Lula from a fiscal policy perspective

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Fiscal policy under Lula's first government

The fiscal budget is the outcome of the desires from different society segments to benefit from scarce public resources. Costs range from pensions, civil servants' salaries, public services, welfare system, economic growth stimulus projects, etc. It is up to the elected government to balance out these demands against the limited resources available. The latter is also partially determined by society whenever the tax burden is redefined.

The only time Lula was ever called upon to face the limits imposed by fiscal restrictions was in his first year of government. Lula chose to uphold orthodox macroeconomic policy – responsible fiscal and monetary policies – instead of softer solutions to the economy's adjustment. In February 2003, the primary surplus target increased to 4.25% of the GDP from 3.75%, as suggested by the previous administration, imposing a 14-billion (1.0% of GDP) cut to that year's planned budget (link).

Figure 1: Budget cuts implemented in February 2003

Social Areas	From (R$ mn)	To (R$ mn)	%
Cities	2.200	326	↓ 85,2%
Bureau of Women Policies	24	4	↓ 83,3%
Bureau of Human Rights	120	23	↓ 80,8%
Agrarian Devlopment	1.100	709	↓ 35,5%
Labour	785	523	↓ 33,4%
Social Assistance	1.230	984	↓ 20,0%
Social Security	1.470	1.220	↓ 17,0%
Health	2.464	2.300	↓ 6,7%
Education	7.200	6.920	↓ 3,9%
Food Safety	1.750	1.720	↓ 1,7%

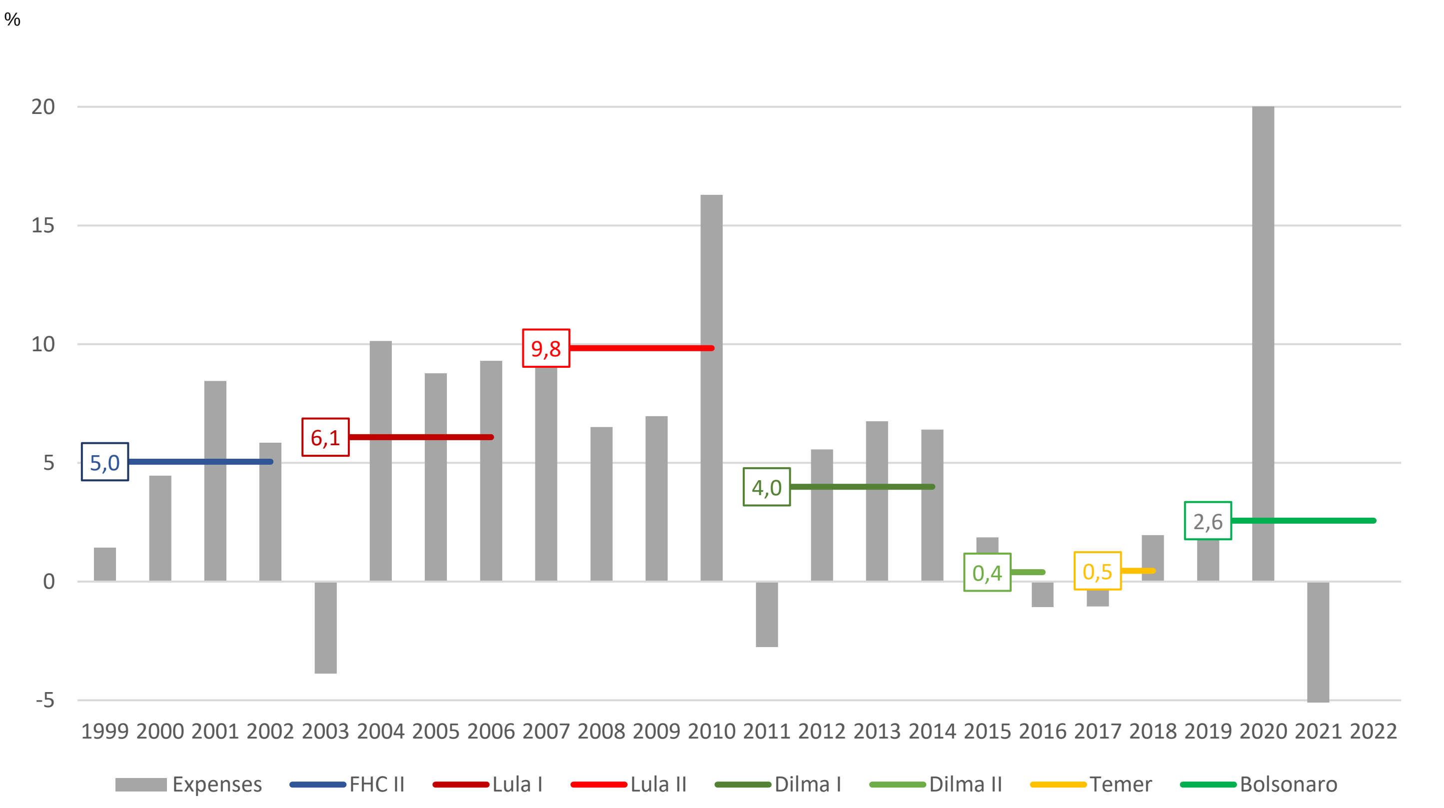
Other Areas	From (R$ mn)	To (R$ mn)	%
National Integration	2.046	188	↓ 90,8%
Sports	370	43	↓ 88,4%
Transports	3.930	1.390	↓ 64,6%
Enviromnet	785	340	↓ 56,7%
Culture	265	129	↓ 51,3%
President´s Office	471	284	↓ 39,7%
Defense	4.620	3.190	↓ 31,0%
Communications	643	446	↓ 30,6%
Mines and Energy	1.280	1.000	↓ 21,9%
Vice-President´s Office	2	2	↓ 11,8%
Union Advocacy	57	46	↓ 19,3%
Intelligence	34	30	↓ 11,8%

Source: *O Globo*, Mar Asset Management

How Lula's administration handled orthodox fiscal policy during his presidential term was clear: prioritizing social spending over investments. The cuts announced in February 2003 were mainly to public investments. More than half from the congressional amendments (already in place then) and the other half, above all, to investments related to the Ministry of National Integration and Ministry of Cities, at the time headed by Ciro Gomes and Olívio Dutra, respectively. Lula upheld the increase to the minimum wage and staff payroll, and the budget for welfare programs. The chosen platform focused on a State centered on social welfare instead of assuming a growth-inducing role.

Lula's administration did not face an enduring situation regarding excess desires in relation to the capability of financing them. From 2004, economic growth was so robust that public resources were abundant for the rest of his terms in Brasília. Despite launching and expanding new public policies, the fiscal balances were better than the targets stipulated year by year. Ultimately, except for 2003, primary expenses grew every year, reaching an annual pace of 6.1% between 2003 and 2006 (Figure 2). Social frictions common to budget planning were very mild, even more so because of a strong GDP and employment growth backdrop.

Figure 2: Real growth of federal government primary expenses by year



Source: *Tesouro Nacional* (National Treasury of Brazil), Mar Asset Management

Despite fiscal ease, the strategy aimed at social spending was kept in place throughout the first term. Spending on investments contracted -1.0% a year, on average, between 2002 and

2006, while spending on welfare benefits grew 8.5% a year. The minimum wage had a real gain of 6.9% in this same comparison basis.

Figure 3: Federal government income and primary expenses growth for selected periods – real growth rate by year (1998-2015)

%, a yr.

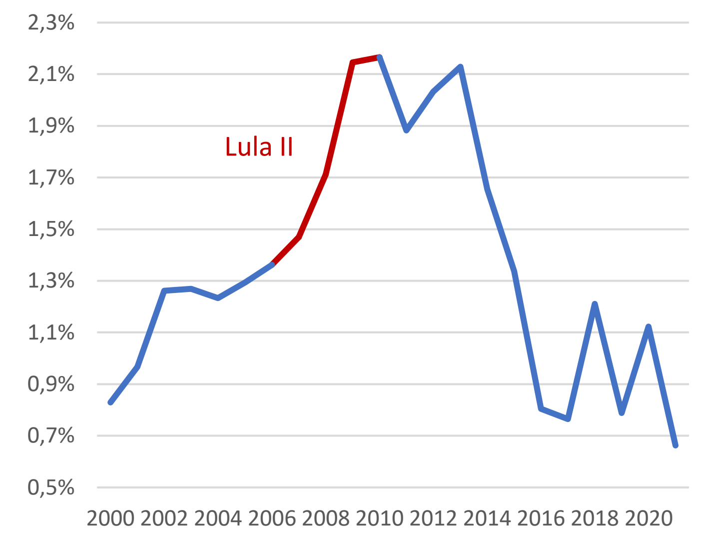
	1998-2002	2002-2006	2006-2010	2010-2014	2014-2015
Total Revenue	**6.5**	**4.7**	**3.6**	**1.5**	**-6**
Total Expenses	**3.9**	**5.2**	**5.5**	**3.8**	**-3.2**
Staff	4.4	1.3	4.1	-0.4	1.7
Social Benefits	5.7	8.5	4.5	4.6	-0.1
Subsidies	-12.5	29.7	17.2	20.7	-11.9
Operational Costs	2	3.6	4.8	4.5	-4.5
GFCF	-1.2	-1	24.5	0.3	-41.7
Other Capital Expenditures	0.4	-3.3	11	-2.5	-14.2
GDP	**2.3**	**3.2**	**4.6**	**2.2**	**-3.8**

Source: *IPEA* (Institute for Applied Economic Research) Orair (2016), Mar Asset Management

Lula's second term was even less restricted. Besides keeping with social spending growth, his administration changed its strategy about the State's role. From then on, the State would also be the primary inductor of GDP growth. Public investments from direct public administration grew 24.5% a year on average between 2007 and 2010. Para-fiscal spending also climbed up the ladder. Investments by state-run companies grew two-fold between 2007 and 2009, and the *BNDES*'s (Brazilian Development Bank) spending neared 4% of GDP. Not only did government programs assist the poorer class, but they also increased subsidies and government contracting, amplifying the share of society directly benefiting from public spending.

Figure 4: State-run companies' investment

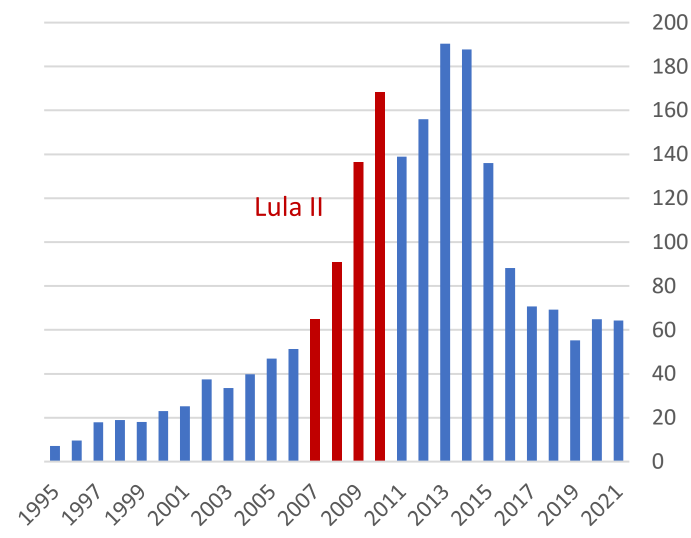
% of GDP



Source: *Ministério da Fazenda* (Ministry of Finance), Mar Asset Management

Figure 5: BNDES outlay

R$, bi.



Source: BNDES, Mar Asset Management

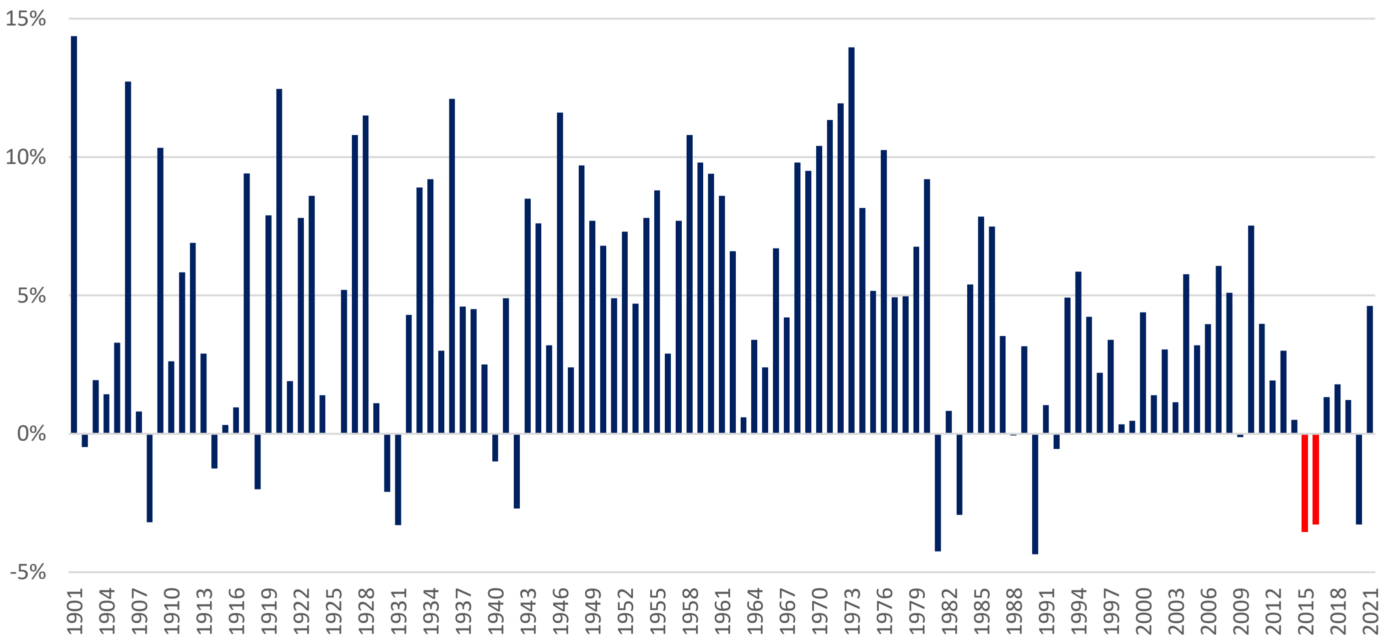
The fiscal crisis under Dilma's administration

When the *PT* administration was forced to recalibrate fiscal policy more intensely, tragedy came about. The slowdown in economic activity during Dilma's term affected tax collection. The government went all-in on their bet, incrementing fiscal and para-fiscal stimulus measures in an economy that was already above full employment. The government implemented an aggressive model of expansionary fiscal policy, which demanded fiercely tight monetary conditions via increased interest rates, placing fiscal dominance first and foremost and ruining economic confidence altogether.

Economic growth, as expected, failed to occur, the fiscal balance worsened every single year, and the negative commodities shock in 2014/2015 triggered a confidence crisis, leading the country to the arguably worst recession in history.

Figure 6: GDP growth since 1901

%



Source: *Ipea* (Institute of Research and Applied Economics), Mar Asset Management

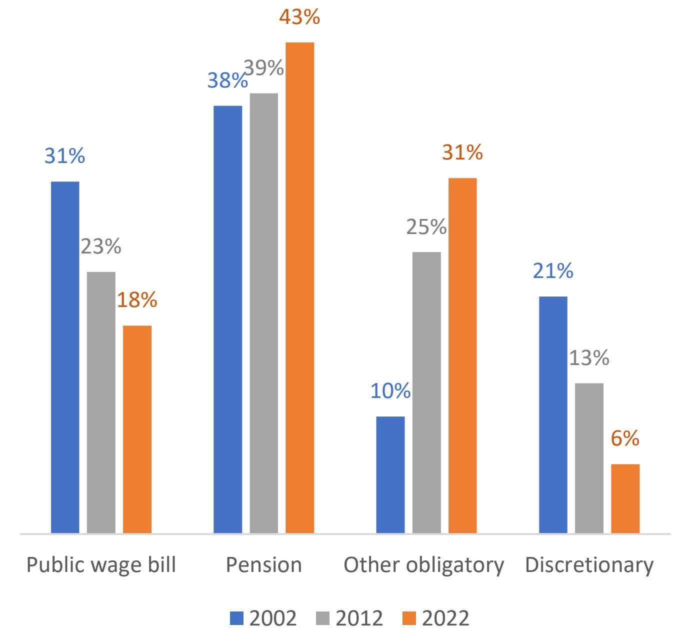
Dilma's administration's reaction to the fiscal balance deterioration was untimely and dubious. In 2014, the primary balance was negative for the first time since the 1990s, arousing a confidence crisis. To combat it, Dilma called upon Joaquim Levy for the Ministry of Finance to promote the necessary fiscal adjustment. From early on, the new minister implemented tax hikes and subsidies reduction. The crisis revealed itself to be much more significant and broader than imagined. Brazilian big oil Petrobras began an aggressive process of deleveraging, BNDES's spending shrunk, the water crisis and the BRL devaluation pushed inflation up high, and the GDP dwindled by nearly 4% in 2015. The measures then were insufficient to halt the fiscal balance from worsening at Mach speed.

When minister Levy took office, there was little fiscal room to act. A decade earlier, backed by strong economic growth, Lula's lack of budget restriction encouraged him to take on promises that outlasted his time in office. The problem was that many measures that did fit into Lula's budget were, by nature continuing and mandatory expenses. In other words, permanent. The following presidents were sure to suffer (or enjoy) their consequences. In plain English, these measures increased primary spending during Dilma's administration.

The year 2015 demanded too big a fiscal adjustment for such little room and budget rigidness. Levy was left with attempting to implement fiscal squeeze measures in areas, which, mainly in President Dilma's viewpoint, would do more harm than good to the fiscal balance, for they would further impair GDP growth. The best example was the minister's proposal to end the payroll tax break, contested in public by Dilma (e.g., link). Levy had been in high water and was eventually replaced by Nelson Barbosa in 2015's end. The latter did not have enough time to warm his seat, as Dilma was ousted in April 2016, relegating a primary deficit of -2.5% of GDP.

Figure 7: Composition of primary expenditure

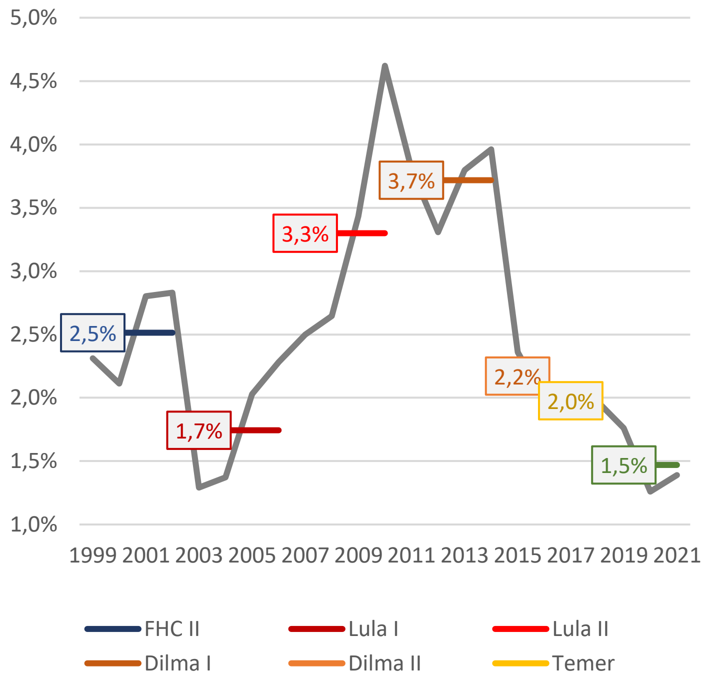
% of GDP



Source: *Ministério da Fazenda* (Ministry of Finance), Mar Asset Management

Figure 8: Investments as % of total federal government primary expenditures

R$, bi.



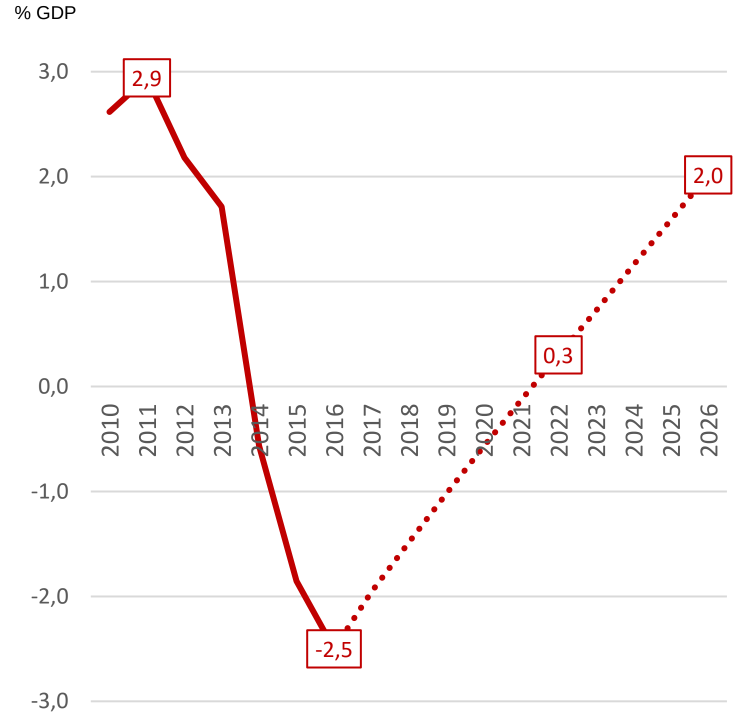
Source: Observatório de Política Fiscal, Mar Asset Management

The 2016 fiscal adjustment

Michel Temer took office amid a recession, a negative 2.5% primary deficit, and very narrow fiscal leeway. It was common knowledge that the fiscal situation was unsustainable and that a solid fiscal adjustment was due. Because more than 90% of expenses were mandatory, the possibility of carrying out an adjustment close to 4 points of GDP – necessary scope to make debt sustainable – focused solely on chopping expenses was not viable. Furthermore, such an immense tax burden increase seemed equally unacceptable given the critical economic situation at that time. The solution to bypass the public balance confidence crisis was elaborating a plausible plan for the primary result, in the long term, to return to a level compatible with debt sustainability.

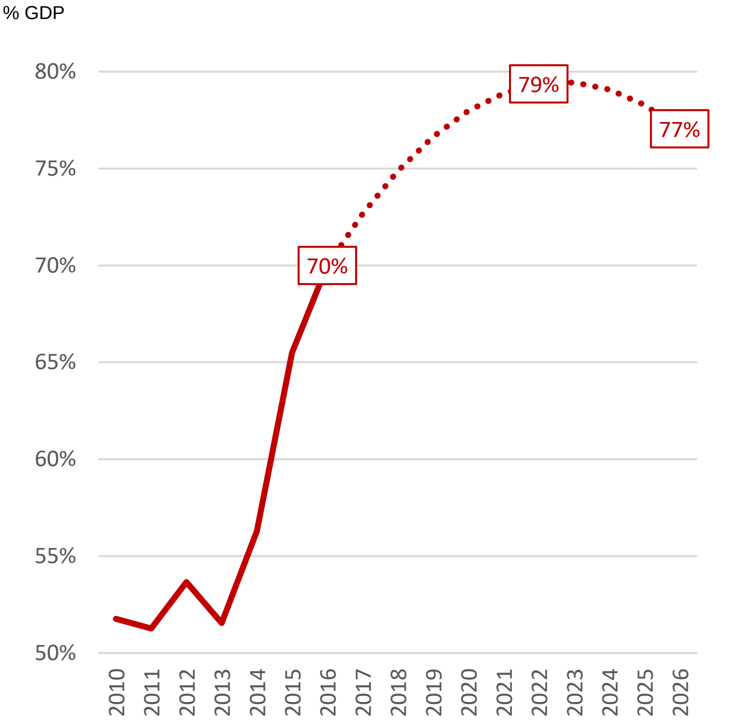
The spending cap was signed into law in late 2016. The measure did not enforce any effect on spending reduction initially. It was a mere commitment that primary expenses would remain "frozen" for ten years. This would allow for the primary balance, with GDP growth throughout the years and, thus, tax revenue, to converge gradually towards levels supporting public debt stability. It was up to the following governments to take the necessary measures to fulfill this rather tricky promise.

Figure 9: Observed vs. estimated primary surplus at the time of spending cap bill approval



Source: BCB, Mar Asset Management

Figure 10: Observed vs. estimated General Government Gross Debt at the time of spending cap bill approval



Source: Banco Central do Brasil, Mar Asset Management

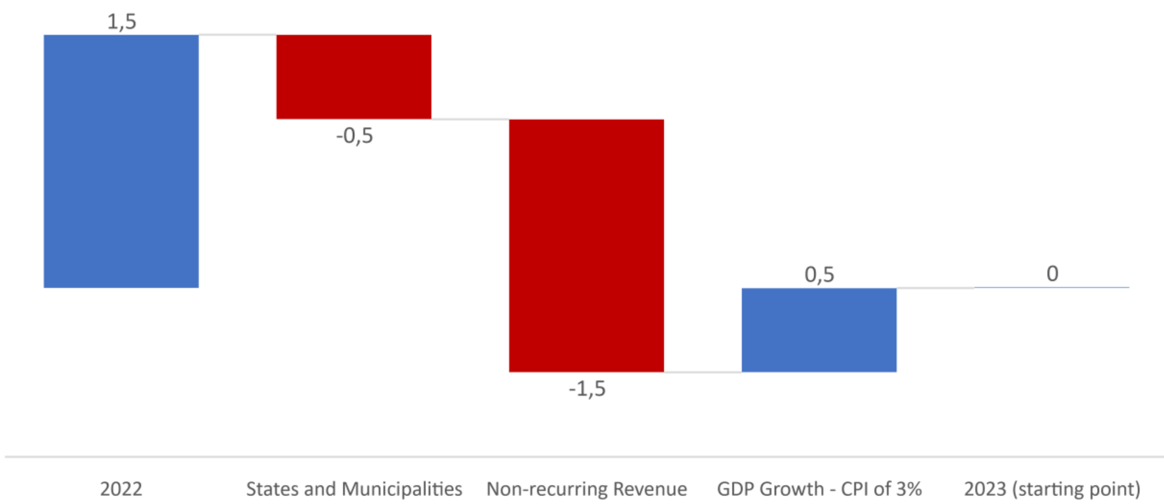
Brazil under Bolsonaro/Guedes

With extreme fiscal restriction, no budget slack for investment, and discretionary expenses close to the minimal threshold, Bolsonaro's administration had no choice but to implement social and staff spending cutbacks. The government approved the social security (*INSS*) reform in 2019, the minimum wage had no real gain since 2017, and the government implemented a widespread government staff expenses reduction by not granting nominal increases to salaries and extensively reducing civil servants hiring throughout his term.

Increased expenditures during the Covid-19 pandemic were largely accounted for by a nominal GDP growth well above expectation. Ultimately, Bolsonaro's administration's final year will end with a primary balance adjusted to non-recurring revenue close to zero. Not too different a starting point from what was expected for this moment back in 2016, when the spending cap was made law. The same applies to the gross debt level. Despite all the economic mess brought about by the pandemic and its fiscal responses, government Lula III starts from a fiscal point in line with the plan devised in 2016.

Figure 11: 2022 Primary Surplus and 2023 Starting Point

% GDP



Source: *Tesouro Nacional* (National Treasury of Brazil), BCB, Mar Asset Management

Lula is not Dilma. But who, in fact, is Lula?

Mutatis mutandis, the current scenario, is roughly similar to late 2002. Brazil had fragile fiscal accounts in both periods, but previous governments had already implemented measures that demanded little change to ensure a sustainable fiscal path. There was no need to pass significant reforms to guarantee the country's solvency. Even so, both required a clear indication from President Lula that he would uphold a responsible fiscal policy.

This indication is costly and involves first breaking (or postponing) campaign promises. We witnessed that in 2003, with budget cuts regarding socially attractive investments, such as irrigation projects in the semi-arid Northeast. Most of the market expected something similar this time around. For instance, he would maintain the spending cap, excluding only expenditures needed to cover *Bolsa Família* (cash transfer program, formerly *Auxilio Brasil* under President Bolsonaro) at R$600 – (R$50 bi. additional cost, or 0.5% of GDP above the cap).

However, his first indications floated in the opposite direction. In a November 10 speech, the president-elect Lula spoke of a wide-range increase in public expenditure to meet different social demands and the need for a growth-inducing State. He was literal in saying such demands overshadow fiscal responsibility. From a federal budget standpoint, fulfilling society's desires would be solved by the fictional measure of removing the budget restriction. Such a solution does not exist, and the bottom line is that the budget would ultimately be balanced out by higher inflation or increased tax burden.

The government transition team is working to pass a *PEC* (constitutional amendment) that would take the standing primary balance to a negative 2.0% of the GDP deficit. The so-called "Transition *PEC*" establishes a R$175 bn waiver for a primary spending increase. Moreover, according to talks between Transition members and congressman Marcelo Castro, the 2023 budget rapporteur, there will be no update to the fiscal accounts guiding parameters for the coming year. The most important of them is the *IPCA* inflation in 2022, which determines the spending cap adjustment for 2023 and is still projected at 7.2%. Most likely, it will close at 6.0%, representing a R$30 bn reduction to the current budget.

Should the PEC pass as is, we would be back at 2016's initial stage and with the fiscal anchor (spending cap) hammered. In 2016, the market (public debt financer) accepted the promise of a gradual recalibration and, thus, admitted financing the consecutive fiscal deficits for many years. Hardly it will do so without an indication like the spending cap approval.

Figure 12: Impact on expenditures from measures on the next administration's agenda

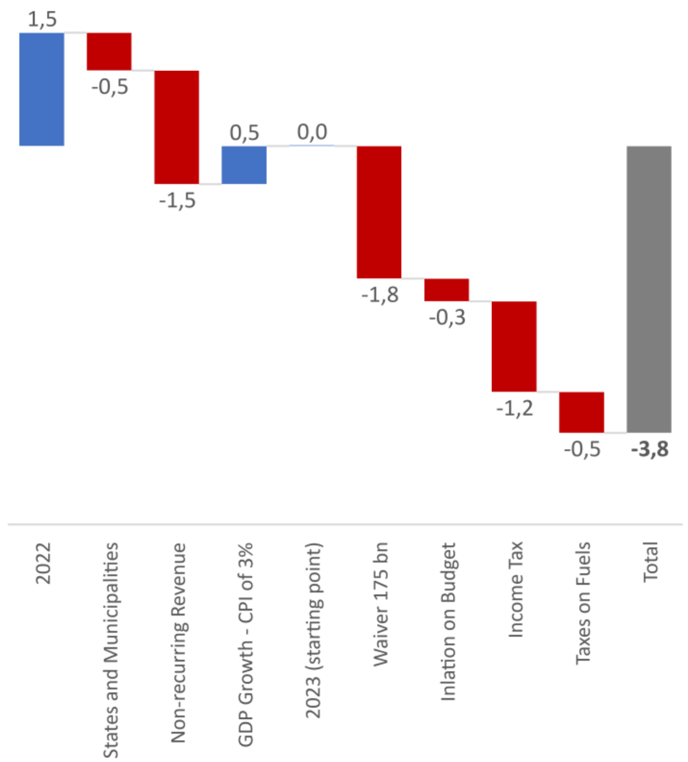
% GDP

Measures	Primary impact in 2023
Bolsa Familia entitlement increase 600 + 150/child	70
Spending Cap adjustment	30
Public investments	30
Min. wage increase of 3,4%	24
Government staff payroll increase	3.5
Restructuring of current expenditures	23
PERSE (Show business Stimulus Program)	*2*
Aldir Blanc Law (Culture Stimulus Program)	*3*
FNDTC (National Fund for Sci. & Tech. Development)	*6*
Farmacia Popular (*Medication Assistance*)	*1.5*
Other	*10*
National Nurse Wage Floor	16.3
(*ICMS*) State taxes compensation	20
Total	**217**

Source: Mar Asset Management

Figure 13: Impact from measures at the 2023 primary balance's starting point

% GDP



Source: BCB, Mar Asset Management

In some respects, the situation could be even worse. In 2016, the output gap was quite negative, making way for GDP growth above its potential for several years. Currently, with the unemployment rate at its lowest level in years, the positive risk to GDP growth corresponds to the effects on potential growth from the structural reforms implemented in the last six years.

How would 2023 Lula react to the current scenario?

Even if Lula does become "2003 Lula", one with fiscal responsibility, the ongoing scenario should take him to unchartered territory. We have briefly discussed above how the Transition *PEC* affects the fiscal chart starting point. Another aspect is how control over expenses will unfold. The speed with which primary balance will converge, if at all, to a level compatible with public debt stability.

As we discussed in the last section, it was only once difficult for Lula to balance the budget; in his first term. Even so, cuts were concentrated among investments and project drafts. Besides, the choice for fiscal adjustment was seen as the faster measure, but with a higher starting cost, to carry *PT*'s main goal to increase social spending[1]. The strategy proved correct; from 2004 on, strong tax revenue growth allowed for spending expansion throughout Lula's administration.

The current scenario is not compatible with a sustainable growth of social spending. Because the starting point is rather negative, the primary expenses growth will have to remain below revenue growth for an extended period, so the primary balance will converge to a level capable of stabilizing public debt. This period will last the whole of Lula's third term.

Fiscal restrictions are evident when we consider the impact on primary expenses growth of only a few of the promises made by the President-elect. An (i) increase to the minimum wage based on past GDP growth, (ii) a gradual comeback of public investment to the 2014 level, and (iii) a policy of increasing and recouping civil servant wages, combined with the creeping growth of *INSS* (National Social Security Institute) expenses, would be enough for real primary expenses increase of 3.0% a year. Even if the GDP grows 3.0% above the *IPCA* index, the primary balance will present a modest improvement from one year to the next and remain in deficit for decades.

This situation is entirely different from 2003. The fiscal squeeze would not constitute a decision with the initial cost to make way for reaping the benefits later during his time in office. As we see it, fiscal contraction is a matter of solvency, or political survival, for that matter.

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[1] Palocci, then Minister of Finance, in an interview in late 2002, asserted: *"It is better to make an effort like this, more concentrated, and inaugurate a period of a more lasting growth than to go for the other option, with softer adjustment for a longer period. I presented this option to President Lula before his taking office. I said: "Look, the situation is critical and we have two options, among several others, but two that seem compatible with our platform and sits within our commitment, within the Letter to the Brazilian People. One option is a strong adjustment to inaugurate a period of growth and this will be troublesome, it will not be easy. We cannot raise taxes. We will have to cut in the flesh. The second option is to go for a softer adjustment, for two, three years, impossible to know for how long". But the President chose the first option and I think it he was right. I told him I preferred this stronger option."* (link).

It is not clear whether the 2023 Lula subscribes to this view. Likewise, it is not clear how 2003 Lula would have reacted to such a scenario during his first term. A dismal growth in social spending does not seem compatible with his current term's intentions – providing social reforms using public policies.

Figure 14: Specific subheadings' contribution to yearly primary spending growth

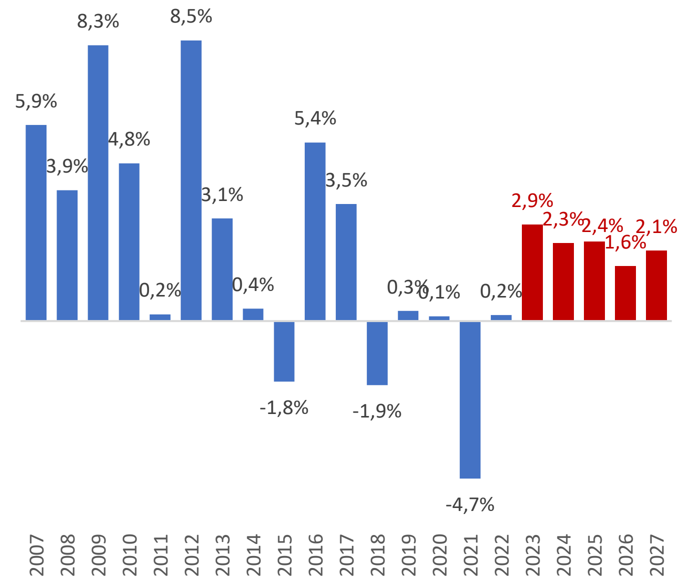
p.p.per year

Measures	p.p. real expenses
Demographic growth of soc. security and *LOAS**	1.0
Minimum wage raised GDP last five years	0.8
Public investment – back to 2014, as % level of GDP	0.5
Demographic of civil serv. pensions	0.4
Civil servant wages - 150% recouping + 0,5% real value increase	0.3
Demographic growth of salary allowance compensation and unemployment benefit	0.0
Total	3.0

Source: Mar Asset Management **LOAS* (Social Assistance Fundamental Law - benefits for the elderly or disabled)

Figure 15: Minimum wage growth in real terms

%



Source: BCB, *IBGE* (Brazilian Institute of Geography and Statistics), Mar Asset Management

The alternative would be a revenue-side adjustment. Seriously boosting the tax burden, at the very least, could allow expenditures to grow in sync with GDP during Lula III. The problem is that the adjustment would have to be massive, around 3pp of GDP if combined with the Transition *PEC*'s waiver. It is no walk in the park to raise as big a fund. The *CPMF* (Financial Transactions Provisional Tax) extinguished in 2008, for instance, collected less than 2% of GDP. Such a significant increase to the tax burden would meet fierce resistance from society (especially in the states where Lula lost the elections). It would be tough to approve in a Congress with no sizeable majority (see assessment).

Box – Simulations for Public Debt Sustainability

The main fiscal issue in a developing country such as Brazil is simple: is public debt sustainable? The answer is also simple. It will depend exclusively on three variables' dynamics: interest rate, GDP growth, and primary surplus.

Public Debt Dynamics

$$\Delta d_t = d_{t-1}(r-g) - sp_t$$

$d_t - Debt/\text{GDP}$
r – *real interest rate*
g – *GDP growth*
$sp_t - primary\ surplus/\text{GDP}$

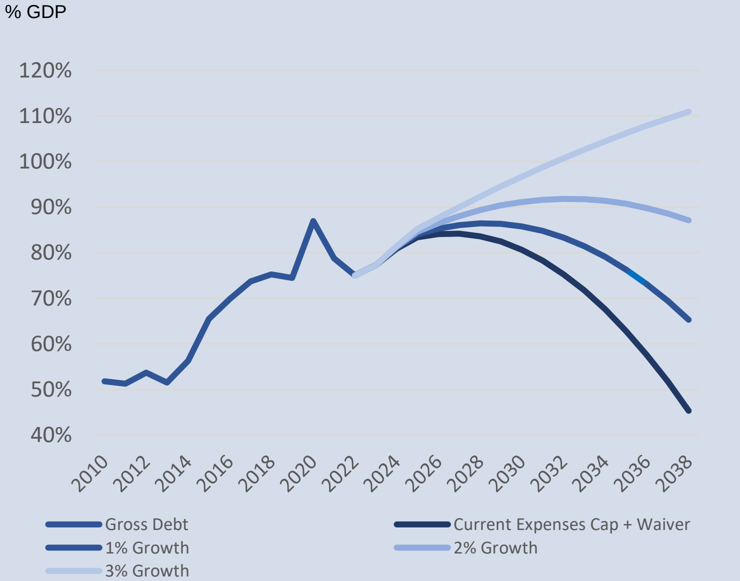
The only variable the government directly controls is the primary surplus. For it to be acceptable, a government must ensure a sequence of primary balances, guaranteeing debt convergence in reasonable scenarios for real GDP and interest rate growth.

The fiscal sustainability pervades confidence that, at some point, we will have a surplus high enough to stabilize the public debt. This level for Brazil is at around 0,5-1,5% of GDP, supposing (i) a long-term real interest rate of 4.0% and (ii) real GDP growth of 2.0%, and (iii) GDP price deflator, on average, 1.0 pp above *IPCA*. Considering these hypotheses and supposing the primary balance starting point is -2.0% of GDP (compatible with the proposed R$205 bn waiver), public debt convergence would only occur in scenarios with very low primary expenses or massive tax hikes.

Figure 16: Primary surplus under different hypotheses of expenses growth without tax hikes

Source: BCB, Mar Asset Management

Figure 17: Gross debt dynamics under different hypotheses of expenses growth without tax hikes



Source: BCB, Mar Asset Management

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