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Brazil: Closer to the fiscal precipice

Even as the politically fragile Temer government has loosened fiscal targets, an unruly Congress remains a growing problem

The weakened Temer government – which had once promised a "bridge to the future" – bowed to the politically inevitable this week when it sharply revised up its 2017–20 primary deficit targets. Although the market reacted well initially and ratings agency S&P reaffirmed Brazil's sovereign rating in a nod to Finance Minister Meirelles' efforts, we still see a serious risk of a downgrade before yearend.

Key judgments

- In a defeat for Temer's economic "dream team", the government has added R$199 billion in spending (equivalent to 3 per cent of GDP in 2017 terms) to the country's 2017-20 primary deficit targets after the Congress refused to pass austerity measures; Meirelles is increasingly in a position similar to that of Dilma's respected but ultimately sidelined Finance Minister Joaquim Levy in 2015.
- Although Meirelles succeeded in curbing a move towards bigger primary deficit targets, particularly for 2017 and 2018, the "Temer cost" for saving the enfeebled President appears likely to grow; meanwhile, there are signs that a feared plea bargain of a top financial operator of Temer's PMDB party has entered its final stretch.
- To keep the 2018 primary deficit at its new target, the government is betting on such optimistic forecasts as R$20 billion in extraordinary revenues for new infrastructure and energy concessions, but red tape and electoral politics could scotch these plans.
- The federal spending cap will face additional political pressure: there is a growing risk that it too could be lifted in 2018-19.

Important information
Please see disclaimer ⓘ

The bridge to a fiscally uncertain future . . .

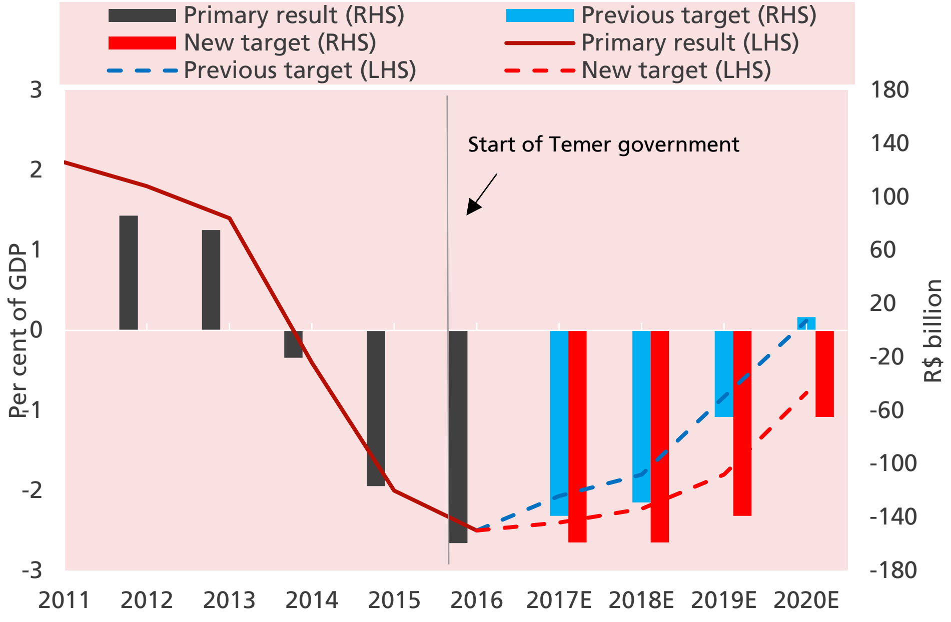
Brazil is on track to have seven consecutive years of primary deficits, after the Temer government sharply loosened fiscal targets

Following the legislature's refusal last week to vote through key austerity measures (for more details, see our 10 August 2017 note Is pension reform still possible?), the politically enfeebled Temer administration on Tuesday belatedly announced its new primary deficit targets – after having twice postponed that announcement in what is an ominous harbinger of the bruising political fight that lies ahead. As we anticipated last week, the 2017 and 2018 primary deficit targets have been revised up by a combined R$50 billion (US$15.7 billion / [R$3.18/US$]) to R$159 billion/year, which is level with the 2016 primary deficit. However, the government also loosened the 2019 and 2020 primary targets this week by another R$149 billion in extra spending (see Chart 1 below).

An additional 3 per cent of GDP in spending has been added to the 2017-20 primary budget forecast

This not only adds a combined additional total of R$199 billion (3 per cent of GDP in 2017 terms) to the 2017–20 primary budget deficit target; it also puts the country on track for seven consecutive years of primary deficits. In all, the government now projects R$522 billion in federal primary deficit spending in 2017-20, equivalent to 7.9 per cent of GDP in 2017 terms.

Chart 1: Federal primary budget surplus/deficit and targets



Sources: Finance and Planning Ministries.

The increased deficit is at odds with Temer's vow to put Brazil onto a fiscally sustainable path

While this comes as little surprise – indeed, we have long forewarned it would happen (for more background, see our 8 July 2016 note The fiscal abyss still looms; our 13 April 2017 note Temer digs an even deeper fiscal hole; and our 28 July 2017 note Can the market really decouple from the political crisis?) – the trend is clearly at odds with the Temer administration's long-touted goal of returning Brazil to the path of fiscal sustainability. Moreover, although Finance Minister

Henrique Meirelles tried to pin the blame for the missed fiscal targets largely on lower-than-expected inflation – which erased an estimated R$20 billion in 2017 tax revenues – rather than the Finance Ministry's own overly optimistic expectations, he failed to mention that populist salary hikes and related benefits granted by President Michel Temer in 2016 added an estimated R$30 billion to government spending this year alone.

Temer's political fragility has led to more fiscal erosion

Meirelles also avoided any mention of Temer's recent loosening of the fiscal taps (estimated at R$13 billion or more) in order to survive the Lower House vote on the first indictment charge against him (for more background, see our 3 August 2017 note The cost of Temer's victory). Nor did he refer to the legislature's growing unwillingness – even before the JBS plea bargain – to pass key austerity measures, which led directly to the current fiscal impasse (for more details, see our 28 April 2017 note Growing signs of friction in Temer's allied base).

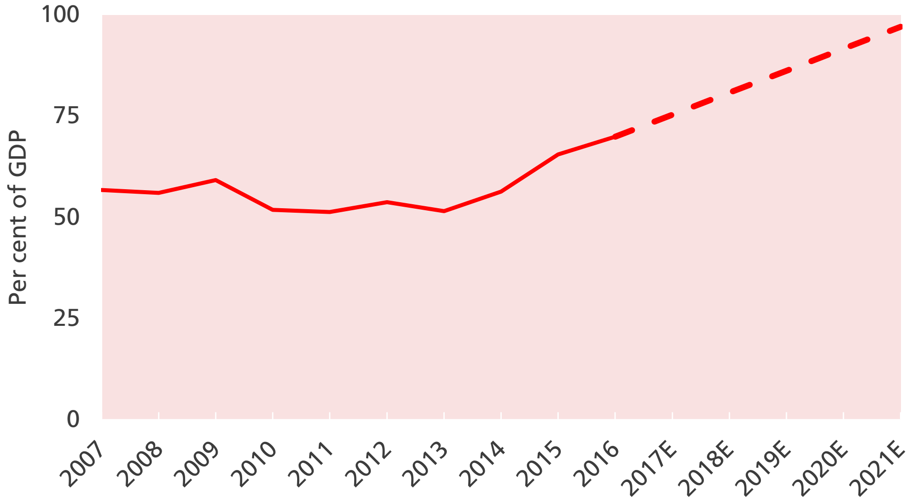
Meirelles is increasingly in a position similar to Dilma's former Finance Minister Joaquim Levy in 2015 . . .

The result is a big blow to Temer's economic "dream team", not least Meirelles, who had agreed to assume command of the Finance Ministry on condition that he have full autonomy to direct fiscal policy and set primary targets without undue political interference. One of Meirelles' longstanding mantras was that primary targets should be set early and maintained no matter what. This was designed to keep market confidence in the economic team high – a lesson that Dilma's respected but ultimately sidelined Finance Minister, Joaquim Levy, in 2015 had learned too late.

. . . faced with threats of legislative revolt and a blanket refusal by Congressional leaders to raise taxes

Another battle that Meirelles lost this week was his crusade to try to raise more taxes in order to increase revenues – a solution ultimately vetoed by Temer after top legislative leaders had once again balked at passing any significant tax hikes ahead of the 2018 October general election. In the latest sign of obstinacy on this issue, Senate President Eunício Oliveira – who belongs to Temer's PMDB party – on Wednesday warned that if it came to either revising up the primary deficit target or raising taxes, he would choose the former.

Chart 2: Brazil's rising gross debt level



Sources: Banco Central, TS estimates.

That means that if the government's quest for more extraordinary revenues in the next 18 months fails (see p. 8-11 for more details), the primary deficit target will rise more than the Finance Ministry is projecting in 2017–18. This, in turn, will push the country's already ballooning gross debt – at 73.1 per cent of GDP as of June – past 80 per cent of GDP by the end of next year and to more than 90 per cent as early as 2020 (see Chart 2 above), as we have previously warned.

. . . but a ratings downgrade has been delayed

However, although Meirelles emerged battered from this latest battle, he still came out on top this week, if only temporarily, in part because the government managed to hold the line against a concerted effort by Temer's allied base to push the 2017 and 2018 primary deficit targets to as high as R$170 billion/year. Furthermore, Meirelles took the precaution of reaching out to all three of the principal ratings agencies and reportedly asking them to postpone any downgrade by at least three months. All three ratings agencies currently rate Brazil's sovereign credit at two notches below investment grade, with a negative outlook.

Ratings agencies have given the administration the benefit of the doubt

In a sign of the respect that Meirelles still enjoys from the market, S&P – which had placed Brazil on "credit watch" in late May following the JBS plea bargain (meaning that there was a 50 per cent chance of a downgrade over the following three months) – removed the country from that list on Tuesday evening and reaffirmed its current rating. The agency did this on the grounds that: 1) the political landscape was "somewhat more settled"; 2) the economy appeared to have "stabilized despite fluid politics"; and 3) the government remains committed to advancing its reform agenda, including "some pension reform". Nonetheless, S&P acknowledged that the window for pension reform was closing fast – something that we have long highlighted would occur by Q3/17 (see our 22 July 2016 note Why the window for Temer's structural reforms is already closing). It added that failure by the Congress to pass key pieces of fiscal legislation could lead to a downgrade, as could the relaxation of fiscal targets by the government.

But the future of Brazil's rating will hinge on pension reform

Moody's, too, offered some temporary relief to the government this week while at the same time issuing a clear warning when it noted that it had expected a revision up of the 2017 primary deficit target but not of the 2018-2020 targets. Nonetheless, it indicated that it would likely await progress (or lack thereof) on pension reform before considering a ratings downgrade. Yet as we have previously written, once the one-year deadline to the October 2018 general election is reached, legislators will be increasingly leery of passing any pension reform that is not diluted to the greatest possible extent, meaning that we will soon know what the Congress has decided.

Ticking bomb ahead for Temer and the PMDB

The fiscal challenge is greater still because Temer needs support to win the vote against a second pending indictment charge

Although the political situation for pension reform at this late stage would be challenging even in the best-case scenario, the unpopular President is also facing growing difficulties in managing a rebellious Congress ahead of at least one more indictment charge by Attorney-General Rodrigo Janot expected within the next four weeks. While Temer won the Lower House vote against the first criminal charge (on passive corruption) against him early this month, he is still being investigated for two more charges: obstruction of justice and racketeering.

Meanwhile, legislative complaints against Temer this week were ominously reminiscent of those against Dilma

In the latest sign of Congressional rebellion, several members of a joint budget committee on Wednesday complained of the "arrogance" of the Temer administration in summarily vetoing several budget directives back in July and warned that, as a result, it would "not be easy" to pass Meirelles' new primary deficit targets. Although such threats do not necessarily mean that the committee will inflict a mortal blow on the new fiscal targets up front – particularly as the government has promised to release up to R$10 billion from its budget freeze by September should the targets be passed this month – the rhetoric in the Congress this week has been ominously reminiscent of the complaints against former President Dilma, Temer's ill-fated predecessor. We warn that this similarity should not be underestimated: Temer's ability to maintain governability is at growing risk.

A key micro reform – a presidential decree to reduce subsidized loans from the BNDES – is at risk of expiring

Meanwhile, the Centrão ("Big Centre") bloc of mid-sized and small parties has continued to set its sights on posts held by the market-friendly Brazilian Social Democratic Party (PSDB) – notably the Cities Ministry and the post of Government Secretary. While Temer is racing to free up second- and third-tier posts, party leaders have warned that if the most coveted posts are not ceded, they will not even support key micro-reform measures, such as a presidential decree that would reduce subsidized loans from state-run development bank BNDES by changing the fixed basic long-term rate (TJLP) – currently at 7 per cent – to a market rate (TLP) over the next five years. If the decree is not voted through by 6 September, it will expire, which would send another negative sign to the market. The measure has been championed by the economic team as having the potential to save up to R$100 billion and was also mentioned by Finance Minister Meirelles as an important reform in his discussions with ratings agencies.

An explosive plea bargain against Temer's PMDB by Lúcio Funaro is in the final stages . . .

Adding to the likely political shocks ahead for the government, there have been signs this week that the plea bargain of top financial operator of Temer's PMDB party, Lúcio Funaro (currently in preventive detention), has entered its final stretch and that Funaro could ink the deal before Janot leaves office. Only one roadblock remains to a deal being signed: a standoff between Funaro and federal prosecutors as to the length and conditions of his prison term. Although Funaro this week told local press that there was still a big difference between the two sides – suggesting that he is willing to hold out for better terms –

both sides have a clear incentive to signing the deal before Janot leaves office on 17 September.

If so, while it remains unclear if Funaro has enough dirt to bring down Temer and whether the plea bargain can be ratified by the nation's highest court (STF) before Janot's term ends, the risks ahead will be considerable for the administration. For example, Funaro has already told a lower-court judge in Brasilia that Temer personally asked that R$20 million in kickbacks from Caixa Econômica loans be funnelled into PMDB campaigns, including his own vice-presidential campaign in 2014.

. . . and, at a minimum, will push up the fiscal cost that Temer must pay to win the vote

Even if damaging evidence from Funaro's plea bargain does not come in time to swing the second Lower House indictment vote against Temer, it is likely to push up the fiscal cost that the President will have to pay to his allied base in return for their support. Furthermore, it has the potential to be devastating for the PMDB over the next six to 12 months, including for Temer's two closest advisers, Presidential Chief-of-Staff Eliseu Padilha and his infrastructure tsar, Wellington Moreira Franco (both of whom have also been seriously implicated by the Odebrecht plea bargain).

Funaro has hard evidence that will make life difficult for top PMDB members as well as dozens of congressmen

As a leading PMDB financial operator between 2010 and 2014, Funaro has the data and documents to prove that illicit wire transfers were made to high-ranking PMDB politicians (including the numbers of secret bank accounts, bank transfer slips, the contacts and meeting times of couriers, and other documents). Moreover, because Funaro was the only suspect who successfully made a plea bargain deal in the case of the 2005 *mensalão* ("big monthly allowance") scandal of former President Lula, he, unlike the others, has already been through the process once; and consequently, he has been extremely conscientious about keeping evidence to prepare for a potential future deal. To make matters worse for the members of Temer's allied base, Funaro was close to former Lower House Speaker Eduardo Cunha (currently in preventive detention) and Temer's former Government Secretary Geddel Vieira Lima (now under house arrest), and reportedly videotaped dozens of congressmen coming to his São Paulo office to pick up kickbacks.

Temer's victory in the indictment vote would likely worsen Brazil's fiscal situation, especially as other legal threats against him exist

Should the Lower House fail to give the green light to proceed with the indictment process again Temer, the President is likely to remain a weak and increasingly ineffective figurehead until the end of his term, making it even more difficult to advance with the reform agenda and keep the fiscal lid on an unruly Congress eager to push up spending ahead of next year's general election. To add to the possible threats against him, the Brazilian bar association (OAB) this week filed an appeal to the STF asking that its impeachment motion against Temer (which was summarily shelved by Lower House Speaker Rodrigo Maia) be given the green light. Although Justice Alexandre de Moraes, who is a Temer ally, has been put in charge of this case, a new scandal involving Temer could intensify public pressure for this or the nearly other two dozen impeachment motions against the President to proceed.

In this context, we continue to see Lower House Speaker Maia – who is next in line for the presidential succession and less tarnished by corruption scandals – as the better choice to take over as the country's interim President. The market may continue to be complacent about these risks, but we warn that things could easily swing from bad to worse for Brazil's fiscal situation. The larger the fiscal hole grows, the harder it will be for the next President to close it. At the same time, significant investments in the real economy are likely to remain on hold as both fiscal and political uncertainty grows ahead of the 2018 presidential election. This will not only delay the economic recovery but worsen the fiscal outlook as tax revenues continue to falter.

A closer look at the 2018 budget

Without pension reform or big tax hikes, the government faces a huge challenge in meeting its new 2018 primary deficit target

Just how difficult it will be for the government to balance its budget without pension reform is plainly evident from the government's preview of its proposed 2018 budget. While the social security deficit for the private sector is already projected to increase by an additional R$35 billion next year – up from around R$180 billion this year – and to grow by an additional R$40-50 billion/year in the future (absent a robust pension reform), the Planning Ministry could only come up with just R$14.5 billion of minor additional recurring revenues (see Table 1 below) to fill the budget gap, because the Congress had already rejected the idea of big tax hikes.

Table 1: Recurring tax measures proposed for the 2018 budget

Measure	Projected revenues (R$ billion)
Annual income tax on closed investment funds	6
Suspension of a planned increase in export tax credit deductions (REINTEGRA) of 2% of revenues to 3%; the tax credit will stay at 2% for 2018.	2.6
Full reinstatement of the payroll tax for more than 40 sectors*	4
Higher social security tax on federal employees of up to 14%	1.9
Total	14.5

*Originally proposed as a presidential decree, this bill recently expired after the Congress failed to vote it through; the government is planning to send a modified bill to the legislature in the hopes that this one will pass, but even if it does, the measure would only take effect 90 days after it is signed into law.

Sources: Planning Ministry, local press reports.

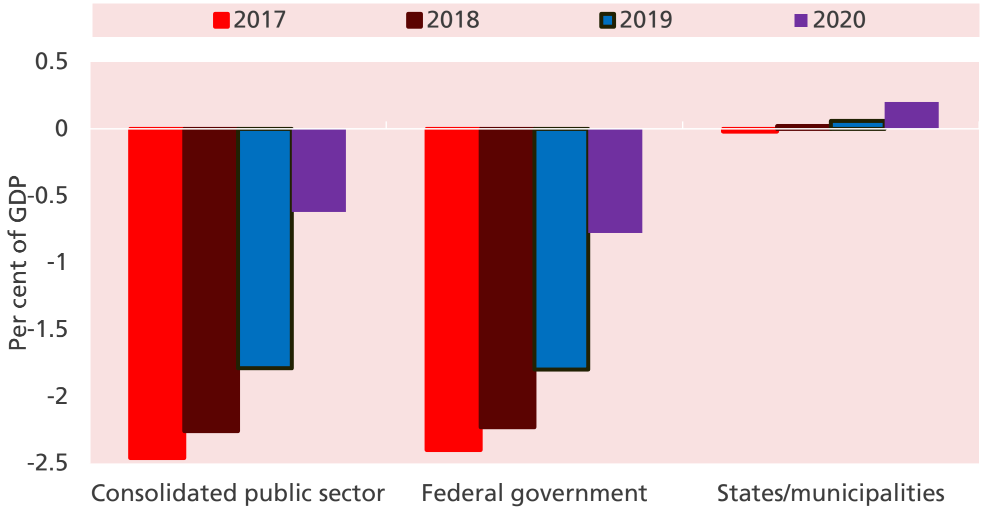
The planned postponement of federal salary hikes will run into opposition

On the cost-cutting side, the government has proposed a one-year delay of salary hikes (granted by Temer himself) for several categories of federal employees in the executive branch in 2018 in order to save R$5.1 billion. Even here, though, the government in the past week watered down the Finance Ministry's proposal of up to R$9.5 billion in fiscal savings by excluding military personnel from this measure. Meanwhile, federal employees have already threatened to stage protests against this proposal and there is also concern that the courts will rule in their favour. If that were not enough, all these measures must be approved by the Congress to go into effect, and there is no guarantee that legislators eager to win re-election next year will be up for the task.

Revenue projections for the consolidated public sector also appear overly optimistic

Overly optimistic projections were also evident for the consolidated public sector as well. For example, the Planning Ministry has kept its 2017-20 projections for fiscal savings from states and municipalities level with its previous estimates, even though it now projects that this category will receive R$8.5 billion less in planned federal transfers next year. However, with reduced funding, it is unclear how states and municipalities will be able to succeed in reversing their expected primary deficit this year of R$1.1 billion to a primary surplus of R$1.2 billion in 2018 and R$16.6 billion by 2020, amidst evidence that a growing number of states and municipalities alike are also heading towards a fiscal reckoning. We would not be surprised if current primary deficit projections are ultimately revised up even further.

Chart 3: New 2017-20 primary budget projections for the consolidated public sector



Sources: Finance and Planning Ministries.

The scramble for extraordinary revenues

The government is hoping to rely on revenues from more privatizations to meet its fiscal target for next year

As part of its effort to keep the 2018 primary deficit target at no higher than R$159 billion, Finance Minister Meirelles and Planning Minister Dyogo Oliveira this week also announced a series of measures aimed at boosting extraordinary revenues next year. With tax hikes off the table (at least for now), the administration has naturally been forced to switch its focus to privatizations (for more background, see our 23 February 2017 note Infrastructure agenda gains traction) and is racing to increase the number of concession auctions scheduled to be held next year in a bid to raise some R$20 billion.

Airport concession sales are at the heart of the new plan . . .

Although the plan is clearly a work in progress, the administration has promised to streamline the sale of additional airport concessions that could raise a projected R$6 billion. Following the successful sale this March of concessions to operate and expand four airports (for more on the airport concession sale see our 17 March 2017 note The war ahead), the government is hoping to sell another group of airports next year.

. . . and the government will test a new concession model next year

However, because it is devising a new concession model for these auctions, it is unclear how quickly this programme will come to fruition. As it currently stands, the model involves a scheme to group blocks of regional airports that will then be sold together. In the northeast, it is planning to sell the Recife airport in Pernambuco state in a single block with the airports of Campina Grande and João Pessoa in Paraíba state, Maceió in Alagoas state, Aracajú in Sergipe state and Juazeiro in Ceará state. In the centre-west, it wants to sell the airport concessions in Mato Grosso state, with the Cuiabá airport as its showpiece, alongside the airports in Barra do Garças, Alta Floresta, Sinop and Rondonópolis.

Although politicians like this idea, it is unclear still whether the new auction model will attract investors

This model has been welcomed by politicians, many of whom fear that once the concessions for airports in the main capital cities are sold, secondary cities will remain off the government's radar screen and thus attract limited investment in the future. What remains to be seen is whether this model will also appeal to investors, who could be concerned about bidding top dollar for airports that are being sold based on their future potential rather than proven current revenues.

The recent return of the Viracopos airport concession is a warning sign to investors

This issue has been highlighted by the recent decision of the owners of the concession for Viracopos International Airport in Campinas (São Paulo) – sold at great fanfare in 2012 – to forfeit the concession. The decision was made after both passenger and cargo traffic came in well below projected because of the economic downturn. We believe that the auction terms for these block concessions will ultimately cater to private-sector demand, which has been the case under the Temer administration to date. But any terms perceived as too favourable to investors are also likely to come under a magnifying glass, in turn sparking the risk of populist pushback in an election year.

São Paulo's Congonhas airport is a likely candidate to be sold next year . . .

Still up for debate in the government is the possible sale of the prime concession for Congonhas airport in the city of São Paulo. As the government scrapes the bottom of the barrel for new revenues, it has discarded – for now – its original idea of selling the concession for Rio de Janeiro's Santos Dumont airport. Both airports have been completely renovated by the government-controlled airport management company INFRAERO and would not need significant improvements. As a result, the government could charge a much higher concession fee for the assets, which would help close the gaping fiscal hole.

. . . but its sale could erode the already fragile finances of INFRAERO

However, there are real concerns that the sale of either airport – and especially Congonhas – would destabilize INFRAERO's already fragile accounts. This is because these two airports are the most important sources of revenue left for the state-run company. While the Planning Ministry has affirmed that it will sell the concession for Congonhas, the Transport Ministry has expressed strong opposition to the sale, precisely because of concerns about the future of INFRAERO. The Planning Ministry has also indicated that it would allow INFRAERO to sell its stakes in the concessions that were sold in the Dilma era, which include Brasilia, Guarulhos (São Paulo), Confins (Belo Horizonte) and

Galeão (Rio de Janeiro). But it is unclear how much the company could raise from stakes in these non-controlling holdings, not least at a time when passenger traffic continues to suffer because of the economic crisis.

Critics warn that selling these assets at the end of an economic crisis will mean lower revenues from their sale

Critics have also said that the government is picking the worst time to sell prized assets like Congonhas, because valuations may fall as a result of the decline in air traffic owing to the crisis. But the Planning Ministry argues that since only limited investment is required for Congonhas, it could raise as much as R$5.6 billion for that concession alone and also demand immediate payment of the concession fee. Without this payment, the government will fail to meet its projected fiscal target in 2018.

More energy assets on the block too

The sale of Eletrobras generation assets is being considered too . . .

In addition to its ambitious new privatization plan for airports, the government has announced a series of measures aimed at boosting extraordinary revenues in the energy sector by an estimated R$7.5 billion. The economic team is working closely with the Mines and Energy Ministry on two fronts – electricity and oil & gas.

. . . but new legislation needs to be passed for the sale of these assets

As regards electricity, the goal is to pass the new proposed regulatory framework for the power sector in order to allow the government to sell generation assets held by Eletrobras. Currently, these generation assets – which were forced to participate in the Dilma-era concession renewal programme – charge extremely low rates for the electricity they generate. As a result of these artificially low rates, Eletrobras has been losing money on its operation and maintenance. The new legislation – which is still in the public consultation phase – would allow the plants to charge market rates for their power. Once the rates are increased, the government would sell these generation assets to the private sector. However, under the current proposal, only one third of the revenues would go to the federal government; the remainder would be divided between Eletrobras and a government-controlled fund that invests in power infrastructure in under-served regions.

This could take longer than the government would like

Although the plan is good, it is based on the assumption that the new electricity model, which was introduced by the government only last month, will rapidly move through the legislative process and be approved in time to sell these assets as planned. But we believe that as members of the Congress are more focused on the political reform and securing their own survival in office, the government's micro-reform agenda will take longer to pass than the administration hopes. Furthermore, because it is a priority project for a weakened government, it appears increasingly likely that the approval of this reform – not to mention the proposed new regulatory frameworks for the biofuels, mining and natural gas sectors – will come at an as-yet-unknown cost for the administration.

Because of red tape, the government may have trouble meeting its privatization targets for 2017

As we have seen time and again in Brazil, longstanding plans for assets sales often fail to be implemented – and the Temer government has not proved an exception to this rule. For example, despite plans laid last year to sell the concessions of two highways and three railways in H2/17, thus far the administration has made only snail-like progress on these tenders. The first rail auction – of a southern segment of the North-South Railway – is currently scheduled for Q1/18, while the two highway concessions have been tied up at the Federal Audit Court (TCU) and may only be tendered next year as well. In addition, although it looks likely that the administration will eventually be able to raise R$11 billion from the sale of four hydroelectric plants controlled by Cemig, ongoing legal uncertainty has clouded the potential sale. This too means that the revenues may only come next year, rather than this year. Although the government is still projecting that it will raise a total of R$25.7 billion from concession sales this year alone, over 40 per cent of its projection was seen coming from the sale of the Cemig plants.

Likewise, the planned sale of six power distribution companies controlled by Eletrobras could fail to take place by yearend. Eletrobras CEO Wilson Ferreira said last week that the company is still waiting for the final concession terms to be released by the BNDES next month. With the clock already ticking down, it will be difficult to complete the sale of the six companies by the end of the year. Furthermore, because these distribution companies are not profitable, the revenues from their sale could be limited.

The Planning Ministry is also considering early renewals of concessions that expire in 2028 . . .

In addition to the privatization plan, the administration is floating the idea of boosting revenues by offering early renewals of concessions for electricity assets that were sold in the late 1990s. These 30-year concessions – which expire in 2028 and are held by companies such as AES Tietê, China Three Gorges and Engie – would be renewed ahead of schedule for a fee. We believe that it is unlikely that these concession renewals will take place next year, especially since the TCU has already rejected other government proposals to offer early concession renewals or extensions to the private sector. As a result, these revenues are unlikely to make it into the public coffers next year, as hoped.

. . . and mulling additions to its planned oil & gas auctions to boost revenues

On the oil & gas side, the administration is also considering increasing the number of offshore areas that it offers in next year's auctions. With high hopes that the three upcoming offshore oil & gas auctions that it has planned later this year – one in September (the 14th E&P Round) and two long-awaited pre-salt rounds in October – will be successful, the government has already announced plans to hold four more oil & gas auctions in 2018 and 2019. This includes two auctions for E&P concessions and two pre-salt auctions. Although the offshore areas to be sold off have already been determined, the government is considering increasing their number in next year's auction in an effort to boost revenues. Though potentially positive for 2018, the plan could reduce revenues in 2019, when the new government will also be scrambling to meet its primary deficit target – thereby making it a case of robbing Peter to pay Paul.

Conclusion: The federal spending cap at risk

As a result of its failures in the legislature, the government has also failed to address the long-term fiscal imbalance

The government's increasingly frantic struggle to come up with viable measures that will boost short-term revenues and help close the fiscal gap in the absence of a robust pension reform highlights the risks to the country's long-term fiscal sustainability. The use of extraordinary revenues is not a new approach – indeed, it was the go-to plan for both the Lula and Dilma administrations. Because these revenues often fail to materialize, Brazil consistently missed its fiscal targets during the Dilma government, although some of these problems were masked with the use of creative accounting. Although the current administration has not resorted to such techniques, it has failed in the one arena it was supposed to be an expert at – legislative deal-making for key fiscal reforms. As a consequence, the fiscal hurdles that the country faces in the short and medium term have ballooned, notwithstanding the top-notch economic team working with Finance Minister Meirelles.

Focused on re-election, legislators are unwilling to boost tax revenues or to cut spending

Since the 2018 presidential election is right around the corner, Brazil will face some difficult challenges. In recent history, the tendency of incumbent Presidents has been to boost spending in election years. But without pension reform and with the Congress also opposed to big tax hikes, the current administration will be hard pressed to come up with new sources of revenues. This means that its only major structural reform to date – the federal spending cap – could soon be threatened too.

The federal spending cap is already acting as a fiscal straitjacket . . .

When the legislation on the spending cap was passed late last year (for more background, see our 14 October 2016 note The race to jump-start growth), it was interpreted by many in the market as a precursor of a likely pension reform and consequently the ideal answer to Brazil's immediate fiscal woes. But the reality has always been that the spending cap – as we forewarned back then – was an imperfect solution that would act as a fiscal straitjacket for important areas of the federal budget, while doing nothing to curb ballooning pension payouts. Its effectiveness was therefore guaranteed only if pension reform were approved too.

. . . even as pension reform has been put on the legislative back burner

But with politicians in Brasilia across the political spectrum more interested today in securing their own survival via voting through a highly questionable political reform ahead of the one-year deadline to the October 2018 election, the pension overhaul has been pushed to the back burner. Moreover, the longer it takes for a real pension reform to be approved, the more onerous and politically unsustainable the spending cap will become. When even a deeply experienced politician like Temer is finding it difficult to govern a fragmented legislature composed of nearly 30 political parties – handicapped as he is by increasingly scarce funds with which to convince legislators to vote in the government's favour – it will be still harder for less skilled politicians.

Without pension reform, the next President could be forced to repeal the spending cap

We believe that the new President who takes office in 2019 could immediately be forced to water down or even repeal the spending cap legislation because it will be impossible to comply with its strict terms. In a worse case scenario, this topic could be anticipated next year, in the run-up to the 2018 presidential election. And while a viable tactic for a market-friendly President could be to try to muscle through a pension reform by offering an increase in the federal spending cap in exchange for the approval of the former, the short-term effect of such a strategy would be to boost Brazil's primary deficit expenditures even further, thereby delaying a return to fiscal sustainability.

This topic could be raised during the 2018 presidential race, which could add to market jitters

Furthermore, there is still no guarantee that Brazil will elect a centre-right candidate next year. For now, it is an open question whether former President Lula will be in the race. Yet even if he does not run, the other likely candidate on the left – former Ceará Governor Ciro Gomes – espouses economic policies that are reminiscent of the Dilma era. We believe that it is possible that Ciro, along with other candidates, will attack the spending cap during next year's campaign, highlighting the risk that Brazil's fiscal policy will continue to stay off course when the new government assumes power in 2019.

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