Economic Views –Brazil's Tax Cuts and Fiscal Risk

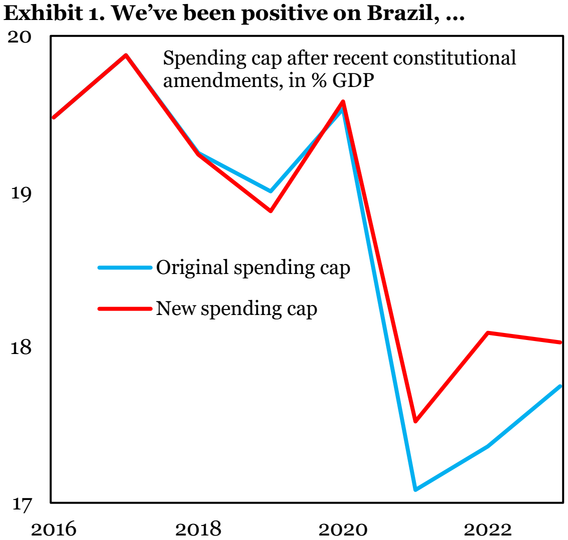
February 15, 2022

Sergi Lanau, Deputy Chief Economist, slanau@iif.com, @SergiLanauIIF
Martín Castellano, Head of LatAm Research, mcastellano@iif.com, @MCastellano44
Filipe Carvalho, Research Analyst, fcarvalho@iif.com

- We have been more constructive than consensus on Brazil, ...
- despite the relaxation of the spending cap agreed last year, ...
- as spending in 2022 will still be lower than before covid.
- However, tax cuts under discussion complicate the picture, ...
- as they have the potential to compromise debt stabilization.
- We will turn less constructive if large tax cuts are approved.

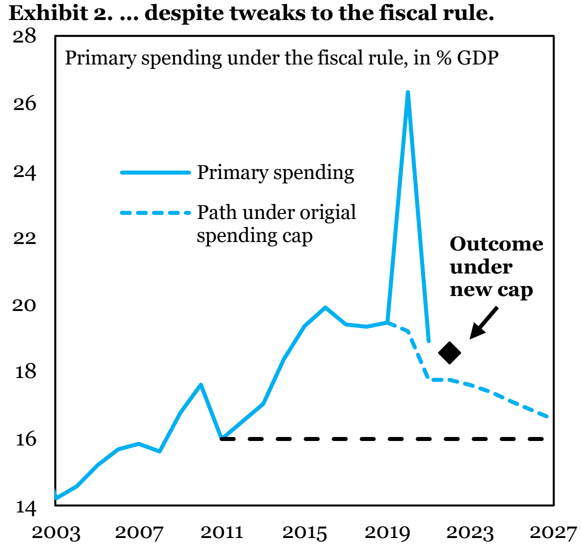
Last year, we stuck to our constructive view on Brazil through the ups and downs of the 2022 budget discussions. The relaxation of the spending cap initially spooked markets but we argued that Brazil would still spend less in 2022 than in 2019 under a looser cap, something very few EMs will do. Eventually, markets digested revised spending targets and term premia fell. We expect more tweaks to the spending cap in the future as the original setup aimed at undoing years of fiscal largesse at breakneck speed, something politically and socially challenging. Falling spending on an electoral year is not a common occurrence in Brazil historically, but it will happen this year. However, pressure is materializing on the tax front. Proposals to cut taxes in 2022-23 may cost from 0.5% to 1% of GDP this year. They are problematic because, unlike other EMs, Brazil's revenue did not rise much coming out of the pandemic. If sizable tax cuts are approved, we will turn less constructive on Brazil. Avoiding steep debt increases will become harder, as the combined impact on the primary deficit of the looser spending cap and tax cuts could add up to as much as 2% of GDP. In scenarios where tax cuts are large and not reversed after 2023, debt stabilization would be a distant prospect.

Exhibit 1. We've been positive on Brazil, ...



Source: Haver, IIF

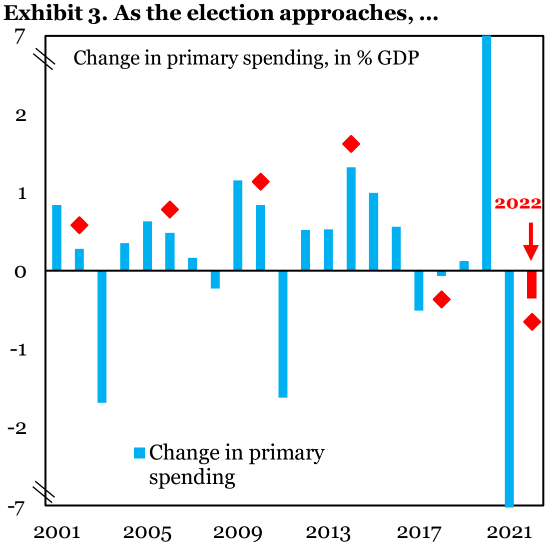
Exhibit 2. ... despite tweaks to the fiscal rule.



Source: Haver, IIF

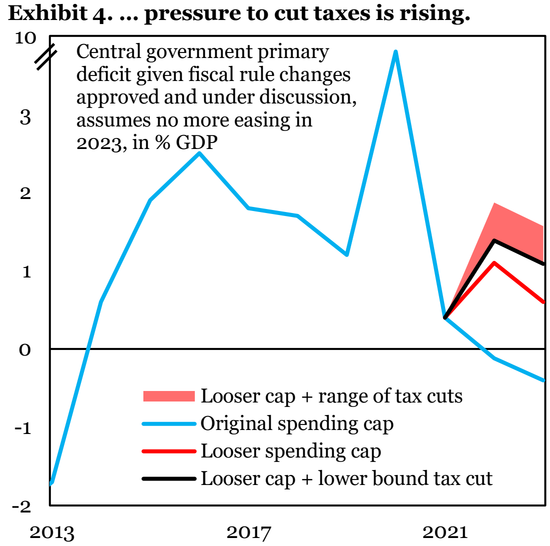
Brazil implemented one of the largest fiscal expansions in the world in 2020, suspending a fiscal rule that freezes spending in real terms. Last year, spending did not fall back to the level prescribed by the rule, but adjustment was significant. The 2022 budget was another political struggle due to the demanding spending cap. Primary spending had to fall 2% of GDP according to the cap, a real challenge coming out of a recession and approaching an election. News that the fiscal rule would be changed to avoid sharp cuts spooked markets. We remained positive throughout because the revised spending cap still enforced spending cuts in 2022 relative to 2019 (Exhibits 1 and 2). Moreover, spending space created by tweaks to the formula linking nominal spending and inflation is temporary. In the end, Brazil is one of the EMs that will spend the least in 2022 relative to 2019. This is no small feat given Brazil's track record in electoral years. Spending increases are common as elections approach (Exhibit 3). That said, political pressure to ease policies has materialized elsewhere. Several proposals to cut taxes are under discussion. Many involve constitutional amendments to avoid offsetting measures in 2022-23. We think a no tax cut scenario is impossible at this point. The mildest proposal, supported by the ministry of finance, would cut taxes on industrial products (IPI) and federal fuel taxes, at a cost of 0.5% of GDP. Other proposals entail measures such as broader fuel tax cuts, subsidies to cooking oil, and aid to truckers. A price stabilization fund that would be detrimental to Petrobras' profitability has also been floated. Items like state fuel tax cuts may not go ahead but in downside scenarios we think revenue losses of up to 1% of GDP could materialize.

Exhibit 3. As the election approaches, ...



Source: Haver, IIF

Exhibit 4. ... pressure to cut taxes is rising.

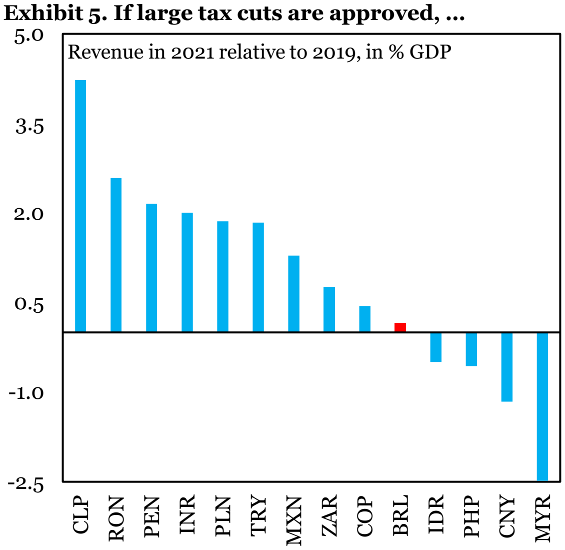


Source: Haver, IIF

Tax cuts are potentially problematic. The combination of recent changes to the spending cap and tax cuts could worsen the primary deficit drastically relative to a now impossible 'full fiscal rectitude' scenario (Exhibit 4). Potential tax cuts are only supposed to last two years but there is an obvious risk that revenue falls permanently. This is no good news in any scenario but is especially concerning in Brazil. The revenue windfall we have seen in several EMs is minuscule in Brazil and even nonexistent if we subtract transfers by revenue sharing from gross revenue (Exhibit 5).

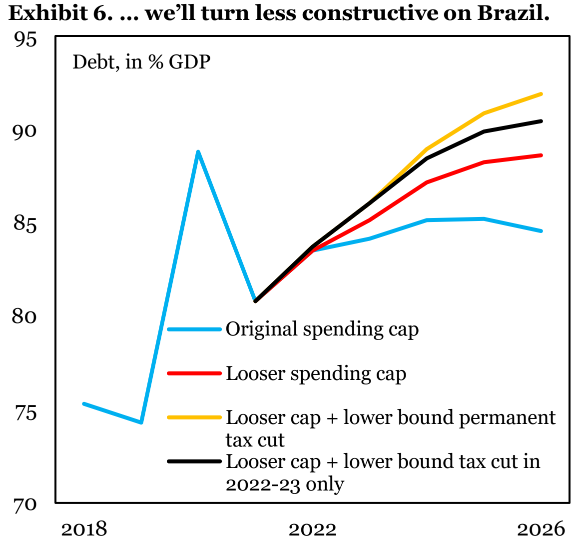
How much of an issue tax cuts are ultimately depends on what they imply for debt stabilization. News are not great on that front. Late last year, we argued that debt still had a chance of remaining at high but manageable levels after changes to the spending cap. We forecasted a slowly increasing debt ratio through 2026. Brazil could handle that given low FX debt and a mostly domestic investor base. Tax cuts could complicate debt sustainability, even if at the lower bound of existing proposals (Exhibit 6). The impact obviously depends on whether cuts are actually offset in 2024. We see even the most modest proposals as potentially problematic in the medium term but would be especially concerned if tax cuts surpass 0.5% of GDP.

Exhibit 5. If large tax cuts are approved, ...



Source: Haver, IIF

Exhibit 6. ... we'll turn less constructive on Brazil.



Source: Haver, IIF