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Brazil – Inflation

Possible Tax Hike: a Tail-Risk for Inflation

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- **The possibility of a tax (or contribution) hike on "essential living" goods is a major upside tail-risk for inflation, which could bring it to above the BCB's target levels in the relevant horizon for monetary policy.**
- **Estimates of the impact on inflation are highly uncertain and range from 0bps, in the best-case scenario, to +150bps, in the worst-case scenario. However, the probability of approval, in our view, is low, so our baseline scenario does not consider that tail-risk.**
- **Our forecast for IPCA inflation remains at 1.50% for 2020 (BCB's target is 4.00%), 2.70% for 2021 (BCB's target is 3.75%) and 3.50% for 2022 (BCB's target is 3.50%). Moreover, abstracting from this upside tail-risk of a potential tax hike, we continue to see the usual drivers of inflation (output gap, inflation expectation and inertia and imported inflation) suggesting downside risk to our 2021 forecast, which is currently the main horizon for monetary policy.**

Introduction

The government presented its tax reform proposal, to be discussed alongside the bills proposed by the Congress. Although it did not include the end of tax exemptions on "essential living" items (food and hygiene products), they said this issue will likely be tackled in a second round of the reform, to be presented next month. If sent and if approved, this would represent a major upside risk to 2021 or 2022 inflation. In this study we present some estimates for the impact of this possible tax hike on IPCA inflation.

The possibilities of a tax hike on "essential living" goods

The first possibility, in our view, is if the bill for hiking "essential living" goods is sent alone and treated as such. In that case, the government would, in our view, likely try to merge PIS and Cofins, which are contributions and not taxes per se. The Brazilian law says that contribution hikes should follow just a 90-day grace period; therefore, if approved in 2021 the impact on IPCA inflation would come also in 2021.

The second possibility, in our view, is if the bill for hiking "essential living" goods is treated in the broad context of the tax reform, which is being discussed in "PECs" (constitutional amendments) both in the Lower House and the Senate – note that even if the government sent the bill alone, Congress may decide to append it to the whole tax reform. The broad tax reform is being discussed in the context of a creation of a unified tax on goods and services. The Brazilian law says that tax hikes should follow the annual principle; therefore, if approved in 2021 the impact on IPCA inflation would come only in the following year, 2022. There is also a low probability, in our view, that the bill is approved already in 2020, in which case the impact on inflation would be realized in 2021.

It is also important to underline that the government said the tax hike, if sent, would be partially compensated by a tax return for low income workers assisted by social programs. However, a great part of low/medium income workers not included in those programs would still be affected by the rise in inflation, so the approval of that kind of measure in a context of rising unemployment, falling income and high food inflation (hovering around 8% YoY), in our view, is more difficult in a political sense. Hence, our baseline scenario does not consider the tax hike for "essential living" goods and that is why we refer to it as a tail-risk.

Estimates of the possible impact on inflation

Bearing in mind the timing of the impact discussed in the previous section, we provide estimates for the possible impact of the tax hike on inflation. We draw different scenarios, which we present below:

1) **The proposal is not sent or not approved: no impact on IPCA.** Although we are writing this report to highlight the risk of approval, this is a tail-risk and, as such, we have to make clear that our base-scenario still considers there will be no kind of tax (or contribution) hike for "essential living" goods.

2) **The tax hike is approved for all "essential" items: impact of +150bps on IPCA inflation.** This estimate should be seen as a worst-case scenario; see the last line of Table 1. As stated in the last paragraph of the previous section, this approval, in our view, is difficult in a political sense, so we consider the chance of approval is low.

Table 1 – Detailed impact of scenario 2 and division by elasticity used in scenario 4

Essential living items (DIEESE/Procon-SP)	Weight on IPCA (%)	Impact (bps)
Rice	0.52	6
Beans	0.16	2
Sugar	0.19	2
Coffee	0.30	4
Wheat flour	0.05	1
Cassava flour	0.10	1
Potato	0.24	3
Onion	0.20	2
Garlic	0.15	2
Egg	0.25	3
Margarine	0.06	1
Italian dressing	0.00	0
Soy oil	0.19	2
Powdered milk	0.19	2
Milk	0.68	8
Loaf bread	0.10	1
French bread	0.81	10
Pasta	0.15	2
Cracker	0.45	5
Meat (bovine and swine)	2.42	29
Chicken	0.94	11
Sausage	0.35	4
Cheese and yogurt	0.70	8
Ham	0.10	1
Fish	0.23	3
Fruits	0.92	11
Washing powder	0.23	3
Bar soap	0.03	0
Sanitary water	0.06	1
Fabric softener	0.17	2
Detergent	0.15	2
Multipurpose cleaner	0.03	0
Toilet paper	0.21	3
Toothpaste	0.27	3
Soap	0.30	4
Deodorant	0.46	6
Tampons	0.11	1
Low elasticity (grey)	**6.28**	**75**
High elasticity (white)	**6.19**	**74**
Total	**12.47**	**150**

Source: Santander, based on DIEESE/Procon-SP "essential living" basket, provided by MCM Consultores

3) **The tax hike is approved only for specific items[1] which are not really "essential": impact of only +11bps on IPCA inflation.** The problem with this scenario is that the benefits would be significantly reduced, as it is impossible to tax some specific items (for example, it is not possible to tax only specific prime meat cuts), so the measure would only apply to some fish types and dairy (see footnote 1 for the full list of items). Hence the fiscal effect would also be reduced (R$ 1.2 bn[2] in comparison with R$ 15.1 bn[2] in the scenario where all items are taxed), reducing, in our view, the incentive for the government to work on that proposal from a political standpoint.

4) **The tax hike is approved for all "essential" items, but estimates considering elasticities/ability to pass-through price hikes to consumers: impact of +68 bps on IPCA inflation.** Scenario 2 is a simple "accounting" exercise and does not consider elasticity of demand. Considering the low elasticity items (see Table 2 for a reference), where pass-through could be full or quite high, the impact on scenario 2 could reach 75bps (last lines of Table 1). The high elasticity items also sum 74bps (last lines of Table 1), but in their case pass-through would be quite low or zero, so the impact would be much lower. In a scenario of 70% pass-through on low elasticity items and 20% on high elasticity items the full impact would be +68bps on IPCA inflation.

[1] We based scenario 3 (including the list of specific items) on a study carried out by the government in September 2019, "Boletim Mensal dos Subsídios da União – Desoneração da Cesta Básica" (table of specific items is in appendix II).

[2] According to the same government report cited in footnote 1.

Table 2 – Price elasticity of demand of food items by income class

Items	Low	Medium	High	Average
Meat (bovine and swine)	-1.3	-1.3	-0.7	-1.1
Cereals, vegetables and tubers	-0.3	-0.6	-0.7	-0.5
Bread and pasta	-0.3	-0.3	-0.4	-0.3
Milk and Yogurt	-1.2	-1.4	-1.3	-1.3
Chicken and eggs	-0.1	-0.4	-0.1	-0.2
Fruits	-2.4	-1.9	-1.2	-1.8
Greens	-0.1	-0.9	-0.5	-0.5
Fish	-1.8	-3.7	-2.5	-2.7

Source: Silva e Menezes Filho (2017), in Boletim Mensal de Subsídios da União – Desoneração da Cesta Básica, September 2019. Note: we also have considered hygiene products to have low elasticity.

5) **The tax hike is approved only for specific items which are not really "essential", but estimates considering elasticities/ability to pass-through price hikes to consumers: impact of 0bps on IPCA inflation.** The specific items targeted are all more consumed by high income people, hence their elasticities are high. Considering that the full potential impact is only +11 bps and the high uncertainty of those estimates, it is reasonable to argue that the impact on inflation would be virtually zero.

Conclusion

The possibility of a tax (or contribution) hike on "essential living" goods is a major upside tail-risk for inflation, which could bring it to above the BCB's target levels in the relevant horizon for monetary policy. However, the probability of approval, in our view, is low. The different scenarios of possible impacts on inflation is summarized in Table 3 below and the reader can also use different pass-through numbers to generate other estimates in scenarios 4 and 5.

Table 3 – IPCA impact by scenarios

IPCA impact (bps)	No reform	Tax hike for all "essential" items	Tax hike only for specific "essential" items
With elasticity	0	150	11
Without elasticity	0	68	0

Source: Santander estimates.

Finally, our forecast for IPCA inflation remains at 1.50% for 2020 (BCB's target is 4.00%), 2.70% for 2021 (BCB's target is 3.75%) and 3.5% for 2022 (BCB's target is 3.50%). Moreover, abstracting from this upside tail-risk of a tax hike, we continue to see the usual drivers of inflation (output gap, inflation expectation and inertia and imported inflation) suggesting downside risk to our 2021 forecast, which is currently the main horizon for monetary policy.

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