Spending cap and fiscal policy credibility

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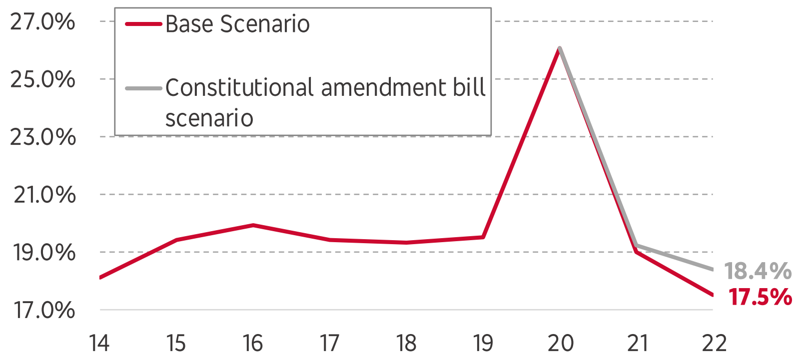
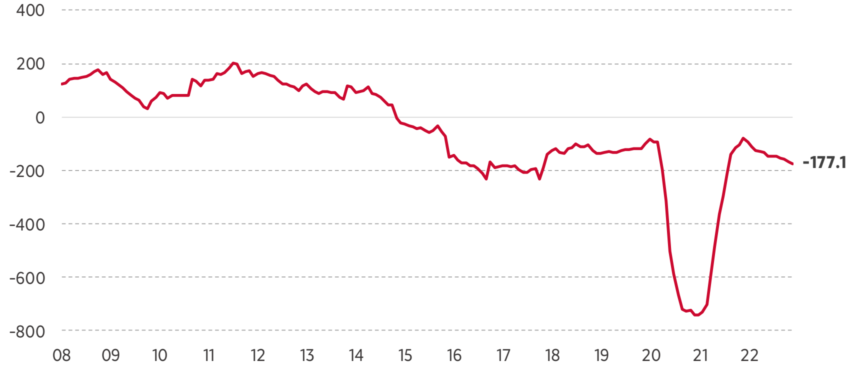
The spending cap was created in 2016 as a way to discipline public spending and reduce the debt growth rate. By conditioning the expansion of expenses on inflation, the rule obligates the Federal Government and the National Congress to define priorities in the allocation of public resources, in order to accommodate the demands for spending. Since its adoption, public spending has stabilized as a proportion of the GDP and a downturn was expected before the pandemic. The strategy of the cap has always been a gradual adjustment in public finances. Even so, two very positive side effects were observed so far: a drop in interest rates and inflation levels to near international standards.

Chart 1: Primary Spending of the Central Government (% of the GDP)



Source: STN, Bradesco

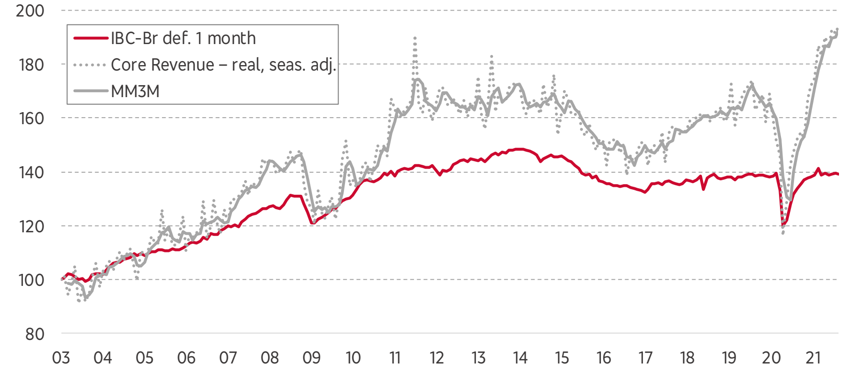
Chart 2: Primary balance in real terms
In constant BRL as of Dec/2020



Source: STN, Bradesco

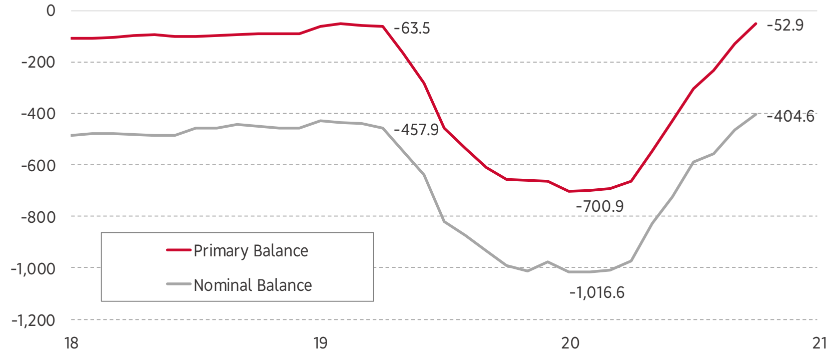
Even when faced with expanded spending to deal with the pandemic, the cap played an important role in limiting other spending. The strong increase in tax collection in the country, partly the result of inflation and non-recurring factors, combined with the control of non-pandemic spending allowed fiscal indicators to quickly return to the pre-pandemic level. This has always been the strategy of the spending cap: over time, improved tax collection would raise the primary surplus and reduce public debt.

Chart 3: Core revenue (activity-sensitive) and IBC-Br
Seasonally adjusted



Source: Federal Revenue of Brazil (RFB), Central Bank of Brazil, Bradesco

Chart 4: Consolidated public sector result
BRL billion, 12 months



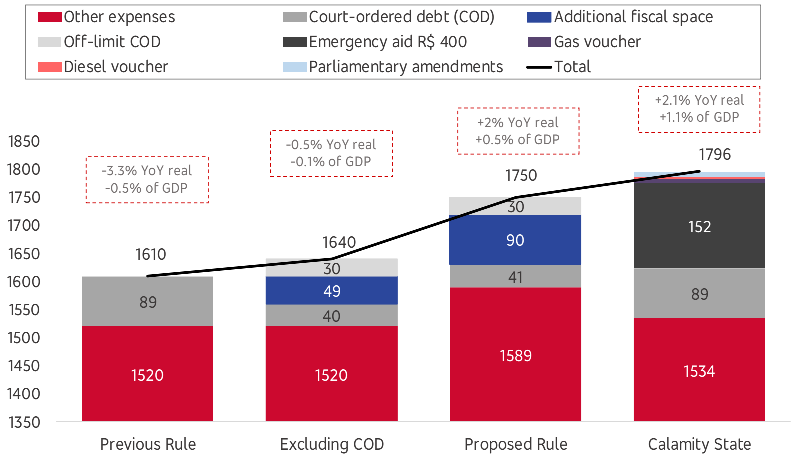
Source: BCB, Bradesco

The social and health consequences of the Coronavirus pandemic still demand support for the most vulnerable. However, a false dilemma has been established between the spending cap and social programs. In a longer perspective of time, the lack of reforms in recent decades is responsible for the current low margin of maneuverability of the public budget to serve the most vulnerable. The absence of an administrative reform, lack of prioritization of existing social spending (such as the salary bonus, for example) and late approval of a pension reform take a toll in terms of the rigidity of mandatory spending. On the revenue side, the absence of a tax reform that makes us more competitive and reduces inequality as well as the existence of subsidies that contribute little or nothing to income growth or distribution also explain the scenario.

All the same, even if it is not possible to quickly revert this situation for the benefit of serving the most vulnerable today, there would be solutions with low fiscal costs and for the regime itself. A program that would increase the focus of the allowance and revert parliamentary amendments to care for the most vulnerable, for example, combined with the reduction of subsidies could be designed to have no fiscal impact, even if some temporary arrangement were needed to circumscribe the cap constraint. Alternatively, the exclusion of court-ordered debts from the cap and their recalculation would open up some fiscal space for *Auxílio Brasil*. This seems to be the solution that would imply greater transparency, less fiscal impact and less loss of quality in the budget[1]. In any case, either by removing the court-ordered debts from the spending cap with recalculation, or by defining an annual payment limit, the relief would be of around BRL 50 billion.

The constitutional amendment bill under debate shifts the IPCA reference used to readjust the cap from June to December. In addition to the creation of an annual limit for the payment of court-ordered debts, the constitutional amendment bill would free up about BRL 90 billion in the cap for 2022. This amount is enough to accommodate the BRL 50 billion in additional expenses with *Auxílio Brasil*[2] and there would still be BRL 24 billion left over to compensate for the updating of expenses indexed to the INPC, which should be handled in the 2022 budget, BRL 4 billion for the truck driver aid program announced by the government, and another BRL 12 billion for parliamentary amendments, which broadens the scope of the initiative beyond strictly serving the most vulnerable.

Chart 5: Primary spending subject to the cap
BRL billion



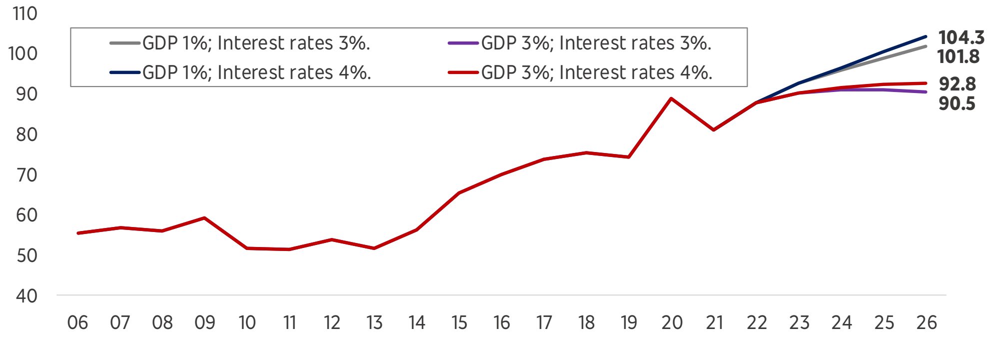
Source: STN, Bradesco

Thus, changing the spending cap rule at this point reduces the credibility of the fiscal policy. Even though the change of indexation included in the spending cap amendment keeps the cap formally in place, it weakens the signaling power given by the inscription of the cap in the constitution. If the constitution does not work as a shield for spending, the fiscal risk premium has to rise. Not resorting to alternatives with lower fiscal impact raises risk premiums likewise. In the face of an initial expectation of reduced public spending, it will now move into stability. The primary balance is expected to be negative by BRL 120 billion next year, becoming a surplus only between 2024 and 2025. Thus, even if these changes do not imply an expansion of spending with respect to the GDP, they attenuate or postpone the expected effects of adopting the spending cap and weaken its signaling, since the constitutional barrier is shown to be fragile in the face of alternative choices. A consequence already evident in the short term is the worsening of financial conditions, with a depreciation of the exchange rate, drop in the stock market, and an increase in interest rates, with an impact across all of society, including the most vulnerable.

[1] As explored in our Depec Highlight on 9/29/21.
[2] This amount, added to the budget of BRL 35 billion for the *Bolsa Família* program in 2022, guarantees the continuous payment of BRL 225 to 17 million families, on average, and an additional amount that raises the benefit to a minimum of BRL 400 for one year.

In the long run, the loss of credibility of the fiscal policy tends to negatively impact the debt/GDP trend. Persistent fiscal uncertainties can result in Treasury financing difficulties, lower economic growth, and an increase in the economy's equilibrium interest rates. The cap portrays the decades-old dilemma of public policy choices in Brazil. It is not the villain of social programs, but its weakening can make the already fragile convergence of public debt in the country even more difficult.

Chart 6: Gross debt trend
% of GDP



Source: BCB, Bradesco

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