Scenarios

Brazil: The New Government's First Year, Review and Outlook

The Political Economy

EGA

POLITICAL ECONOMY IN 2023

In 2023, Brazil's political economy was marked by significant efforts to mitigate the impacts of the previous government's expenditures. The primary focus was on increasing revenue, a task that demanded considerable effort from the government.

Fernando Haddad, who assumed the position of Minister of Finance amidst skepticism, surprised those who questioned his political ability. After a modest start, by the end of the year Haddad ended up being recognized as the government's chief negotiator with Congress. The minister successfully secured the approval of crucial measures that were instrumental in achieving the desired increase in revenue, in addition to the most significant and impactful tax reform in decades.

Haddad also established a zero-deficit goal in the 2024 budget, a remarkable feat that solidified his position as Finance Minister.

For the Brazilian economy, 2023 was a year of challenges and achievements. Under Haddad's leadership, the country took important measures to ensure economic and social stability. The year concluded with government victories, but much work remains to be done, given the need for fiscal control to achieve the zero-deficit target.

Finances

CONTEXT

With the negotiations and approval of the Transition PEC (Constitutional Amendment Proposal), which authorized the new government to increase the spending ceiling by up to BRL 145 billion for one year, President Lula da Silva's administration began working already in late 2022. In the second half of January, the newly appointed minister, Fernando Haddad, announced the first of many packages aimed at improving public finances. In this initial set of measures, changes to CARF (Administrative Council of Tax Appeals), voting procedures, and the end of tax exemptions on federal fuels were announced, both reversing policies implemented by the Bolsonaro government.

The minister's urgency bothered the newly-elected parliamentarians, leading Haddad to slow down negotiations at the beginning of the legislative year. Haddad's intensified his efforts, however, as the months passed. Amidst both successes and mistakes, the minister ended the year recognized as the chief negotiator for the government, successfully gaining approval for his package of measures to reduce the primary deficit, along with the most significant tax reform in decades.

Tax Reform

In his third term as president, Lula chose tax reform as a top priority for his government. This was evident in the establishment of the Extraordinary Secretariat for Tax Reform within the Ministry of Finance. The approval of PEC 45/2019, considered the main triumph of the economic portfolio in 2023, was a milestone, given the urgency of deadlines and the efforts of both the Senate and the Chamber of Deputies.

In this process, the support of the presidents of the Chamber of Deputies and the Federal Senate, Arthur Lira (PP/AL) and Rodrigo Pacheco (PSD/MG), respectively, was crucial for the reform's approval. The promulgated Constitutional Amendment specifically addresses consumption taxation but sets a deadline for the executive branch to submit proposals for changes to income and payroll taxation.

Macroeconomic Policies

Fiscal Framework

The August 2023 approval of the Fiscal Framework, which replaced the Spending Ceiling regime, marked the beginning of a new phase of the Finance Ministry's endeavors in Congress. With ambitious goals to eliminate the primary deficit in 2024, Haddad needed to submit controversial projects to Congress, primarily related to revenue increase, as the government, concerned with maintaining and expanding social policies, resisted reducing its expenditures.

Measure to increase revenues

- **CARF's Casting Vote**

  Changes in tie-breaker rules in CARF voting (Provisional Measure 1160/2023) represented the first major clash of the Ministry in Congress. In addition to the dispute between the Chamber and the Senate regarding the processing of provisional measures, which resulted in the executive sending Bill 2384/2023 to Congress for discussion, Haddad also had to personally explain the importance of approval to lawmakers. The project was approved in August and became Law No. 14,689, on September 20, 2023.

- **Taxation of Offshore Funds and Exclusive Funds**

  Due to conflicts regarding the process of provisional measures, the taxation of offshore and exclusive funds was another controversial topic that the executive needed to send to Congress for prioritization (Bill 4173/2023). The project was essential not only to pursue the zero-deficit target in 2024 but also to justify the increase in the income tax exemption threshold for individuals, approved in the first semester. The new taxation was approved in the middle of the second semester and transformed into Law No. 14,754, on December 12, 2023.

- **Regulation of Fixed Odds Betting (Betting Bill)**

  The regulation of sports betting (Bill 3626/2023) fit perfectly into the new government's agenda, which spent the year exploring new revenue sources. Hindered during the Bolsonaro administration due to strong pressure from Evangelicals, the topic became a priority for the Ministry of Finance from the first month of the term. With initial revenue expectations close to BRL 2 billion, there are projections that the inclusion of online casinos in the text could raise it to a figure close to BRL 15 billion. The bill was approved on the last day of legislative sessions for the year and became Law No. 14,790 on December 29, 2023.

- **Subsidies Bill and Changes in Interest on Equity (Provisional Measure 1185)**

  One of the government's recent victories in Congress, the Subsidies Bill (Provisional Measure 1185/2023), was unlocked after an agreement to overturn the veto on payroll tax relief. According to the bill, subsidies granted by the Union, states, or municipalities should be included in the calculation base for federal taxes such as IRPJ, CSLL, PIS, and Cofins. The government also seized the opportunity to introduce changes to the rules for Interest on Equity (JCP). Finance Minister Haddad's initial idea was to eliminate the mechanism but, without agreement from lawmakers, the alternative was to make fraudulent distribution more difficult. The Ministry of Finance believes that, with this change, revenue could increase by BRL 10 billion in 2024. The bill was approved in the last week of the year and became Law No. 14,789 on December 29, 2023.

Microeconomic Policies

Another focus of the Ministry of Finance for the year was the pursuit of improvements in the credit environment. This has been the primary challenge for the Economic Reforms Secretariat, led by Marcos Pinto. His team made progress on some projects considered important for the government, such as the Guarantees Framework (Bill 4188/2021), transformed into Law No. 14,711 on October 30, 2023, but some are still pending analysis, such as the Insurance Framework (PLC 29/2017).

In addition, the Finance Ministry also emphasized debt reduction, highlighting the Desenrola Program (Law No. 14,690, dated October 3, 2023), a debt renegotiation initiative. During its discussion, lawmakers took the opportunity to address the issue of increased interest rates on revolving credit by instituting a cap of 100% of the debt, approved in Congress and later endorsed by the National Monetary Council (CMN) months later.

Interest rate

With differing views on the variation of the benchmark interest rate, President Lula and the President of the Central Bank, Roberto Campos Neto, had some public disagreements throughout the year. Finance Minister Fernando Haddad alternated between reinforcing President Lula's criticisms of Campos Neto and seeking dialogue with the institution to reach a consensus on the interest rate.

After these disagreements and changes in the Central Bank's leadership, the government managed to initiate a cycle of interest rate reductions. In January, the Brazilian federal funds rate (Selic) was at 13.75% and by December 2023 it had already decreased to 11.75%. However, the government still does not have full control of the institution, as the current president's term concludes at the end of this year.

What to expect for 2024?

The Finance Ministry's greatest challenge in 2024 will be to maintain the targets set by the Fiscal Framework during an election year, which is shorter and more challenging in legislative terms. Achieving a zero deficit will already be a significant initial challenge but reaching a primary surplus in 2025 is even more ambitious. To further complicate Finance Minister Haddad's situation, the payroll tax exemption for 17 sectors remains a reality, despite the government’s thus-far unsuccessful attempts to reduce its impact on the budget.

Gradual Reversal of Payroll Tax Exemption, PERSE, and Tax Compensation (Provisional Measure 1202)

The first obstacle of the year will be resolving the issue of overturning the veto on the extension of the payroll tax exemption. The minister took a controversial step by sending an MP in 2023 that bypasses the Congress decision and gradually reverses the exemption for these sectors starting in April. The Provisional Measure also repeals the Emergency Program for the Resumption of the Events Sector (PERSE) and limits tax offsets.

The Ministry of Finance is committed to exploring possibilities that can mitigate the anticipated impact and has been tirelessly dedicated to negotiations, seeking alternatives that may result in positive effects for all involved. Regarding the possible partial return of the MP, there is no consensus among the senators. With the start of legislative activities, some meetings have already taken place, and the expectation is that the MP will be maintained, but the payroll tax exemption, a more sensitive issue in its text, is likely to be addressed through a new bill.

It is important to note that the unease among the lawmakers is evident, as shown by ongoing meetings between the Ministry of Finance, presidents of the legislative houses, and party leaders. This active dialogue highlights the sensitivity of the issue and the search for consensus that takes into account various perspectives. However, the final decision on the measures to be adopted is not likely to be made until mid-March.

Regulation of Tax Reform

Another priority for the Finance Ministry will be to advance the Tax Reform regulation approved last year. The regulations regarding consumption will need to be submitted to the legislature via a complementary bill (PLP) by June 17, 2024, as stipulated in the PEC-approved text. Considering the expectation that the Congress may be less active in the second semester due to municipal elections, the economic team has been working to submit this/these project(s) as early as possible. One possibility is to submit the income reform along with the regulation of the consumption reform in March.

To assist in the development of these regulations, the Finance Ministry has established 19 working groups that will discuss different aspects of the Constitutional Amendment. The government aims to seek collaboration from the private sector for this purpose, but formal invitations have not yet been extended.

Income Reform and Interest on Equity

Minister Haddad has already spoken about the difficulty of approving an Income Reform this year. The need to comply with the Fiscal Framework, in addition to the regulation of the Tax Reform, would, according to Haddad, practically take up all the time available for negotiations with lawmakers. However, according to the Constitutional Amendment of the Reform, the text will need to be submitted by March 19, 2024. Additionally, the minister left open the possibility of regulating issues such as Interest on Equity (JCP) through intralegal norms such as ordinances, but did not delve into the matter.

Central Bank Presidency

The appointment and approval of the then executive secretary of the Ministry of Finance, Gabriel Galípolo, for the Directorate of Monetary Policy of the Central Bank, played a crucial role in initiating the desired interest rate reduction by the government. With the recent achievement of the autonomy of the Central Bank and the impossibility for the President of the Republic to dismiss the President of the Central Bank, it is evident that the process of choosing directors and, especially, the future president of the institution must be carried out with extreme caution and criteria by the presidency.

Campos Neto's term ends on December 31, 2024, so discussions about his successor should take place throughout the year, allowing for a clearer and more accurate understanding of the directions the Brazilian economy will take in the coming years. The expectation is that Lula's nominee will be someone capable of leaving their mark on the conduct of monetary policies, reflecting the ideals and goals set by the government. The choice of the next director of the Central Bank, therefore, goes beyond the technical sphere, becoming an important gauge for the expectations and guidelines that will guide economic management under Lula's leadership.

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