Brazil Macro: Fiscal Policy

Spending Cap Rule: Narrowing the Margin for 2021

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- In this brief report we explore an additional fiscal challenge for complying with the spending cap in 2021. Beyond the possibility of creating a new welfare program, the mismatch between the inflation index that is used to readjust the spending cap limit and the index used to adjust budget benefits should generate pressure to comply with the spending cap in 2021, in our view.

- The spending cap limit will be readjusted 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 tracking should reach +3.2% (from +2.3%) given the recent pressure on food prices.

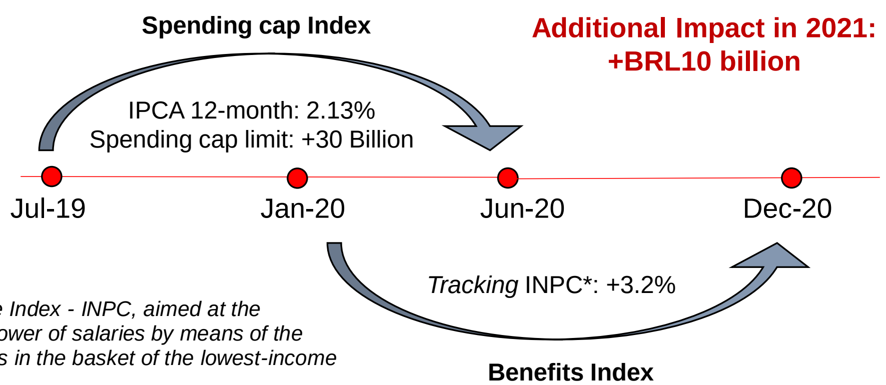
- As a result, our estimate of BRL8.5 billion of surplus for next year has changed to insufficiency of BRL1.5 billion to comply with the spending cap rule, making its fulfillment in 2021 even more challenging. It is possible for the spending cap to return to a surplus of BRL5.0 billion if the veto (of not extending the payroll tax breaks to 2021) is maintained (BRL6.5 billion). **Compliance with the spending cap remains feasible, in our view. However, it could lead to a decline in discretionary expenses, and thus to the partial shutdown of some public services.**

- On the other hand, this mismatch will help the margin for 2022 by BRL5 billion. For the period from 2023 to 2026, we think it is necessary to approve fiscal reforms to curb mandatory expenses totaling BRL130 billion, in addition to measures to ensure compliance by 2022.

With the recent spike in food prices, our consumer inflation tracking for the IPCA increased to around +3.0% in 2020, compared to a forecast of 2.3% in our base scenario. This price increase in the second half of the year will put additional pressure on the 2021 spending cap, which will be adjusted by the accumulated IPCA for the 12-months period ended June 2020, according to the constitutional amendment. In other words, the mismatch of the spending cap readjustment index (IPCA to June 2020: 2.13%) and benefits (INPC expected for December: 3.2%)—see Figure 1 below—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 creation of new mandatory expenses (such as the new welfare program).

According to our previous estimate, the surplus for the spending cap limit next year would be BRL8.5 billion, and with the expected mismatch between the inflation indexes this margin changed to BRL1.5 billion of insufficiency; that is, a total impact of BRL10 billion, especially with an increase in social security benefits (BRL 8billion)—see Figure 4.

Figure 1. Mismatch between inflation indexes



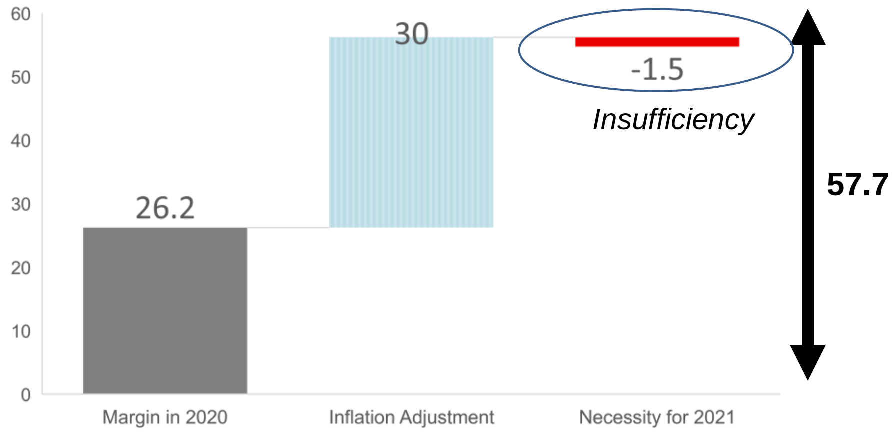
**The National Consumer Price Index - INPC, aimed at the correction of the purchasing power of salaries by means of the measurement of price changes in the basket of the lowest-income salaried population*

Sources: National Treasury, IBGE and Santander.

For 2021, in our current base scenario the nominal increase in total expenses will be 4.4% (not considering the War Budget[1]), an increase of BRL64 billion. Expenses for social security benefits represent the largest increase, around BRL36 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), personnel expenses are expected to rise by BRL3.8 billion. In turn, spending on *Fundeb*—fund for education (an expenditure not subject to the spending cap)—is expected to increase BRL3.2 billion (from BRL16.5 billion in 2020 to BRL19.7 billion in 2021). Finally, other compulsory expenses are expected to rise by BRL16 billion in 2021.

In this scenario, according to our calculations, expenses subject to the spending cap are expected to grow by approximately BRL58 billion in 2021, 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 surplus of 2020), totaling BRL26.2 billion. In addition, there is the margin created by the 12-month IPCA correction until June (2.13%), which adds BRL30 billion. Consequently, we observe that the balance implies an insufficiency of only BRL1.5 billion.

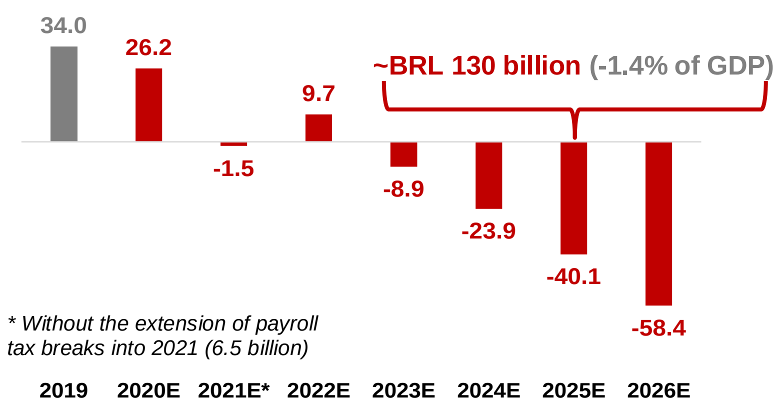
Figure 2. Spending Cap in 2021 – BRL billion



Sources: National Treasury, IBGE and Santander.

The opposite effect should occur in 2022, considering that the accumulated inflation up to June should be higher than that of December. The ceiling will be adjusted by inflation close to 3.3%, while the benefits will be adjusted by 2.8%, according to our forecasts. This should generate an additional clearance of BRL5 billion in relation to our previous scenario (+4.7 billion)—see Figure 3. It is worth mentioning that compliance with the spending cap rule until 2022 should be observed with the implementation of four measures: (i) Real stability of the minimum wage; (ii) Nominal stability of public servants' wages; (iii) Hiring freeze in federal public services; and (iv) Ban on the creation of new mandatory expenditures.

Figure 3. Surplus (+) or Insufficiency (-) to comply with the constitutional spending cap (BRL billion)



Sources: National Treasury and Santander.

[1] 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.

Even with this mismatch in the inflation indicators, it should be possible to comply with the spending cap in the next two years. In addition, the margin to the limit (surplus) on the spending cap may increase to BRL5.0 billion next year, if the veto to not extend the payroll tax breaks for 2021 is maintained (BRL6.5 billion)[2]. However, with this limited margin there is a higher risk of compression in discretionary expenses, and of having a partial shutdown of some services in the public sector.

In general, we expect the return to gradual fiscal consolidation from 2021, which will require a lot of discipline from the public administration. As of 2023, compliance with the rule will only be possible if the government is able to approve additional measures to reduce mandatory spending. From 2023 to 2026 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 reinforce the need to comply with the rule, both from the point of view of risk reduction[3] and debt management[4].

Annex

Figure 4. The effect of higher inflation in the Government's expenditures

	PLOA[1]	Santander		Δ (BRL bn)
BRL billions	**2021**			
Expenses		Old	New	New-Old
Total expenses	**1,516.8**	**1,496.1**	**1,506.1**	10.0
Social security benefits	704.4	703.1	711.2	8.1
Personnel and social charges	337.3	325.7	325.7	0.0
Other Compulsory Expenses	475.0	467.3	470.2	2.9
Discretionary	108.4	108.0	108.0	0.0
INPC (inflation index)	2.1%	2.3%	3.2%	0.9%

[1] Budget Bill proposal

Sources: Ministry of Economy, National Treasury and Santander.

[2] If Congress overturns the veto, and the payroll tax exemption continues, it would mean further difficulty in complying with the spending cap for 2021—adding up to BRL6.5 billion in new expenses (as the Treasury has to "repay" part of the nearly BRL12 billion in tax breaks to the INSS, or social security institute).

[3] 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] 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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