The Economic Challenges of the Incoming Administration

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Lula's victory in the presidential election opens up a space for a somewhat more in-depth discussion of the proposed policies for the next four years. The "Letter to the Brazil of Tomorrow" released shortly before the election by Lula's campaign team set a direction for the economic agenda, reaffirming his commitment to an increase in spending on social programs, but implementation details, including each program's design and budget, have yet to be worked out. This will presumably happen after the new economic team has been appointed.

Broadly speaking, the Letter indicates three important elements of Lula's economic agenda: reformulation of the social protection network, strengthening existing educational and health policies and maintaining or expanding the welfare budget; economic development based on public and private investment in infrastructure, with state-owned banks such as BNDES and state-owned enterprises such as Petrobras playing a key role; and microeconomic structural reforms including new labor laws, a real minimum wage hike and a tax reform to enable the income tax threshold to be raised to BRL 5,000 per month.

Preliminary calculations of the aggregate cost of fulfilling Lula's main campaign promises in 2023 – such as continuing to hand out BRL 600 per family under the Auxílio Brasil cash transfer program plus BRL 150 per child and raising the minimum wage by 1% or 2% above inflation – point to BRL 70 billion (if not more), in line with the fiscal waiver already mentioned during the campaign. However, the rise in spending may turn out to be far greater if the investment plans reported in recent news stories materialize, as well as other probable initiatives not covered by the existing budget, such as the measures to support the cultural industry known as the Aldir Blanc Law and the Paulo Gustavo Law (Table 1).

One of the main economic challenges the new administration will face will be precisely finding the right balance between the rise in spending and fiscal responsibility. In the near term, the restrictions imposed by the spending cap (still in force) make yet another constitutional amendment inevitable, since the budget for 2023 does not cover any of Lula's campaign pledges. In the longer term, the entire fiscal framework will have to be reformulated, as successive constitutional amendments to allow waivers of the spending cap have eroded its credibility. A new rule will be required to make public spending predictable, with clear and transparent metrics that are compatible with social demands and the role of the state in this process.

**Table 1: Expected Expenses and Revenue Losses in Lula's Government**

Program	Expense (+) or Revenue Loss (-)	Included in Budget Law?
Auxílio Brasil - Additional BRL 200	52 bn	No
Auxílio Brasil - Additional BRL 150 per child up to 6 years old	18 bn	No
PIS/COFINS exemption on fuels	-53 bn	Yes
IRPF Table Correction	-100 bn	No
Minimum Wage Readjustment, Real 1-2%	5/10 bn	No
Public Servent's Wage Readjusment	2/3 bn per p.p. increase	14.2 bn (4-5% increase)
Debt negotiation program	7 bn	No
Farmácia Popular	1.2 bn	No
End of SUS Queue	10 bn	No
Public Investments (PAC)	50 bn	No
Total	**Aprox. 300 bi**	

Source: BOCOM BBM

The fiscal outlook is made more complex by profound uncertainty about the trajectory of federal tax revenue. This year it has been significantly bolstered by the economic recovery, formalization of the economy (which becomes visible to the tax authorities), post-COVID global growth, and above all rising prices of energy and metallic commodities such as oil and iron ore. In particular, the dividend paid by Petrobras to the federal government (its majority shareholder), revenue from natural resource exploitation and taxes paid by the extractive sector jumped from 1% of GDP in 2020 to 2.3% in June 2022 (Figure 2). As the main developed economies slow down and demand for key commodities falls, taking their prices with it, this upward trajectory of federal tax revenue is unlikely to continue.
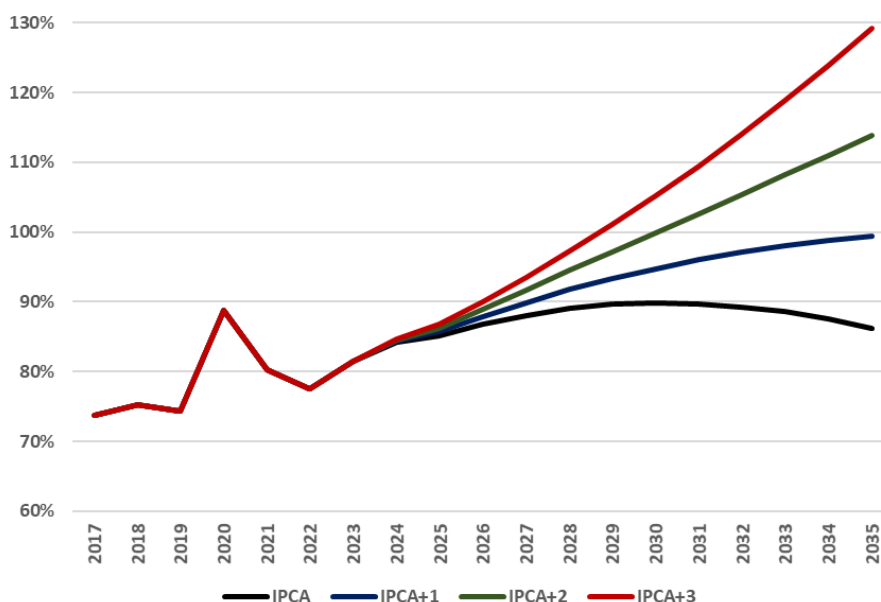
Our scenario for the public debt assumes an increase of about BRL 150 billion in expenditure in 2023. This would cover Lula's main campaign pledges except the higher income tax threshold. Under this baseline scenario, we project gross debt at 77.5% of GDP in 2022 and 81.5% in 2023. Looking beyond 2023, the spending growth trajectory becomes crucial to determine the sustainability of the debt. Under a scenario in which spending rises in line with inflation from 2024 onward, we see the debt reaching 90% in 2029 and then falling or stabilizing. In the absence of measures to increase tax revenue, a rise in spending above inflation would drive the debt higher, and it could surpass 100% of GDP in ten years' time. This exercise evidences the importance of establishing a credible fiscal anchor to guarantee long-term fiscal sustainability.

Figure 2: Dividends from Petrobras to the Federal Government + Revenues from natural resources exploitation + Revenues from federal taxes paid by the mining sector (without social security) - Accum. 12 months, in % GDP
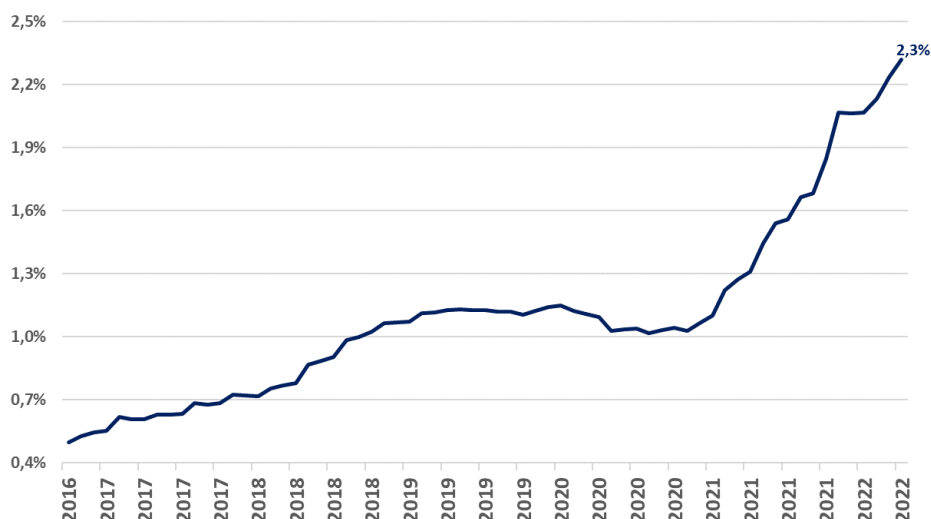
Source: BCB, National Treasure, Ministry of Economy, Brazilian Federal Revenue Office, BOCOM BBM

Figure 3: General Government Gross Debt Scenarios (% GDP) by Alternative Spending Growth Rates

Source: National treasure, BOCOM BBM

Our main macroeconomic projections are shown below.

ECONOMIC FORECASTS	2019	2020	2021	2022F	2023F
GDP Growth (%)	1,1%	-3,9%	4,6%	2,8%	1,0%
Inflation (%)	4,3%	4,5%	10,1%	5,5%	4,7%
Unemployment Rate (eoy ,%)	11,7%	13,9%	11,1%	8,2%	8,5%
Policy Rate (eoy, %)	4,5%	2,0%	9,3%	13,75%	11,25%
External Accounts					
Trade Balance (US$ bn)	48	32	36	44	50
Current Account Balance (US$ bn)	-65	-24	-28	-41	-40
Current Account Balance (% of GDP)	-2,8%	-0,9%	-1,8%	-2,2%	-2,0%
Fiscal Policy					
Central Government Primary Balance (% of GDP)	-1,2%	-10,0%	-0,4%	0,7%	-0,8%
Government Gross Debt (% of GDP)	74,3%	88,8%	80,3%	77,5%	81,5%