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Fiscal Risks on the Horizon

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The 2024 federal budget, the first designed to comply with the new fiscal framework, established a series of tax collection measures aimed at achieving equilibrium between revenue and expenditure in the coming year. Starting from a deficit in 2023 – due in part to the fiscal expansion arising from the constitutional amendment that waived the spending cap right at the start of the incoming administration (*PEC da Transição*) – and a real increase in expenditure in 2024 on that basis, the tax collection effort will have to be significant if the primary deficit is to be eliminated. But to what extent will the government be able to act to produce the promised result?

To cut the deficit to zero, the government has sent Congress a budget bill containing proposals aimed at rebuilding the fiscal base, several of which have yet to be debated, such as taxation of income from exclusive funds (dubbed the "super-rich") and offshore companies incorporated in tax havens, as well as abolition of the right to deduct "interest on equity" from corporate tax obligations; previous enactments requiring specific implementing legislation, such as the inclusion of state sales tax (ICMS) on the basis for calculating corporate income tax and social contribution on net income (CSLL); and potential measures whose fiscal impact is uncertain, such as rulings favorable to the government deriving from reinstatement of its casting vote as a tiebreaker in decisions by the Administrative Council for Tax Appeals (CARF). The impact of these measures may add up on paper to an amount sufficient to cut the deficit to zero next year (Table 1), but the actual outcome is very hard to predict and entails considerable risk.

Table 1: Revenue Measures in 2024 Budget (BRL billion)

	Govern Estimated Impact	Market Scenario	Aproved	Sent to National Congress	Not sent to National Congress
IRPJ/CSLL on ICMS tax credits	35	30			
Carf	56	30			
Transaction of major theses in the Judiciary with PGFN	12	0			
Transaction with IRS	30	0			
Offshores	7	7			
Exclusive funds (flow)	6	10			
Exclusive funds (stock)	7	0			
JCP	10	7			
Esport beating	2	2			
Low value imports	3	0			
Total	168	86			
Other Measures already approved					
Return of PIS Cofins on gasoline/ethanol	39	39			
PIS Confins on ICMS tax credits	58	17			
Transfer pricing	23	6			
Return of PIS Cofins on diesel	18	18			
Total	306	166			

Source: BOCOM BBM, Ministry of Finance

First, there is uncertainty regarding support in Congress for these new measures, since changing tax breaks is unpopular and opposed by various lobbies and vested interests. It is worth recalling that the proposal to tax income from offshore companies had to be resubmitted via a specific bill because Congress did not vote on the provisional measure submitted previously, which expired as a result.

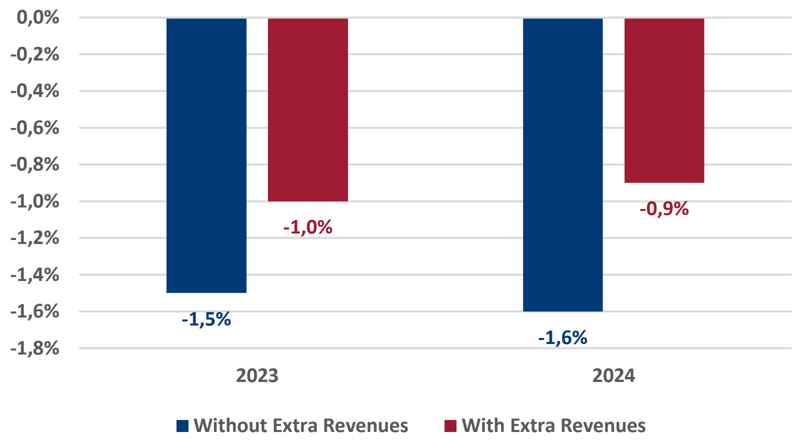
Second, some measures enacted earlier, such as including ICMS in the PIS/COFINS tax base, are not yielding revenues as expected. The government's projection amounted to BRL 60 billion per year, or BRL 5 billion per month, but data from the National Treasury shows less than BRL 4 billion per month on average in added revenue for June and July. There is also a difference between the Treasury's data and the Federal Revenue's statistics, and the latter does not show any atypical variation.

Third, tax collection adjustments increase the tax burden and affect individuals' decisions on saving, employment and human capital accumulation, and companies' decisions on production, investment, and innovation. Therefore, the tax base is not immune to the tax collection effort.

Alongside those considerations, it is worth noting that the positive fiscal results obtained in recent years were largely due to temporary factors such as rising commodity prices, post-pandemic economic growth spurt after reopening, and generous dividends paid out by state-owned companies, none of which will recur next year. A sharp fall in tax revenue due to economic slowdown or a decline in oil income would present an additional challenge to the achievement of the 2024 target.

Our baseline scenario incorporates BRL 80 billion in additional revenue from the new measures, leading to a 0.9% of GDP deficit in 2024. Under a more pessimistic scenario that does not factor in the effects of any of the new measures announced by the government for next year's budget, we project a central-government primary deficit equivalent to 1.6% of GDP in 2024 (Figure 1).

Figure 1: Central-Government Primary Result Forecast (% GDP)



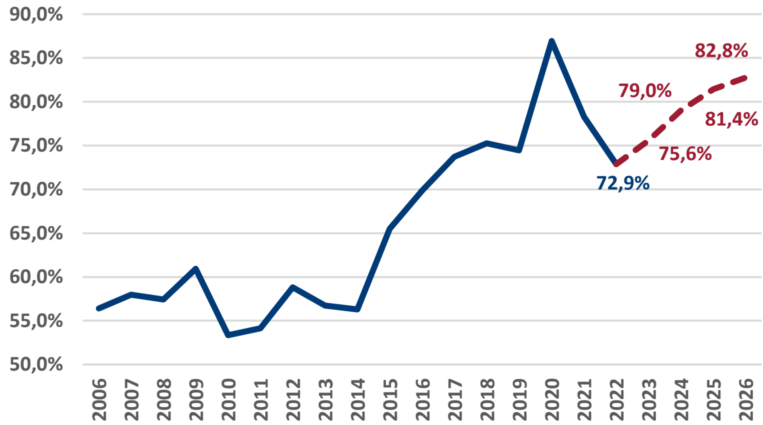
Source: BOCOM BBM, National Treasury

To offset the rise in expenditure mandated by the new fiscal framework, the government will have to boost tax collection. Failure to do so endangers the sustainability of the public debt and the solvency of the government.

The good news is that economic activity remains resilient. Second-quarter GDP surprised even the most optimistic analysts, with growth of 0.9% compared with the previous quarter. The contributions of sectors less sensitive to the business cycle, such as agriculture and mining, were decisive for the overall result, but the service sector, which carries the most weight on the supply side, also played an important role by growing 0.6%. After the announcement, market forecasts for real GDP growth in 2023 migrated from around 2% to near 3%, and this should help contain projections for the debt-to-GDP ratio.

This ratio fell from 86.9% to 72.9% between 2020 and 2022. We project 75.6% in 2023, with a rise to 82.8% by 2026 due to the more expansionary fiscal rules with few guarantees of a revenue increase (Figure 2). After 2026, the trajectory will depend on parameters defined by the next political cycle. Given all uncertainty surrounding the debt-to-GDP ratio in the medium and long term, and skepticism about achieving of the zero primary deficit target in the first year of the new fiscal framework, fiscal uncertainty brings risk to inflation dynamics and economic growth. Our other projections are set out in the table below.

Figure 2: Debt-to-GDP Ratio Forecast



Source: BOCOM BBM, BCB

ECONOMIC FORECASTS	2019	2020	2021	2022	2023F	2024F
GDP Growth (%)	1.2%	-3.3%	5.0%	2.9%	2.9%	1.4%
Inflation (%)	4.3%	4.5%	10.1%	5.8%	4.8%	3.6%
Unemployment Rate (eoy ,%)	11.1%	14.2%	11.1%	7.9%	8.5%	9.0%
Policy Rate (eoy, %)	4.5%	2.0%	9.3%	13.75%	11.75%	9.0%
External Accounts						
Trade Balance (US$ bn)	27	32	36	44	60	42
Current Account Balance (US$ bn)	-68	-28	-46	-56	-39	-50
Current Account Balance (% of GDP)	-3.6%	-1.9%	-2.8%	-2.9%	-1.8%	-2.3%
Fiscal Policy						
Central Government Primary Balance (% of GDP)	-1.3%	-9.8%	-0.4%	0.6%	-1.0%	-0.9%
Government Gross Debt (% of GDP)	74.3%	86.9%	78.8%	72.9%	75.6%	79.0%