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Brazil Macro: Fiscal Policy

Spending Cap Rule: Squeezing the 2021 Margin, Relieving 2022

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- On November 30, the electricity sector regulator (Aneel) unexpectedly decided to reactivate its tariff flag system for December 2020, setting the flag as red (level 2) — an indication of unfavorable hydro plant reservoir levels. This decision has led us to increase our 2020 IPCA tracking by 45 bps, implying a YE2020 number of 4.3% (up from 3.8%).
- This news and its implications further aggravate the mismatch between the inflation index used to readjust the spending cap limit and the index used to adjust budget benefits, potentially generating pressure to comply with the rule in 2021 and posing an additional fiscal challenge to comply with the spending cap — not considering the possibility of creating a new welfare program and increasing mandatory expenses.
- The spending cap is set to readjust the maximum limit in 2021 by the 12-month IPCA until Jun-20 (+2.13%), while the benefits should be adjusted by **INPC (another inflation index) at the end of the year, which according to our new tracking should reach +5.0% (from +3.3%).**
- As a result, our estimate of insufficiency to comply with the spending cap rule has changed to BRL11.3 billion, making its fulfillment in 2021 even more challenging**. Compliance with the spending cap remains feasible, in our view. However, we believe that compliance would requires significant fiscal discipline, potentially leading to reduced discretionary expenses and a partial shutdown of some public services.**
- In our opinion, we note the importance of approving fiscal measures in order to improve 2021 margins, which is becoming even more important to avoid a partial shutdown. We believe that another possible additional measure for the government is to file a judicial claim against the extension of the payroll tax exemption until 2021 (BRL6.5 billion).
- On the other hand, this mismatch will help 2022 margins, it has increased to BRL15 billion, according to our numbers. For 2023-2026, we think it is necessary to approve measures to ensure the compliance to the rule by 2022, including fiscal reforms to curb mandatory expenses of BRL130 billion.

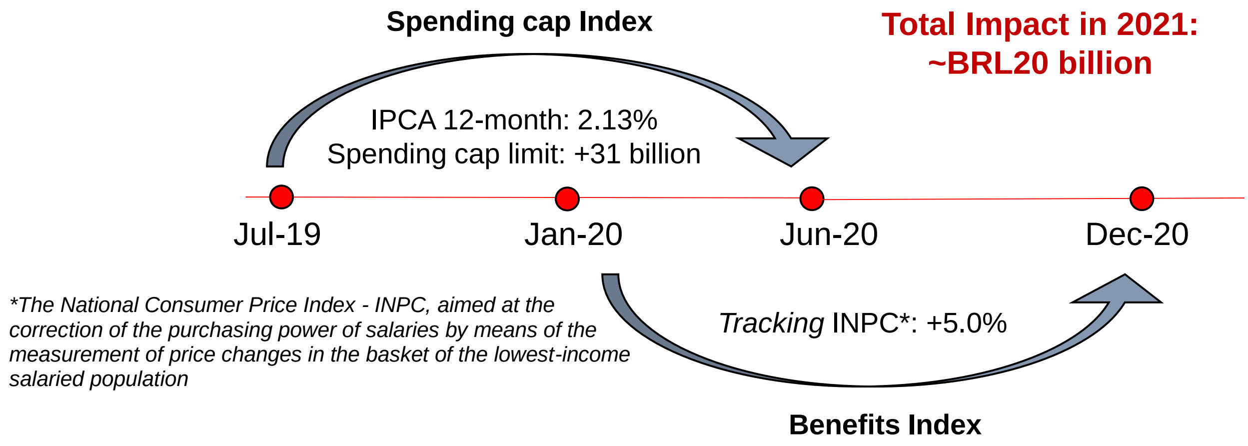
With the recent spike in food prices and Aneel's decision unexpected decision to reactivate the tariff flag system (with a +45-bp impact on IPCA), our consumer inflation tracking has increased by ~4.3% in 2020, compared to our earlier forecast of 3.3%. This 2H20 price increase will put additional pressure on the 2021 spending cap, which must be adjusted by the accumulated IPCA for the 12-month period ended June 2020, according to the constitutional amendment.

In this report[1] we explore the impact of the recent price pressure that further aggravate the mismatch between the inflation index used to readjust the spending cap limit (IPCA to June 2020: 2.13%) and the index used to adjust budget benefits (INPC expected for December: 5.0%)—see Figure 1.This mismatch will generate additional pressure on the spending cap limit in 2021, reducing the margin for compliance with the rule and requiring additional efforts (i) to comply with the limit and (ii) to accommodate the possibility of increase in mandatory expenses (such as the new welfare program).

According to our previous estimate, the insufficiency for the spending cap limit next year would be BRL1.5 billion, and with the new increase in the inflation tracking this margin changed to BRL11.3 billion of insufficiency; that is, a new total impact close to BRL10 billion (and BRL20 billion as total inflation impact), especially with an increase in social security benefits (BRL16 billion)—see Figure 4.

[1] We explored this issue on a recent publication: **Santander Macro Brazil Fiscal Policy - *Spending Cap Rule: Narrowing the Margin for 2021*** – October 20, 2020 - Available on: http://bit.ly/BR_Santander

Figure 1. Mismatch Between Inflation Indexes

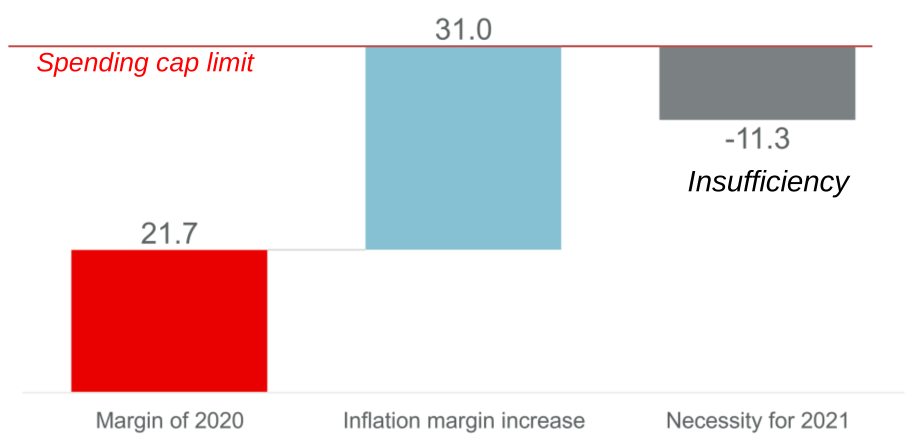


Sources: National Treasury, IBGE and Santander.

For 2021, we estimate that the nominal increase in total expenses will be 5.1% (not considering the War Budget[2]), to BRL74.2 billion. Expenses for social security benefits represent the largest increase, around BRL49 billion. The increase in the BPC (welfare benefit program) will be close to BRL5 billion. Even with the wage freeze for public servants until 2021 (Complementary Law 173/2020), we expect personnel expenses to rise by BRL4 billion. In turn, we expect spending on *Fundeb*—fund for education (an expenditure not subject to the spending cap)— to increase BRL3.2 billion (from BRL16.5 billion in 2020 to BRL19.7 billion in 2021). Finally, we expect other compulsory expenses to rise by BRL13 billion in 2021.

In this scenario, according to our calculations, we expect expenses subject to the spending cap to grow by approximately BRL64 billion in 2021, compared to a margin of BRL52.7 billion, which is the amount needed to comply with the rule for next year, as shown in Figure 2. Part of this amount will be offset by the 2020 margin (excluding the war budget), which is the expenses subjected to the rule less its maximum limit for 2020 (e.g., the positive margin of 2020), totaling BRL21.7 billion. In addition, the space created by the 12-month IPCA correction until June (2.13%) adds BRL31 billion to the margin. Consequently, we observe that the balance implies an insufficiency of BRL11.3 billion.

Figure 2. Spending Cap in 2021 (BRL bns)



Sources: National Treasury, IBGE and Santander.

The legislative calendar is quite short in 2020, as the legislative agenda probably will end on 18 December. However, Figure 3 details some measures that can increase the margin of the spending cap margin, and avoid the partial shutdown of some public services.

[2] War Budget: a constitutional amendment approved by Brazil's lower house of Congress to separate coronavirus-related spending from the government's primary budget to shield the economy from the crisis.

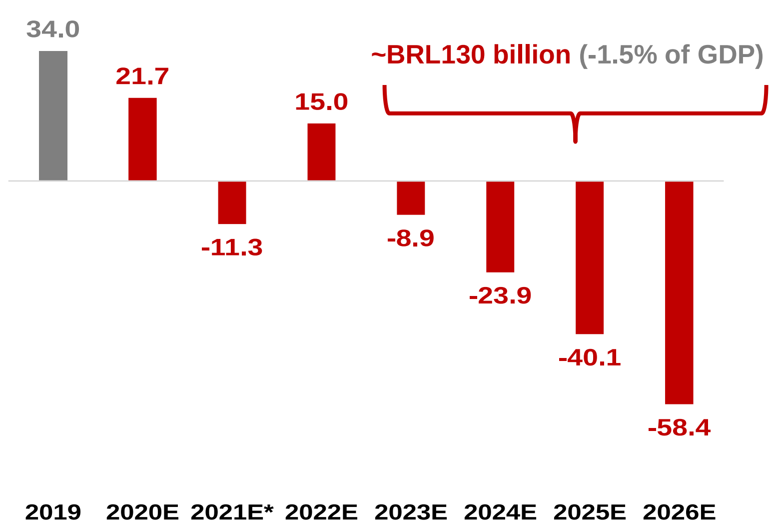
Figure 3. Measures That Could Increase the Margin in 2021 (BRL bns)

Measure	Impact (BRL bn)	Method
Reduction of public servants' working hours and wages (up to 25%)	9.0	PEC (Constitutional amendment)
File a judicial claim against the extension of the payroll tax exemption until 2021	6.5	STF
Freezing of social security benefits above 3 minimum wages	3.5	PEC (Constitutional amendment)
Regulation of the public service wage ceiling	3.0	PEC (Constitutional amendment)

Sources: Santander estimates.

In the short term, we anticipate that the most significant challenge to comply to the spending cap will occur in 2021, as the opposite effect of the inflation index should occur in 2022, considering that the accumulated inflation up to June should be significantly higher than that of December. The spending cap will be adjusted by inflation close to 5.9% (IPCA), while the benefits will be adjusted by 3.3% (INPC), according to our inflation tracking. This will generate an additional clearance of BRL5.3 billion in relation to our previous scenario (+BRL9.7 billion)—see Figure 3. The total impact of inflation index mismatch is BRL10 billion. We highlight our belief that compliance with the spending cap rule up to 2022 can be met with the implementation of four measures: (i) real stability in the minimum wage; (ii) nominal stability in public servant wages; (iii) a firing freeze for federal public servants; and (iv) a ban on the creation of new mandatory expenditures.

Figure 3. Surplus (+) or Insufficiency (-) to Comply with Constitutional Spending Cap (BRL bns)



Sources: National Treasury and Santander.

Even with this mismatch in the inflation indicators, it will be possible to comply to the spending cap in the next two years. However, with this limited margin there is a higher risk of compression in discretionary expenses and a partial shutdown of some services in the public sector, especially in 2021.

In general, we expect a gradual return to fiscal consolidation from 2021 onward, which will require a lot of discipline from the public administration. Beginning in 2023, we expect compliance with the rule to be only possible if the government is able to approve additional measures to reduce mandatory spending. From 2023 to 2026, we believe that it will be necessary to contain mandatory expenses to a total of BRL130 billion, according to our calculations (Figure 3).

Compliance with the spending cap is essential to reduce fiscal risks. We recently published two reports that reiterate our belief in the need to comply with the fiscal rule — both from the point of view of risk reduction[3] and debt management[4].

Appendix

Figure 4. The Effect of Higher Inflation in the Government's Expenditures

	PLOA¹	Santander		Δ (BRL bn)
BRL billions	**2021**			
Expenses		July	December	New-Old
Total expenses	**1,516.8**	**1,493.1**	**1,513.0**	20.0
Social security benefits	704.4	700.1	717.2	17.1
Personnel and social charges	337.3	325.7	325.7	0.0
Other Expenses	475.0	467.3	470.1	2.9
INPC (inflation index)	2.1%	2.3%	4.9%	2.6%

[1] Budget Bill proposal

Sources: Ministry of Economy, National Treasury and Santander.

[3] **Santander Macro Brazil - *Mind the (Fiscal Risk) Premium* –** October 06, 2020 - Available on: https://cms.santander.com.br/sites/WPS/documentos/arq-mind-the-fiscal-risk-premium/20-10-09_140012_special+-+mind+the+%28fiscal+risk%29+premium.pdf

[4] **Santander Macro Brazil Fiscal Policy - *Borrowing Requirements and Debt Management: The Importance of the Fiscal Adjustment* –** October 07, 2020 - Available on: https://cms.santander.com.br/sites/WPS/documentos/arq-borrowing-requirements-and-debt-management/20-10-09_140544_special+-+borrowing+requirements+and+debt.pdf

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