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SPECIAL REPORT

MEASURES TO CURB THE RISE IN PRICES

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- Since March 2020 (pre-pandemic), fuel prices are up 62%, while electricity prices are up 25% at the consumer level. Moreover, the global energy shortage continues to pose upward risks for fuel and electricity prices (particularly fuel) in Brazil. As a result, the government is seeking measures (beyond the ongoing interest rate hiking cycle by the Brazil Central Bank, or BCB) to curb the pressure arising from inflation. Several measures are being discussed in Congress that imply short-term downward risks for inflation (although with a potential rebound in 2023 and beyond), but also imply a worsening of fiscal accounts. The main measures are: the PLP 18/22 law to reduce ICMS tax, PLP1143/21 regarding the use of tax credits in electricity, and a constitutional amendment (PEC) to compensate the states that reduce the ICMS tax to below 17% by the end of the year.
- PLP 18/22 aims at permanently capping the VAT tax (ICMS state tax) on fuel, electricity, telecom and transportation, which are levied at the state level. Adding the temporarily reduction (until December 31) in federal taxes (PIS/Cofins and Cide taxes), we estimate a potential fiscal loss of BRL65 billion in 2022 from the measure and a potential drop of close to 250 bps in the IPCA index in 2022. The full year impact would be BRL90 billion for fiscal accounts. However, as part of the tax break for the federal government would be temporary, there could be a rebound in the IPCA index in 2023 (+64 bps) and a recovery in fiscal revenue.
- We also highlight that there is a debate about accelerating the use of tax credits from electricity distribution companies, which, according to *Aneel* (national energy agency), could reduce tariff adjustments by 8% on average, potentially leading to a 32-bp decline in the IPCA index in 2022 (but adding upward risks in 2023 and beyond). This will affect the fiscal accounts through lower revenue resulting from the anticipation of tax credits.
- Everything considered, in a scenario we see as unlikely—assuming all measures and full pass-through of the tax cut to consumers are approved—the IPCA index could potentially register an annual reduction of ~310 bps in 2022 (with a +64-bp rebound in the IPCA index in 2023) and a BRL93 billion fiscal loss in 2022 for the public sector (and a loss of BRL90 billion in 2023 for regional governments).
- Our current fiscal scenario does not include the measures to curb inflation, as there is uncertainty about the final outcome of the proposals. We estimate a BRL35 billion (0.4% of GDP) primary surplus for the public sector for 2022. In a simulation, considering all measures are approved, this would lead to a deficit close to BRL60 billion (0.6% of GDP), yet we believe that partial approval is more likely, implying a balanced result (0% of GDP) for the year. On inflation, our baseline scenario also does not yet include the approval of any measures, and we project the IPCA index to reach 9.5% at YE2022 and 5.3% at YE2023—the risk of the new legislation is for lower inflation in 2022 and higher in 2023. We did not include this in our scenario, as the timing and the overall impact are still unclear.
- The approval in Congress of at least some of these measures is likely, in our view, but the timing is still uncertain. PLP 18/22 has already been approved in the Lower House, but the Senate has yet to vote. Regarding the PEC, there is only a draft of the text. Moreover, if approved, there is still a possibility that the Supreme Court, worrying about fiscal losses, could decide to temporarily remove the effect. Therefore, as of now, we still do not incorporate any impact from these measures in our baseline forecasts.
- In our view, this debate does not materially affect our monetary policy outlook. We believe that even if these measures reduce 2022 inflation and the inertia for 2023, the associated fiscal risks and the pressure to maintain the stimulus in 2023 will worsen the balance of risks for the BCB's inflation-targeting regime.

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Introduction

Since March 2020 (pre-pandemic), fuel prices are up 62%, while electricity prices are up 25% at the consumer level. Moreover, the global energy shortage continues to pose upward risks for fuel and electricity prices (particularly fuel) in Brazil.

As a result, the government is seeking measures (beyond the BCB's ongoing interest rate hiking cycle) to curb the pressure arising from inflation. Several measures are being discussed in Congress that imply short-term downward risks for inflation (although with a potential rebound in 2023 and beyond) but with a worsening of fiscal accounts. The main measures are: the PLP 18/22 law regarding the use of tax credits in electricity, and a constitutional amendment (PEC) to compensate the states that reduce the ICMS tax to below 17% by the end of the year. The total budget for compensating the states is currently fixed at BRL29.6 billion.

A newly proposed PEC will regulate biofuels, providing for a "favored tax regime for biofuels in the form of a complementary law, guaranteeing lower taxation than fossil fuels, encouraging their use", according to Senator Fernando Bezerra. PLP 18/22 aims at permanently capping the VAT state tax (ICMS) on fuel, electricity, telecom and transportation, which are levied at the state level. In addition, PLP18/22 will remove the PIS/Cofins federal tax from gasoline (temporary in 2022) and ethanol (by 2027). The proposal has been approved in the Lower House, but the Senate has yet to vote. There is uncertainty about the final impact of the new legislation even if it receives final approval, as it would mean a substantial drop in the states' revenue. It is important to consider that even if the law is approved, states may still appeal to the Supreme Court to prevent the bill from taking effect or to moderate the fiscal impact (to make it more gradual over time). In addition, in the Senate the rapporteur included the possibility for the federal government to remove PIS/Cofins taxation of gasoline and ethanol, which means that the government would not need to compensate states for the loss of revenue (needed to comply with the Fiscal Responsibility Law).

It is important to note that the loss of revenue for states has generated debate, and thus, to reach an agreement and to speed up the process, the federal government announced (on 6 June) that it is willing to present a constitutional amendment proposal (PEC) to compensate the states for revenue losses (for reducing ICMS taxes below the 17% cap), with the aim of exempting this from the fiscal rules (constitutional spending cap and Fiscal Responsibility Law, LRF in the Portuguese acronym). PLP 18/22 and the PEC are, as far as we can tell, similar to one another, but we think PLP 18/22 could be approved earlier. The PLP18/22 will also include federal government compensation to the states for the loss of revenue in 2022 due to the reduction in ICMS revenue (if it falls below 5% in nominal terms), which we estimate at close to BRL10 billion. However, the fiscal impact is uncertain, as these revenues are already high this year.

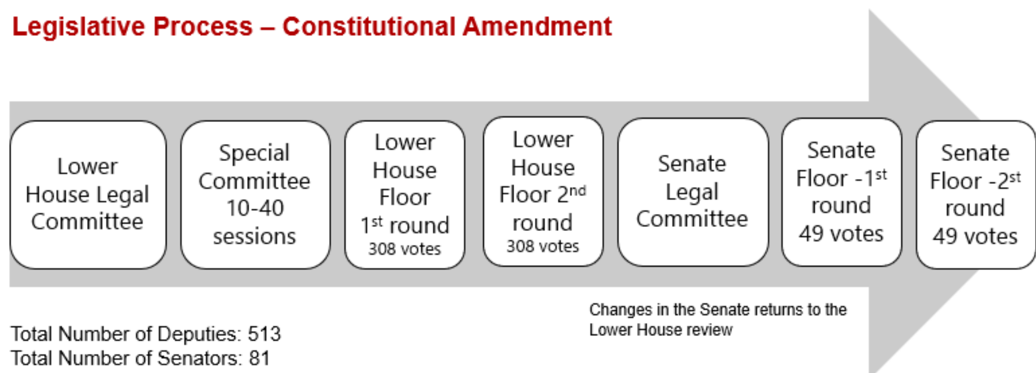
We also highlight that there is debate about accelerating the use of tax credits from electricity distribution companies, which, according to Aneel, could reduce tariff adjustments by 8% on average, potentially leading to a 30-bp decline in the IPCA index in 2022 (but adding upward risks in 2023 and beyond). For the fiscal accounts, we already consider the use of tax credits in our scenario for the coming years. Yet, considering that companies will use more of these tax credits in 2022, we could observe an increase in the revenue loss this year, in line with the amount of those tax credits authorized by Aneel. This is not included in our scenario, but we believe that the impact will be more on inflation than on fiscal accounts.

Regarding the timing for approving the measures, the Senate unveiled the draft of PLP 18/22 this week and will probably vote on it in the coming weeks. It is important to highlight that even with approval of the legislation, states may appeal to the Supreme Court to try to prevent the fiscal impact of the proposal. Regarding the PEC, we believe that even with an agreement between Congress and the executive branch, the proposal will take at least a month to be approved—there is not even a draft of the text yet[1]. The war budget (as part of the pandemic fiscal stimulus, it is exempt from normal budget rules like the spending cap) was proposed on April 1, 2020 and was promulgated in May 7, 2020. It is worth noting that at that time, the Congress was voting virtually. We also

[1] According to press sources, House Speaker Lira could try to negotiate with some members of parliament (from the government's opposition) to expedite the approval process by directing the amendment for a plenary vote without going through committees.

see risks that an exception to the fiscal rules would create uncertainty about the final outcome, along with risks of adding some extra expenditures and stimulus.

Figure 1- Legislative Process



Source: National Congress and Santander.

Everything considered, we believe that at least some of the measures could be approved, resulting in lower inflation in the short term (2022), but possibly higher inflation in the medium term (2023)—and a worsening in the fiscal accounts for the medium term. The main impacts are detailed below.

In our view, this debate still does not affect monetary policy. On the one hand, we expect lower inflation in the short term and, through inertia, likely lower inflation in the medium term; but on the other hand, some of the tax cuts could be reversed in 2023, resulting in a rise in inflation. Moreover, as the tax cuts are aimed at low-elasticity goods/services, at the end of the day people will have more income to spend on other goods/services, which could offset part of the direct downward impact on inflation. Finally, the worse fiscal outlook also means the balance of risks to inflation is tilted more in an upward direction. Therefore, we believe it is not clear whether the tax cuts will reduce inflation.

Inflation Details

Our current inflation forecasts do not include the impact of the approval of possible measures. As of now, we forecast the IPCA index to reach 9.5% at YE2022 and 5.3% at YE2023. In Figure 2, we summarize the potential impact on inflation if all the measures are approved, with immediate effect, and if companies pass through all the tax cuts to consumers. In our view, this scenario is unlikely: first because the fiscal impact would be too substantial, and second because companies will probably use tax cuts to strengthen margins, in our view. Also, particularly for electricity, the possibility of the use of tax credits to curb price increases could reduce the need to speed up state tax cuts. In that scenario, the full possible impact on the IPCA index in 2022 (currently forecasted at 9.5%) is -310 bps. Moreover, at least the part of the zeroing of federal tax on fuel is temporary, ending on December 31, so a rebound of around +89 bps (PEC + return of PIS/Cofins on gasoline) could be registered by the IPCA index in 2023 (currently forecasted to reach 5.3% at year-end). Additionally, although difficult to estimate, we believe that the acceleration of tax credits could also add upward risks for the IPCA index in 2023 and beyond (the credits that were going to be used in the coming years, reducing inflation in those years, will be used more quickly, leading to a greater reduction in inflation now, but causing it to rise later).

Therefore, we believe a more reasonable scenario is to assume that (i) PLP 18 (state tax ICMS cut to 17% and PIS/Cofins federal tax cut) will cover fuel only for the short term (leaving electricity and telecom only for 2024), (ii) the PEC could take a while to be approved, and even so it is unlikely that states will zero the ICMS tax on fuel, and (iii) Aneel will accelerate the use of the tax credits. Moreover, we also assume that the pass-through to consumers of the tax cuts on fuel will be only 70%. In that scenario we envision a 136-bp fall in the IPCA index in 2022, but followed by a +45-bp rebound in 2023, from the resumption of federal taxes on fuel, and +10 bps from the acceleration in the use of tax credits.

Additionally, we can see a third possible scenario in which an agreement is difficult to reach, and the focus ends up being only on diesel prices—and on the use of tax credits in electricity (which does not depend on Congress, only on Aneel). In that scenario, the impact on the IPCA index would be much more limited, as diesel has a weight of just 0.28% in the index.

Figure 2 – Summary of the Inflation Impact of the Proposals

Inflation Scenarios	2022			2023
	Full	Most likely	Low effect	Most likely
I. PLP 18/22 ICMS Cap (Impact)	**-253**	**-104**	**-2**	**45**
Fuels ICMS Cap 17-18%	-85	-59	-2	0
Gasoline	*-80*	*-56*	*0*	*0*
Diesel	*-2*	*-2*	*-2*	*0*
Ethanol	*-3*	*-1*	*0*	*0*
Zeroing PIS-Cofins and CIDE Gasoline	-64	-45	0	45
Telecom cap	-30	0	0	0
Electricity	-74	0	0	0
ICMS cap to 17-18%	*-40*	*0*	*0*	*0*
Changing the ICMS base (TUSD/TUST)	*-34*	*0*	*0*	*0*
II. PEC Fuel (Compensation)	**-25**	**0**	**0**	**0**
Zeroing ICMS Diesel	-4	0	0	0
Zeroing ICMS LPG	-17	0	0	0
Reducing ICMS Ethanol to 12%	-4	0	0	0
III. Tax Credits	**-32**	**-32**	**-32**	**10**
Electricity	-32	-32	-32	10
Total Impact (I + II + III)	**-310**	**-136**	**-34**	**55**
IPCA	**6.4**	**8.1**	**9.2**	**5.9**

Source: Santander estimates

It is also important to highlight that the tax cuts are aimed at "essential" goods/services, meaning goods/services with low elasticity of demand. As a result, consumption of those items would stay more or less the same, but people would have more income to spend on more elastic goods/services, meaning that core inflation could grind higher and reverse part of the expected decline in inflation resulting from the tax cuts. In other words, the income effect of the stimulus would prevail, in our view, and the intention to reduce prices might not be fully achieved.

Fiscal Details

In Figure 3, we summarize the impact of the current proposals for the fiscal accounts in terms of curbing the rise in inflation. We believe that the total impact, if all the measures are approved, would be BRL89 billion (0.9% of GDP) in 2022. This would lead to a primary deficit of close to BRL50 billion (0.5% of GDP), according to our calculations. There is uncertainty as to which measures will be approved. Thus, the timing and the overall impact are still unclear. For now, the constitutional amendment (PEC Fuel) will be limited to 2022, totaling BRL28 billion (0.3% of GDP) of impact. Considering the full year impact (if the measure is extended for next year), it would be BRL88 billion (0.9% of GDP). It is important to note that if the PEC is approved, the ~~downward~~ reduction in inflation would pressure the numbers for 2023. This could add more impetus for new fiscal stimulus ahead.

Figure 3 – Summary of the Fiscal Impact of the Proposals

Potential Impact on Fiscal				
	2022		Full-Year	
	BRL bn	% GDP	BRL bn	% GDP
I. PLP 18/22 ICMS Cap (Impact)	**65**	**0.7%**	**129**	1.3%
1. Fuels ICMS Cap 17-18%	20	0.2%	40	0.4%
Gasoline	14	0.1%	28	0.3%
Diesel	5	0.1%	10	0.1%
Ethanol	1	0.0%	2	0.0%
2. Telecom cap	5	0.1%	10	0.1%
3. Eletricity	20	0.2%	40	0.4%
ICMS cap to 17-18%	5	0.1%	10	0.1%
Changing the ICMS base (TUSD/TUST)	15	0.2%	30	0.3%
4. Zeroing PIS/Cofins and CIDE Gasoline**	16	0.2%	32	0.3%
5. Zeroing PIS/Cofins Ethanol**	3.5	0.0%	7	0.1%
II. PEC Fuel (Compensation)	**28**	**0.3%**	**56**	0.6%
Zeroing ICMS Diesel*	23	0.2%	46	0.5%
Zeroing ICMS LPG*	3	0.0%	6	0.1%
Reducing ICMS Ethanol to 12%*	2	0.0%	4	0.0%
Total Impact (I + II)	**93**	**1.0%**	**185**	**1.9%**

* Revenue loss for States

** Revenue loss for federal government (without Compliance with the Fiscal Responsibility Law)

Source: Ministry of Economy, National Congress, Santander

In Figure 4, we simulate the possible impact considering the hypothesis that we believe could be the outcome, and its impact on fiscal accounts. In the most likely scenario, we see only a partial effect from the ICMS state tax reduction, reaching a full effect only in 2024 onward. For 2022, the effect would be mitigated by this gradual reduction in the ICMS. In the short term, the government will also reduce the federal taxes (PIS/Cofins) on gasoline temporarily in 2022 and for ethanol by 2027. On electricity, as we have highlighted in the inflation section, the impact would be much greater if the tariff bonus is used (which represents a tax credit). We estimate this value close to BRL10 billion in revenue loss in 2022 for the federal government.

In the scenario with low impact, we believe that the cap on ICMS would be limited to diesel prices, reducing the fiscal impact in the short run and leading to a partial reduction in PIS/Cofins. In the most likely scenario, the primary fiscal accounts would be closer to being balanced (0% of GDP) in 2022.

Figure 4– Scenarios and Fiscal Impacts

Fiscal Scenarios	2022			2023
	Full	Most Likely	Low effect	Most Likely
I. PLP 18/22 ICMS Cap (Impact)	**65**	**35**	**13**	**37**
1. Fuels ICMS Cap 17-18%	20	16	5	30
Gasoline	14	10	0	20
Diesel	5	5	5	10
Ethanol	1	1	0	2
2. Telecom cap	5	0	0	0
3. Electricity	20	0	0	0
ICMS cap to 17-18%	5	0	0	0
Changing the ICMS base (TUSD/TUST)	15	0	0	0
4. Zeroing PIS/Cofins and CIDE Gasoline	16	16	8	0
5. Zeroing PIS/Cofins Ethanol	4	3	0	7
II. PEC Fuel (Compensation)	**28**	**0**	**0**	**0**
Zeroing ICMS Diesel	23	0	0	0
Zeroing ICMS LPG	3	0	0	0
Reducing ICMS Ethanol to 12%	2	0	0	0
Total Impact (I + II)	**93**	**35**	**13**	**37**
Primary Balance Public Sector (BRL bn)	**-58**	**0**	**22**	**-85**

Source: Ministry of Economy, National Congress, Santander

For 2023, we believe that the PEC would have a limited impact. The current debate is about ending the fiscal compensation from the federal government this year. Yet, in the legislative debate it is possible that the effect will be postponed to 2023. In our view, the impact for 2023 would be concentrated in the PLP 18/22, which will

reduce the regional governments' primary revenue by BRL50 billion if the more likely scenario materializes (considering a more effective cap on state taxes—which we believe would fall gradually in this scenario). If the PEC in its entirety is approved, the reduction would be BRL90 billion. This could reduce our current forecast of a surplus of BRL15 billion for regional governments, changing it to a deficit, with additional fiscal risks, more stimulus, and implying a possible increase in inflation expectations.

Despite the improvement in the fiscal accounts with cyclical factors (temporary increase in revenue due to the price shock), we believe that in the coming years, regional governments could face the challenge of reestablishing the fiscal balance as fiscal and monetary stimuli come to an end—mainly, in our view, because of pressure to increase mandatory expenditures in the following year (for example, pressure to increase public servants' wages).

It is worth noting that the government has already announced around BRL60 billion in federal revenue reductions this year. In Figure 5 we detail the fiscal stimuli in place, which have already reached 0.6% of GDP. The measures with the greatest impact were the reductions announced precisely to mitigate the effects of inflation. With the reduction in PIS/Cofins taxes on diesel, kerosene, and LNG by the end of the year, this will mean around BRL15 billion in revenue reduction for the federal government. In turn, the government also permanently reduced the IPI tax on industrialized goods by 35%, which adds up to almost BRL24 billion in revenue lost, meaning lower revenues for coming years

Figure 5 – Federal Government: Fiscal Stimulus by Revenue Reduction

Tax waiver measures already in place in 2022	BRL billion	% GDP
Reduction of IPI federal tax by 35%	23.4	0.2%
Reduction of PIS/Cofins of Diesel, kerosene and LPG	14.9	0.2%
Extension of payroll tax exemption	9.2	0.1%
Reduction of import tax rates by 10%	6.0	0.1%
Soccer specific tax regime (TEC)	2.3	0.0%
Extension of PCD benefit	1.3	0.0%
ZPE expansion	1.2	0.0%
IOF reduction for credit support programs	0.8	0.0%
IRRF reduction on aircraft leasing	0.4	0.0%
Others	1.3	0.0%
Total	**60.8**	**0.6%**

Source: Ministry of Economy, National Congress, Santander

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