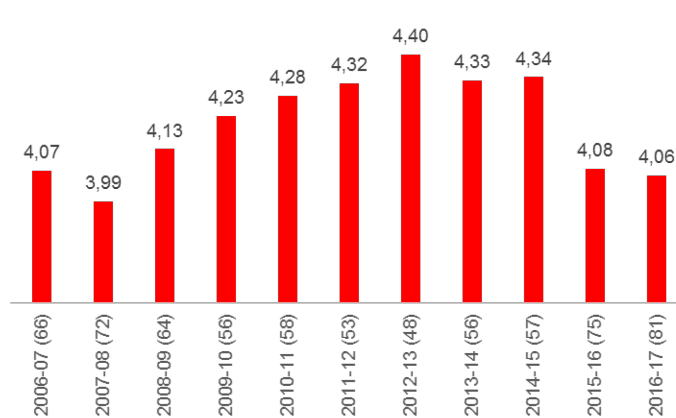
On the fiscal front, in addition to the already approved budget flexibilization (Desvinculação de Recursos da União, DRU), the focus should be on the New Fiscal Regime and on Social Security Reform. While the renegotiation of states' debt owed to the federal government is not a reform per se, it is conditioned on a temporary cap on states' spending growth, similar to the one imposed on the federal government by the New Fiscal Regime, and as such it can be seen at least as a temporary fiscal improvement worth monitoring. **We anticipate the approval of all such reforms: while we note that the government may need to give in during the negotiations in Congress (either in content, or in the speed of the votes, or more likely a bit on both), we do expect that the resulting reforms will be sufficient to ensure public debt sustainability over the medium- to long-run.**

Figure 8 – General government indebtedness



Source: BCB.

Figure 9 – Global Competitiveness Index



Index range: 1-7 (the higher the index, the higher the absolute competitiveness). Values between parenthesis in the axis indicate Brazil's position in the ranking, considering 140 countries.
Source: World Economic Forum.

Something important to highlight is that, unlike all past episodes of fiscal adjustment in the last two decades, this time around, the government is NOT relying on tax increases; rather, it is focusing on initiatives to reduce spending, even if they only produce effects over the medium term. We applaud such a change of focus: we believe Brazil's tax burden is already too high in comparison to its emerging peers. **Nevertheless, one cannot fully rule out that, at some point in time, the government may feel inclined to speed up the fiscal adjustment by reversing some existing tax breaks and/or by eliminating aspects peculiar to our tax system.** This means that, while these are not on the radar as of now, one should keep an eye on the possibility of an eventual taxation on interest on capital and on dividends; these topics are unlikely to re-emerge before 2017, but might go back to the table in the following year. Meanwhile, the re-emergence of the CPMF (a tax levied on financial transactions) might be tempting for it being a fairly easy and fast way to boost tax collection significantly; however, at this point, it seems a rather unlikely choice, be it for its political stigma or for the distortions that its cascading effects imply. Nevertheless, it might be inevitable should market conditions deteriorate for some reason (failure to approve other fiscal reforms and/or worsening international environment, for instance), forcing the government to deliver a primary surplus earlier than planned.

As for competitiveness-enhancing reforms, the government is bound to advance with changes in the pre-salt law, reversing the bias of the previous administration toward a state-led development. This message was further reinforced with the recently announced PPI, which seeks to promote investment in partnership with the private sector. Last but not least, there is a project, under Congressional appraisal that aims at enforcing independence and technicality on regulatory agencies. **We expect material, even if modest and slow-paced, advance on the infrastructure front.** Other initiatives that could boost competitiveness would be tax and labor reforms, but we are skeptical of the government's capacity of approving additional polemical reforms within such a short period in office. On the labor front, it may be possible to advance on two specific points – regulation of outsourcing and prevalence of negotiations with unions over the labor law --, but even on these, we anticipate only a moderate chance of approval, and cannot envisage a feasible time frame for its vote. Finally, hopes of a broad tax reform — creating a more rational system, more aligned with international practice and literature recommendations — have long been abandoned. In the best case scenario, the government may produce meaningful gains for firms if it simplifies and clarifies legislation on specific taxes, one by one. The previous administration had already started an analysis on the potential unification of PIS and Cofins, a theme that might advance. However, the much-wanted unification of ICMS (a state-level, value added tax) legislation remains a distant dream for now, in our view.

In the next pages, we provide a quick view on each of the main reforms that are currently on the radar and provide our opinion on their odds of approval. With many of these reforms not having yet been detailed, both the description of their content and the evaluation of their chances are subject to change over time, depending on the political climate and on eventual changes to the proposals.

Figure 10 – Fiscal and competitiveness reforms: what's in store and what's not

Fiscal reforms	Competitiveness reforms
On the radar: • Budget Flexibilization (DRU) – already approved • New Fiscal Regime • Social Security Reform • States' debt renegotiation	**On the radar:** • Change in pre-salt law • Unification of PIS/Cofins • Unification of ICMS • Regulation of outsourcing • Prevalence of negotiated over legislated • Law of regulatory agencies
Not on the radar: • CPMF • Interest on Capital • Interest on Dividends	**Not on the radar:** • Broad tax reform • Broad labor reform

Source: House, Senate, Santander.

The Reform Agenda (So Far): What's On The Table?

Change in pre-salt law: freeing Petrobras from the obligation to invest

- **Background:** Back in 2010, the government created a law that changed the exploratory regime in pre-salt areas, changing the model from concession to a profit-sharing scheme and requiring Petrobras to be the operator of these fields and have a stake of at least 30% in all new pre-salt auctions. In recent years, with the erosion in Petrobras' financial situation, this obligation represents a severe constraint, either because taking part in new auctions would cause further deterioration to Petrobras' finances or because, faced with the company's inability to participate, it forces the government to refrain from auctioning new pre-salt oil fields and consequently receiving the revenue from the sale of these blocks. In fact, so far there has been only 1 auction of pre-salt oil fields, back in 2013. This bill exempts Petrobras from this obligation, which is a relief to the company and unlocks potential new auctions in the sector, therefore helping to boost government revenue already in 2017, as the government intends to do the second pre-salt auction in 2H17.
- **Legal instrument:** Ordinary law (simple majority, one-round vote in each House).
- **Odds and likely timing of approval:** Very high, unchanged from the version already approved by the Senate. A final Lower House vote is pending and should be concluded in October.
- **What to monitor:** Should the Lower House representatives amend the current version of the text (for instance, reverting to concession from the current profit-sharing scheme), this would require that the bill is once again analyzed by the Senate, further delaying new pre-salt oil auctions. We view this risk as very low.

New Fiscal Regime (NFR): capping spending growth

- **Background:** Federal primary expenditure has been rising steadily for many years and over all recent administrations, moving from 13.8% of GDP in 1997 to last year's 18.5% of GDP, and contributing decisively to the ongoing primary deficit. In order to reverse that trend, the Temer administration has proposed a legislation that caps the growth of overall federal expenditures to the previous year's inflation. In practice, this would maintain federal expenditure roughly constant in real terms (maintaining roughly the current volume of service) but declining as a share of GDP, particularly as the economy resumes growth. In order to make this feasible, the same constitutional amendment that defines such a cap on growth also changes the rules that as of now guide the definition of spending in some areas such as healthcare and education – currently there is a minimum share of the government's revenue earmarked to these areas. The cap on spending growth would be valid for 20 years, with a possible revision after the first 10 years.
- **Legal instrument:** Constitutional amendment (60% support in both the Lower House and Senate, in two rounds in each House).
- **Odds and likely timing of approval:** We believe the New Fiscal Regime will be approved by both Houses, in a relatively fast procedure: approval at the Lower House's special commission is expected for the first week of October and the two floor votes at the Lower House between mid-October and early November. As for the Senate, it may be possible to conclude the whole procedure (commission plus two floor votes) before the end of this year, as long as the vote in the Lower House is concluded by end-October. Otherwise, a final Senate vote may be postponed to end-Q1 2017 (note that, after the Christmas break, Congressional activities are to be resumed only in early February, and the first weeks should be consumed with the elections for presidency of both the Lower House and the Senate).
- **What to monitor:** It is highly likely that the reform is approved with some alterations, to be negotiated between the government and Congress; the key question here is how deep and critical these changes will be. **The rapporteur's document, due in the first week of October after intense backstage negotiation, may provide a good indication of how far the government is willing to give in in exchange for a fast approval**. In our view, it is possible that Congress will shorten the time horizon (with the revision possible after the first 7 years, rather than the proposed 10) and create special rules for healthcare spending, which could grow in real terms, which is justifiable given the change in demography expected for the years ahead. There is also some debate on what the cap should be (last year's inflation, year-on-year inflation measured at mid-year, inflation target), but we believe that past inflation tends to prevail for its simplicity. **Potential negative surprises**: an attempt to shorten even further the validity (covering less than this and the next Presidential terms); an exclusion of both healthcare and education expenditures from the base subject to growth cap. **Potential positive surprise**: an eventual (and, at this point, very unlikely) extension of this rule to states and municipalities.

Social Security: a minimum age, at last?

- **Background:** Social security expenditures have risen from 3.3% of GDP in 1991 to the current 8% of GDP (considering only private sector retirees), despite the fact that the country is still living through a demographic bonus. It is expected that, with no reform, social security expenditure might climb an additional 10% of GDP in the coming decades. Behind these figures, there are two aspects that stand out. One is that Brazilians retire too early, at an average age of 54. This happens because currently rules do not impose a minimum age for retirement; rather, retirement is conditional to a minimum period of contribution (35 years for men and 30 years for women). The other issue is significantly more favorable conditions for retirement of public sector employees (civil servants and military), particularly in terms of computation of benefits. Unlike private sector employees, public sector workers are subject to a minimum age of retirement, however only those hired since 2015 have their pensions computed according to rules similar to private sector retirees: those hired before 2015 remained entitled to pensions equivalent to their last salary before retirement, and no transition rule has been imposed on those who are distant from retirement age. While there are many aspects that could be involved in the reform, it is expected that the government proposal – yet to be sent to Congress – focuses at least on imposing a minimum age for retirement for private sector workers and reducing discrepancy in rules for public and private sector workers.
- **Legal instrument:** Constitutional amendment (60% support in both the Lower House and Senate, in two rounds in each House).
- **Odds and likely timing of approval:** Moderate to high. The economic team has been negotiating behind the scenes to deliver a proposal already aligned with the main political actors, however, the chances are high that the proposal undergoes some changes during negotiations in Congress. It is expected that a basic proposal is sent to Congress in October, with lengthy negotiations in both Houses afterward. Approval by the Lower House might take place in the first semester, and in the Senate, in the second semester of 2017.
- **What to monitor: Just as important as the new retirement rules proposed (which will be valid in entirety for all new entrants in the job market), it is the transition period for those who have already started working but are still far from retirement.** There's been some discussion on the possible imposition of new rules for everyone younger than 50; for those older than 50, transition rules would impose a "penalty", i.e., an additional time for retirement, with the penalty being larger the more distant the worker is from meeting the current requirements. **Potential negative surprise:** Over the course of negotiations, it is possible that Congressmen change this threshold: the lower it is, the longer it will take for social security expenditures to converge to a sustainable trend. **Potential positive surprises:** adoption of a moving minimum age, which adjusts automatically to the rise in life expectancy; and imposing more strict rules also on military.

Regulatory Agencies Law: increasing independence

- **Background:** The bill unifies the legislation on regulatory agencies and improves their governance, by requiring that their boards are composed of members with wide professional experience in their respective area, by making provisions that avoid keeping a position vacant for too long, and by increasing the agencies' independence over their budget.
- **Legal instrument:** Ordinary law (simple majority, one-round vote in each House).
- **Odds and likely timing of approval:** Very high chances of approval. The bill seems set for a last vote at the Senate, after which it will be submitted to the Lower House; a final approval could occur before year-end.

Outsourcing: reducing litigation

- **Background:** Back in 2012, the Ministry of Finance announced a long-sought agreement between all states in order to unify legislation pertaining to the ICMS charged on interstate transactions. ICMS rates, which are currently different at each state, are now set to converge within the following 13 years. The main goals of the new rules are to simplify tax legislation (a major problem in Brazil) and to discourage the so-called "fiscal war", which over the last years has led states to dispute investments by offering lower ICMS rates.
- **Legal instrument:** Ordinary law (simple majority, one-round vote in each House).
- **Odds and likely timing of approval:** The bill was approved by the Lower House in April 2015 and has been awaiting the Senate's review since then. An advance will require that the government sets it as a priority, but once that is done, it should be an easy approval. The question is whether, with two key fiscal reforms under debate between now and end-2017, the government will want to put yet another topic in the agenda.

Prevalence of negotiation over labor legislation: partial flexibilization of Labor laws

- **Background:** Temer's administration has been saying that, as part of its "labor reform" initiative, it intends to send to Congress a bill allowing negotiations between employers and unions to prevail over the rules set in the ancient, rigid labor laws. All topics could be subject to negotiation with unions (including distribution of the week work load, temporary reductions in work hours and salaries, distribution of vacation days over the year), except for a few ones – likely exceptions would be the maximum work week (44 hours), weekly rest, annual vacation, and end-year bonus ("13º salário"). This would allow firms to adjust labor to economic downturns and also to better plan the use of labor according to the seasonality and specificities in the firm's activities, and as such reduce spare labor, lowering labor costs.
- **Legal instrument:** Unclear, as there is no proposal draft yet, but probably either ordinary law (simple majority, one-round vote in each House) or complementary law (absolute majority, one-round vote in each House).
- **Odds and likely timing of approval:** The government leaked some possible aspects that could be encompassed in the law (for instance, the possibility of redistributing the week's work load into fewer days, with a maximum 12h daily journey), to a resounding negative reaction from some segments of society. This led the government to retreat and reconsider the convenience of sending such a proposal to Congress before the key reforms are approved. Therefore, it might be the case that the reform is only sent by end-2017, leaving very little time for a politically-sensitive discussion, particularly difficult at the final year of a Presidential term. Therefore, this could be a theme for the next President and the next Congress.

States' debt renegotiation: debt relief, in exchange for what?

- **Background:** Fiscal lenience, with the substantial increase in expenditures and indebtedness, has been a long-standing and widespread problem, affecting not only the federal government but also several state administrations. A first attempt to address the regional governments' financial problems was made in late 1990's/early 2000's, when the federal government absorbed all state debt owed to market participants, and states became debtors to the federal administration, an agreement that was beneficial to states in that they exchanged a debt in which they paid roughly Selic (then at 45% pa) for a debt with the federal government over which they paid a much lower rate (inflation plus 6% or 9%pa, depending on the state's indebtedness). The agreement was conditional to the states no longer being free to contract debt (only when authorized by both the Senate and the National Treasury), and furthermore making monthly payments to the federal government of up to 13% of their net revenue, which, in practice, forced them to save for those payments and therefore produce a primary surplus. Over the course of the years, the federal administration was progressively less strict in authorizing states' new debts, at the same time that many states significantly increased expenditures (mainly payroll), resulting in new financial difficulties. The previous administration gave in to governors' pressures and submitted a bill to Congress (approved in late 2014) changing the late 1990's debt agreement, changing the rate to Selic or IPCA plus 4% pa, whichever is lower at any given moment, representing a relevant debt relief to regional governments. While highly beneficial to states, this change created a trap for the federal government, given that it changed what was inflation plus a fee to what was explicitly an interest rate (Selic): face to a constitutional rule that forbids government entities from charging compound interest on one another, several states – which were in severe financial difficulties due to the 2014/15 recession and the ensuing decline in tax collection – went to courts and obtained injunctions allowing them to pay simple interest. A few months ago, the Supreme Court fixed a deadline for the federal government to get into agreement with states to settle the matter, leading the federal government to extend for an additional 20 years the original tenors and to offer a two-year partial grace period for states in exchange that they would no longer question the compound interest in courts. Furthermore, the current version of the debt renegotiation bill imposes a cap on states' spending growth during this two-year period, with the cap being past inflation, mimicking the mechanism of the New Fiscal Regime for the federal government.
- **Legal instrument:** Complementary law (50% support in both Lower House and Senate, 257 and 41 votes, respectively, in one-round vote in each House).
- **Odds and likely timing of approval:** High, as the bill is in the interest of all participants. The bill has been already approved by the Lower House and should face a speedy vote in the Senate, with conclusion expected before the end of the year.
- **What to monitor:** States in the North and Northeast, which are not as heavily indebted but are facing difficulties mainly due to high personnel spending, have threatened to ask their senators to block the advance of the bill unless the federal government transfers resources upfront to relieve their finances. The vote could be delayed for some additional months, depending on how negotiations evolve: we expect the government will settle the matter by transferring to these states an additional share of the revenue coming from the regularization of Brazilian assets abroad.

PIS-Cofins: planting the seed of a new VAT

- **Background:** Former Finance Minister Joaquim Levy started studies to unify two social contributions (PIS and Cofins) and to simplify its computation and legislation. Originally, both were levied on gross operational revenues, but over time a series of changes were introduced and two regimes coexist, a cumulative (with the taxes charged on revenues) and a non-cumulative (which also creates the possibility of deducting tax credit computed on costs and expenditures). Furthermore, a series of different tax brackets and special cases were created. As a result, the extremely complex legislation makes it very difficult to compute the tax correctly, increasing the odds that the firms' computations are later questioned by the government and raising the odds of tax liabilities. Levy's draft proposal aimed at unifying the two taxes into one single social contribution, with one single tax bracket, affecting all sectors and keeping only the non-cumulative regime, thus transforming these two complex taxes into one single federal value-added tax.
- **Legal instrument:** Ordinary law (simple majority on a one-round vote in each House).
- **Odds and likely timing of approval:** The economic team is looking into Levy's proposal and intend to use it as a base for a bill, to be sent to Congress further down the road – so to have sufficient time to debate it and also not to cloud the debates on the New Fiscal Regime and on the Social Security reform. In theory, this could mean late 2017. After sent, it should be approved relatively fast.
- **What to monitor:** Although the economic team wants to make the PIS-Cofins reform fiscally neutral (ie not aiming at increasing the collection of these taxes), convergence from the current variety of brackets and regimes to a single bracket, single regime rule would inevitably lead to increase the burden for some sectors and reduce it for others. This is likely to produce a strong resistance from the sectors most negatively affected, but the reduction in indirect tax costs and in the risks of tax litigation could mitigate such resistance.

State-level value-added tax (ICMS): more competitiveness, less uncertainty, but not anytime soon

- **Background:** Back in 2012, the Ministry of Finance announced a long sought after agreement between all states in order to unify legislation pertaining to the ICMS charged on interstate transactions. ICMS rates, which are currently different at each state, are now set to converge within the following 13 years. The main goals of the new rules are to simplify tax legislation (a big problem in Brazil) and to discourage the so-called "fiscal war", which over the last years has led states to dispute investments by offering lower ICMS rates.
- **Legal instrument:** Senate's resolution (simple majority, one-round vote in the Senate only).
- **Odds and likely timing of approval:** Although the bill has been extensively negotiated over the recent years with the states' authorities, it still faces resistance. Richer states complain that the changes in taxation in interstate operations will reduce their collection, whereas less developed states are reluctant to give up the possibility of attracting investments by offering lower ICMS rates. In our view, resistance will only be overcome if the federal government offers some sort of financial compensation to the states – something unlikely to happen amid the current fiscal situation. This means that this bill may not advance before 2019, when the federal government is expected to start delivering primary surpluses, unless some strong, extraordinary revenue materializes before that and allows for such compensation.
- **What to monitor:** With tax regulations representing the most problematic aspect of doing business in Brazil, a simplification on one of the most complex taxes in the country could certainly contribute toward increasing private sector efficiency. Market-wise, the relevance of this measure is that it includes a legal authorization for all previous tax incentives granted by the states during the years of "fiscal war". This substantially reduces the legal uncertainty for companies currently enjoying these benefits. Interestingly, this point might be settled even without the advance of the bill in Congress, as the new President of the Supreme Court, Carmen Lúcia, started a round of negotiation with state governors in order to settle the disputes around past incentives given under the "fiscal war".

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