2022 budget: what alternatives are on the table?

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The 2022 budget proposal was submitted to Congress based on an excessively low inflation assumption. Updating it will require Congress to incorporate the effects of higher than expected inflation and, especially, to address a series of obstacles, mostly political in nature, in the fiscal debate. Despite the BRL 124bn increase in the spending cap between 2021 and 2022 (in nominal terms), it will be very difficult to accommodate all expenditures sought by the administration and Congressional leaders in the cap. The increase in welfare planned by the administration, for example, is not covered in the budget. Nor is the funding for parliamentary amendments. In addition, higher disbursements with *Precatórios* (liabilities generated by court rulings against the government) further aggravate the situation, making the budget proposed by the government almost politically unfeasible.

Updating non-discretionary spending for inflation[1] adds BRL 18 billion to budget expenditures. These include disbursements with social security benefits, *abono* wage bonuses for very low income workers and unemployment insurance. Higher inflation may also lead to pressure from civil servants for pay increases, which would add pressure to the budget if they materialize. Ideally, within the constraints of spending growth cap, the funding for these spending increases should come from cuts in discretionary spending, budgeted in 2022 at BRL 99 billion (excluding congressional amendments).

Table 1: Primary spending of the Central Government and spending growth cap (BRL billion)

Orçamento	2021	PLOA 2022 (I)	PLOA 2022 atual. (II)	Difference (II) - (I)
Total Expenditures	**1,631.8**	**1,646.5**	**1,664.5**	**18.0**
Social Security Benefits	705.9	765.6	781.2	15.7
Payroll	332.4	342.8	342.8	0.0
Other Non-Discretionary	328.6	275.0	277.3	2.4
Wage bonus & unemployment insurance	49.8	63.5	64.4	1.0
BPC	67.8	73.5	74.9	1.4
Non-Discretionary (controlled)	145.6	164.6	164.6	0.0
Bolsa Família	25.4	34.7	34.7	0.0
Discretionary	119.3	98.6	98.6	0.0
Note: Precatórios	55.7	89.1	89.1	0.0
Spending subject to cap	1,473.6	1,610.0	1,628.0	18.0
Spending Growth Cap (EC 95/2016)	1,485.9	1,610.0	1,610.0	0.0
Balance	12.3	0.0	-18.0	-18.0

Source: National Treasury, Bradesco

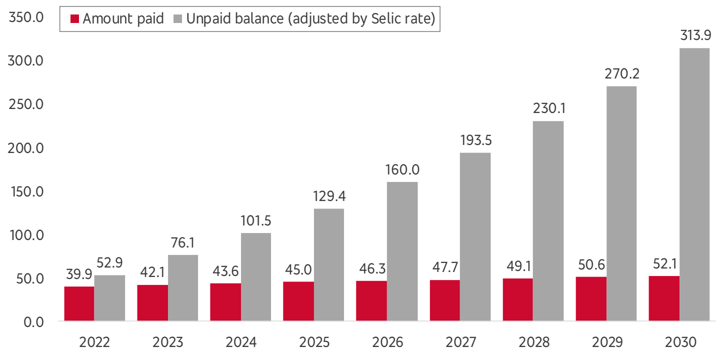
(1) These estimates consider an INPC of 9.0%.

The *Precatório* issue remains unresolved. The budget estimates a BRL 30 bn increase in such disbursements, to BRL 89.1 billion. While some slack within the spending cap was expected for 2022, the increase in *Precatório* payments takes up all fiscal room left in the budget. Once again, ideally, this increase in disbursements should be accommodated within the cap by cutting other spending – that is the point of the spending growth cap, after all. However, it is not realistic to expect the government to seek funding for the scale of the increase in *Precatório* payments and the increases in welfare spending sought by the administration from discretionary spending cuts. Alternative solutions have been proposed for this problem.

Three main alternatives emerged in recent months. The first one, presented by the administration itself in the constitutional amendment proposed to Congress (PEC 23/2021), would implement two rules for *precatório* payments in installments: i) until 2029, when the sum of *precatório* debt due is greater than 2.6% of Current Net Revenues (RCL), excess amounts will be paid in installments[2] and ii) *precatório* payments in excess of BRL 66mn must be paid in installments (permanently). In addition, the government proposal establishes a liability settlement fund, provisioned with privatization receipts, dividend payments by SOEs, concession payment revenues and the revenues from pre-salt oil concessions. Disbursements by this fund would be excluded from the limits of spending growth cap. According to government estimates, its proposal would free up to BRL 33bn under the cap in 2022. However, this proposal has received limited support in Congress.

The second alternative establishes an annual limit for precatório payments. The proposal, which emerged from negotiations with the National Justice Council (and would thus have the blessings of the judiciary branch), would include *precatório* payments up to this limit as part of the expenditures subject to the spending growth cap rules, and would push excess amounts of *precatórios* to subsequent years. The limit would be set by adjusting the amount of *precatório* liabilities disbursed in 2016 for inflation (the same that increases the overall spending cap). If implemented, this proposal would free up to BRL 49 billion in the budget. However, it would lead to the accumulation of unpaid liabilities. According to our estimates[3], by 2030, the outstanding balance of unpaid *precatório* debt would reach BRL 314bn, assuming no other payment instruments are authorized (Chart 1).

Chart 1: Estimate of unpaid precatório liabilities under the "CNJ Proposal" (BRL billion)



Source: National Treasury, Bradesco

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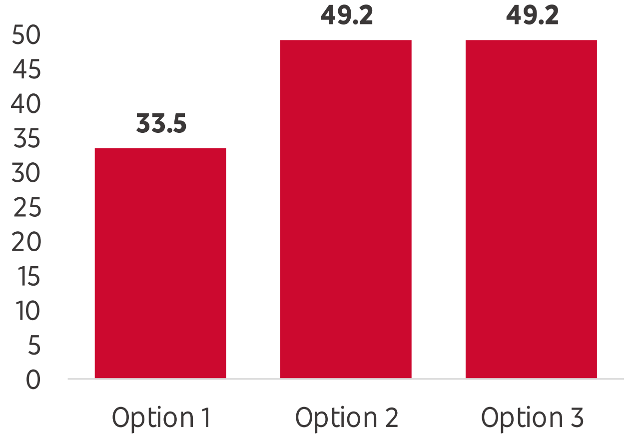
(2) Settlement of *precatórios* with lower values would be prioritized. As the amount increases, the payment falls further back in the queue. When the sum exceeds 2.6% of current tax revenues, outstanding payments would be disbursed in installments. In addition, there would also be a "reconciliation" to offset amounts due to state and municipal governments.

(3) We assume that *precatório* payments remain stable in real terms, and the unpaid balance is adjusted by the Selic interest-rate rate. However, *Precatório* payments in recent years have risen significantly faster than inflation in recent years.

The government and Congress have been negotiating an adapted version of the second alternative. Not all of the details have been hashed out, but the proposal would incorporate the annual limit on *precatório* payments and allow for the offsetting of accounts between the federal government and creditors to avoid excessive accumulation of unpaid liabilities. In practice, whatever doesn't "fit" in the *precatório* payment limit would be pushed to the following year or renegotiated and paid outside the spending cap. This proposal would also create about BRL 49bn in room under the spending growth cap in 2022. The advantage of this proposal is that it allows for some mechanisms to reduce the amount of unpaid *precatório* liabilities accumulating over time.

The third alternative excludes *precatórios* from the spending growth cap altogether. The proposal involves recalculating the spending growth cap back in 2016 excluding precatório payments of that year, and adjusting this recalculated cap for inflation to current prices. *Precatórios* would still be disbursed, but would no longer affect the spending growth cap. This proposal also frees BRL 49bn from the spending growth cap, while *precatórios* would continue to be fully disbursed and would affect the primary fiscal balance (but not be subject to the cap, like *Fundeb* payments).

Chart 2: Fiscal room created under the spending cap by each alternative (BRL billion)



Source: Brazilian Ministry of Economy, Bradesco

All of these alternatives require changes to the Constitution and alter, albeit at different degrees, the quality of the budget. None of them reduce public spending, but rather merely postpone expenses or change accounting rules, opening room to accommodate other increases in spending. Two options appear to be preferable in terms of maintaining budget transparency and minimizing the accumulation of liabilities: the most recent solution considered by the administration, which allows for a broader renegotiation of *precatórios*, or removing this item from the spending cap altogether. These proposals would also probably involve less legal uncertainty, in our view.

Most of the ongoing political deadlock is the result of the efforts by the administration to open up room in the budget for a new social program: *Auxílio Brasil*. The program was established by provisional measure 1061/2021, which reorganized the *Bolsa Família* program, integrating other welfare programs under a single roof. The provisional measure does not mention the estimated cost of the new program, but assuming a total of 17 million beneficiaries, receiving BRL 300 per household per month would imply in a total annual cost of BRL61 billion, or BRL 26 billion more than the current version of the *Bolsa Família* (which has 15 million beneficiaries who receive BRL 190 each).

Besides the need to make room in the spending cap, creating a new social program requires the government to allocate a new source of revenue[4]. Under the Fiscal Responsibility Act, expanding permanent expenditures requires a permanent source of revenue, either by raising taxes or lowering subsidies, or an equivalent cut in other expenses. The source of revenue intended by the government to satisfy this requirement is the taxation of dividends, included in the Tax reform currently being examined by Congress. Note that the tax reform as a whole will likely lead to a net loss of revenue estimated at BRL 22 billion per year (considering the reform as approved by the Lower House), even if the specific taxation of dividends would constitute the new source of revenue needed by the government.[5] There is still a need to make room for Congressional amendments to the budget (the so-called RP9 amendments in budgetary language), and Congress is also examining payroll tax relief for some sectors, which could lead to additional losses in revenues that would affect the spending growth cap rules. Depending on how these are implemented, additional discretionary spending cuts could still be still necessary, even after the changes to *precatório* rules.

The fact is that this deadlock resulted in the positive surprises from current fiscal data not translating into an improvement of expectations. One would have expected that higher than expected tax revenue and lower than anticipated public debt would have resulted in a stronger BRL and lower interest rates, all else equal. However, the deterioration of fiscal risk perceptions outweighed these factors. Until a clear solution for these issues is reached, fiscal uncertainty will continue to influence asset prices, impacting future growth expectations and leading to worse public debt dynamics.

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(4) This happens because the program is not just an expansion of the *Bolsa Família*, but rather, creates a new scope for the welfare program.

(5) Another possibility, still little debated, is to use the upsurge in revenues this year as a source for the new program, provided that part of such increase is considered a permanent improvement in revenues.

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