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ECONOMICS: LATIN AMERICA PERSPECTIVES

BRAZIL: A NEW (UPHILL) FISCAL BATTLE

+ Fernando J. Losada, Senior Economist—Latin America Research, [redacted]

S&P's decision to downgrade Brazil to junk status this month prompted the government to announce a more ambitious fiscal plan. But politicians' reaction to the proposal was lukewarm at best, suggesting the government may not be able to put it fully into action.

After the Downgrade, a Swift Reaction

Shortly after S&P became the first of the big three ratings agencies to cut Brazil's sovereign credit rating to junk status, the government ditched an earlier budget proposal and recommitted itself to fiscal discipline. President Dilma Rousseff rallied around her finance minister, Joaquim Levy, and announced a primary surplus target of 0.7% of gross domestic product (GDP) for fiscal year 2016.

It was the government's recent decision to backpedal on its fiscal promises by reducing its primary surplus targets and increasing its expected primary fiscal deficit that cost Brazil its investment-grade rating. As S&P correctly pointed out, the backpedaling would have caused Brazil's debt ratios to deteriorate sharply over the next couple of years.

What's more, there appeared to be a lack of widespread support for fiscal discipline as a way to address the country's economic malaise. As a result, the S&P kept the rating on negative outlook, suggesting that the rating agency's next move is more likely to be another downgrade rather than a move back into investment-grade territory.

To forestall this, the government has called for a combination of revenue increases and spending cuts worth some BRL60 billion (US$16 billion). The cornerstone of the revenue increases is the reenactment of a financial transactions tax, known as the CPMF, which is expected to generate more than 93% of the projected BRL34 billion incremental revenue. The idea is to maintain the CPMF at a rate of at least 0.2% during the remainder of Rousseff's term.

The government also proposed increases in capital gains taxes and reductions in export subsidies. The main items included in the BRL 26 billion worth of proposed spending cuts include a delay in civil servant salary increases until July 2016, and reductions of housing subsidies, an infrastructure investment program and healthcare outlays (*Display 1, next page*).

The Devil's in the (Political) Details

In principle, the announcement is good news because it suggests Rousseff hasn't given up on the notion of fiscal reform. It also implies that Levy still exerts some influence when it comes to economic policy. We think this recommitment to fiscal discipline could persuade other ratings agencies to delay any downgrades of their own. Moody's, which still considers Brazil investment grade, welcomed the news.

However, we think there's a substantial risk that the government will find itself unable to implement the plan in full. The initial reaction from legislators was barely lukewarm. Eduardo Cunha, the chairman of the lower house, said he wouldn't support the CPMF, though he did vow not to block the initiative in Congress. But he added that he thought Congressional approval this year "is close to impossible."

Meanwhile, local media reported that business leaders don't support the tax plan, especially given Brazil's worsening recession, and would prefer to see more aggressive spending cuts. It's unclear whether the federal government's offer to share the revenues from the CPMF with state governments will be enough in the current anti-tax environment.

Even some lawmakers from the ruling Workers Party oppose the plan, according to local newspapers, especially the proposal to freeze public workers' salaries. The more leftist wing of the Workers Party has called for special taxes on the banking sector and the wealthy. Even former President Luíz Inácio Lula da Silva has reportedly suggested relaxing the fiscal stance and lowering interest rates to boost growth. Organized civil servant unions have warned that they could go on strike.

Congress, Bribery Probe Still Problems

At this point, it looks as though Congress will water down the plan. That will make it difficult for the government to deliver on its fiscal promises in 2016. If Congress strikes the CPMF down, the government may have to rely on nonlegislated taxes such as a special contribution on gasoline consumption, known as the CIDE tax. This would result in less than half of the revenues that would have been generated by the CPMF. It would also push prices higher, thus compromising Brazil's anti-inflation strategy.

To be fair, the fiscal plan is mostly a patchwork rather than a comprehensive strategy to deal with structural fiscal difficulties, including spending rigidity and wage indexation rules. This most likely reflects the Rousseff administration's lack of political capital, which makes it hard to get Congress to sign off on deep reforms.

If Congress changes the plan significantly or if the president lacks the ability to push it through Congress at all, Levy may resign. That could lead to asset price volatility and provide extra incentive for the political opposition to push impeachment proceedings against Rousseff.

And let's not forget that the ongoing corruption investigation, which makes the political climate even more volatile, also makes it harder for the government to garner support for its fiscal plans. This week, the federal prosecutor's office formally accused 15 political figures, including former President Lula's chief of staff, of bribery. The probe has also extended to involve several high-profile international banks that Brazilian prosecutors say may have been involved in a pay-to-play scheme aimed at securing access to official contracts.

Against this backdrop, we think the risk of more ratings downgrades is high.

Display 1
The New Fiscal Plan

Impact of Main Projected Fiscal Adjustment Measures (BRL Billion)

Spending Reductions		
Delay in Public Wage Increases		7.0
Reduction in Housing Subsidy		4.8
Reduction in Healthcare Outlays		3.8
Reduction in Infrastructure Investment		3.8
Government Employment Freeze		1.5
Reduction in Agricultural Subsidies		1.1
Other		4.2
	Total	26.2
Revenue Increases		
Financial Transactions Tax		32.0
Increase in Tax on Capital Gains		1.8
Reduction in Export Subsidies		2.0
Reduction in Subsidies on Interest Income		1.1
Other		2.8
Minus Lower Projected Revenue From Existing Taxes		5.5
	Total	34.2
Total Projected Fiscal Adjustment		60.4

Through September 16, 2015
Source: Local Newspapers and AB

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