Macro Vision

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BRAZIL – Time to strengthen the fiscal framework

- The recent increase in the domestic risk premium is at least partly driven by a worsening perception of the Brazilian fiscal situation, with public debt growing sharply and the fiscal framework (Complementary Law 200/23) losing credibility as an anchor for the evolution of public accounts. The original design carries its own challenges: even if strictly followed, the current rule is not capable of generating sustainable fiscal trajectories in the medium term, unless there is a significant increase in revenues. Moreover, its implementation has been allowing the fiscal policy stance to remain expansionary in an economy with high public debt, signs of overheating, and notable inflationary risks.
- In our view, a sustained improvement in financial conditions would only materialize with the outlook for a more balanced public debt trajectory. A viable initiative in this direction would be to reduce the upper limit of annual real growth in primary expenditures to 1.5%, from 2.5%, as early as 2025, along with complementary measures that provide consistency and credibility to the announcement. If implemented, the change would lead to an improvement of at least 0.4% of GDP in the primary budget balance expected for 2026 and would move forward the expected convergence of gross debt to 85%-90% of GDP by around 2030 (vs. the approximately 120% of GDP by around 2050 that would result from the current rule, according to our estimates). Slower growth in expenditures would reduce the likelihood of extreme alternative scenarios, helping to create a benign cycle of falling risk premiums and appreciating exchange rate, which would relieve the pressure on the central bank to increase interest rates.

The framework is losing its credibility as a fiscal anchor

The recent significant increase in the domestic risk premium is at least partly driven by the worsening perception of the fiscal situation. So far, the government has only acted to reduce the risks of extreme scenarios of non-compliance with the fiscal framework's spending cap (LC 200/23) by 2026. While the approval of the fiscal package has prevented an even sharper deterioration in risk perception, its impacts are insufficient to produce sustained improvement, as they only prevent deterioration in fiscal projections, which already assume compliance with the current fiscal rule.

However, even if the framework is strictly followed, the confidence in its capacity to generate sustainable fiscal trajectories in the medium term has weakened significantly. In addition to the growing risks of non-compliance (even with the recent adoption of measures in the right direction), credibility has weakened because the rule does not establish an outlook for public-debt stabilization unless revenues rise significantly. Notably, the recurring primary balance has not improved even as economic growth surprised to the upside (see chart). The implementation of the rule allows the fiscal stance to remain expansionary in an economy already showing signs of overheating and facing significant inflationary risks, contributing to a scenario of high real interest rates.

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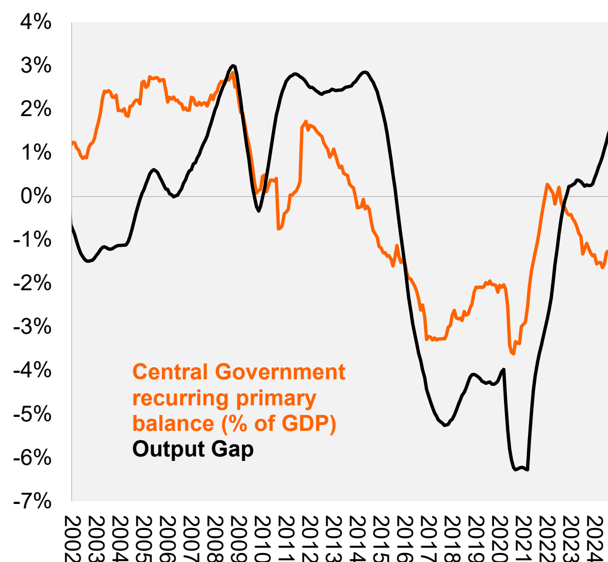
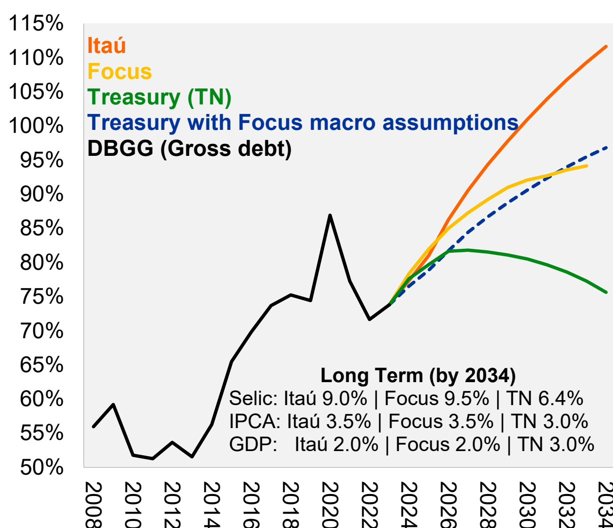
Recurring primary balance has not improved, despite a widening output gap



Source: National Treasury, Itaú

We also note that the National Treasury's official projections for public-debt stabilization in the medium term are based on optimistic macroeconomic assumptions. In these assumptions, debt peaks at 82% of GDP in 2027 and then enters a downward path. The Treasury's long-term macro scenario considers high GDP growth (3.0%) and an exceptionally low Selic benchmark rate (6.4%), consistent with a neutral interest rate of 3.4% (vs. the central bank's latest estimate of 5.0%). When the debt trajectory is simulated using more conservative macro assumptions, such as those in the Focus survey, the scenario for debt stabilization becomes much more challenging (see chart).

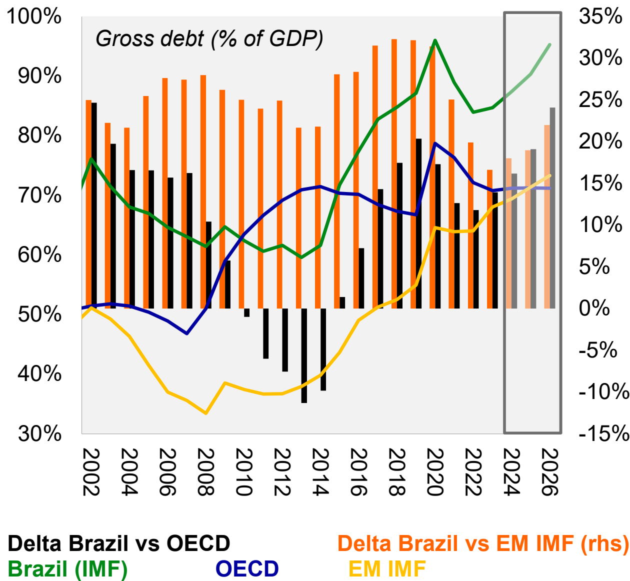
National Treasury's gross debt forecast is based on optimistic macro assumptions



Source: National Treasury, BCB, Itaú

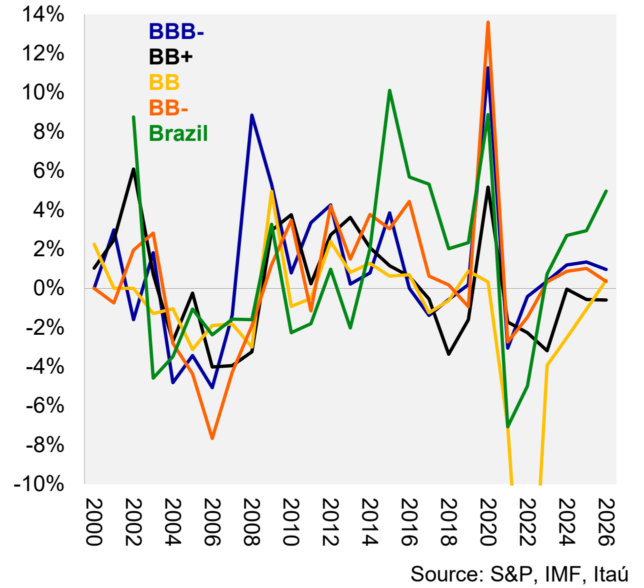
In our baseline scenario, even if the rules of the framework are followed, public debt will rise by an average of 4 pp of GDP per year, reaching 85% of GDP in 2026 (96% of GDP, according to the International Monetary Fund's methodology), widening the gap with other EM and OECD countries (first chart). The trajectory diverges from countries with similar credit ratings (second chart), which makes it difficult for Brazil to recover its investment grade rating, which would bring benefits in terms of attracting foreign investment and the ability to finance public debt under more favorable conditions, in addition to reducing the cost of capital for the economy as a whole.

Debt differential vs. peers is rising again



Source: IMF, BCB, Itaú

Gross debt (pp of GDP) expanding faster than in countries with similar credit ratings

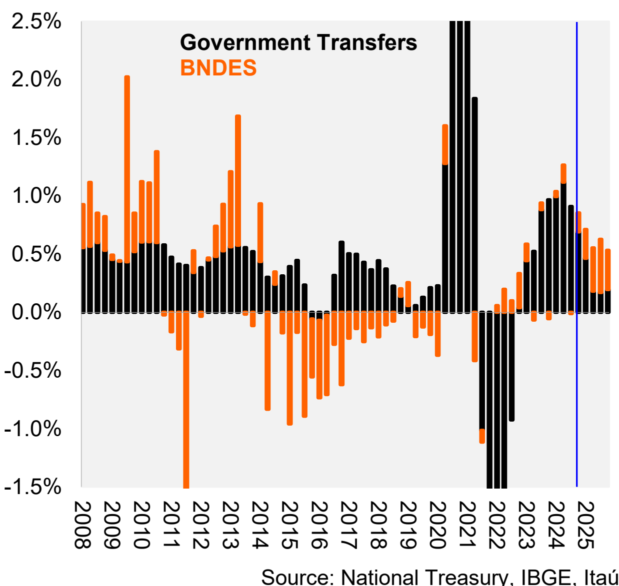


Source: S&P, IMF, Itaú

With recurring primary results around -1.0% of GDP and a surplus that would stabilize the debt at least 2.5% of GDP, the challenge now involves approximately 3.5 pp of GDP. However, if the framework targets are met, the reduction in expenditures as a share of output is around 0.15 pp of GDP per year. Thus, under the framework and all else being equal, an adjustment strategy based on containing expenditure growth would take at least 20 years to stabilize the debt. Given the soft spending containment that is implicit in the regime, a faster adjustment would require a significant and sudden increase in the country's tax burden, which is already high for its level of per capita income.

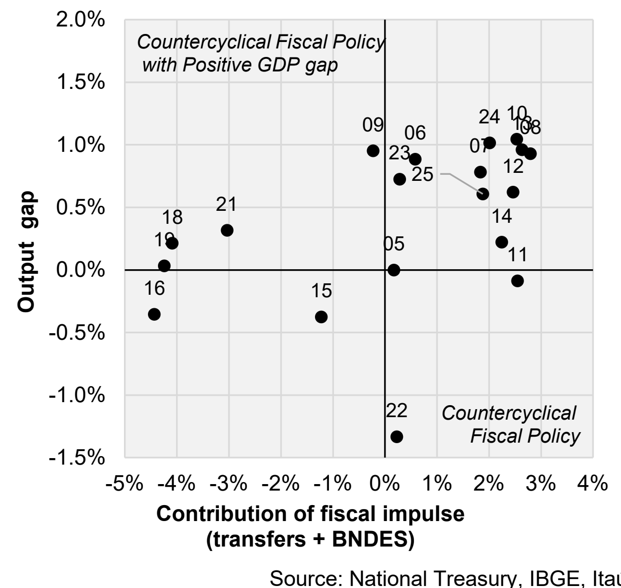
Furthermore, even under the framework, fiscal policy has provided a boost to an economy that already shows signs of growing above potential, making it difficult to anchor inflation expectations around the target and exerting pressure on interest rates (see charts). The rule establishes an upper limit of 2.5% for real annual growth in primary spending, but in recent years, spending on social transfers—which have a greater impact on economic activity—rose 4.5% (under the same metric), driven by the significant increase in the number of beneficiaries of income-transfer programs and the resumption of real increases in the minimum monthly wage. Hence, we estimate that fiscal policy contributed 1.0 pp to estimated GDP growth of 3.6% in 2024 and should contribute 0.6 pp in 2025 due to faster momentum via development bank BNDES (see charts).

Fiscal policy will remain expansionary



Source: National Treasury, IBGE, Itaú

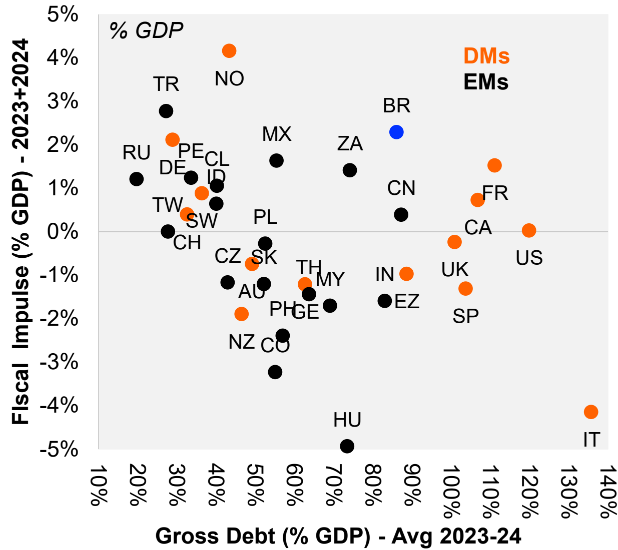
Expansionary fiscal policy, despite positive output gap



Source: National Treasury, IBGE, Itaú

Comparatively, despite having a higher debt level, Brazil's fiscal policy has been more expansionary than that of other countries (see chart). On average in 2023 and 2024, Brazil's fiscal momentum was only smaller than that of Turkey and Norway, which have considerably lower sovereign debt.

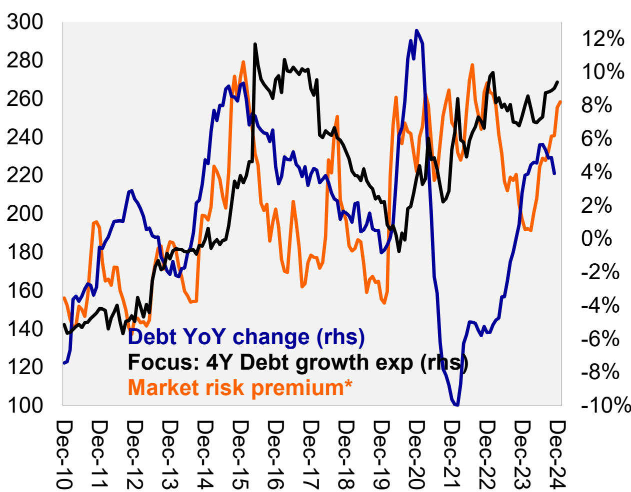
Brazil's fiscal impulse in 2023 and 2024 was large in the international comparison



Source: IMF, Itaú

Thus, we believe that a more consistent improvement in the risk premium and in domestic assets will only materialize with a more balanced public-debt trajectory (see charts). The increase in gross debt anticipated by the Focus survey for the next four years has been correlated with the deterioration in asset prices and in the decoupling of the Brazilian real from other emerging-market currencies. This process was apparently triggered by the change in the 2025 primary balance target in April 2024. In other words, there is a vicious circle in which the slow fiscal adjustment leads to a weakening currency and real interest rates that rise to even higher levels, requiring higher primary balances to stabilize the debt, and so on.

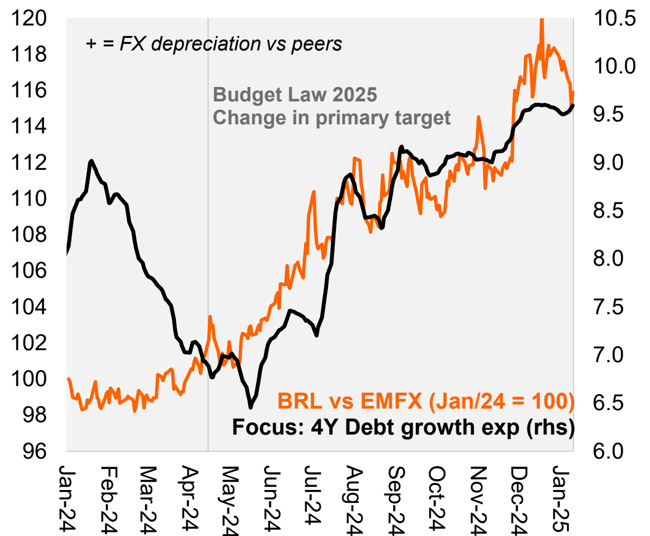
Rising debt, greater risk



* measured from Vol3M, breakeven premium 3Y-5Y, equities EM vs. BZ

Source: BCB, Bloomberg, Itaú

BRL weakening more sharply than its EM peers amid worsening expectations for debt growth



Source: BCB, Bloomberg, Itaú

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Therefore, in our view, an improvement in expectations about the fiscal trajectory is necessary to reverse the recent deterioration in financial conditions. One alternative would be to strengthen the parameters of the fiscal framework, which would reduce the expected increase in public debt in the coming years.

Recalibrating the adjustment: measures to change the spending growth cap to 1.5% per year and subsequent gains

Lowering the upper limit of primary real spending growth to 1.5%, from 2.5%, would significantly improve the outlook for debt stabilization (see table). The announcement of a more ambitious strategy should come with structural savings measures to provide consistency and credibility (see below). This move would make it possible to stabilize gross debt at 85%-90% of GDP by 2030 (compared with 117% of GDP by at least 2048, under the current rule) and reduce expected annual increases to around 2 pp, from 4 pp, per year. Furthermore, a sharper adjustment would make scenarios in which debt does not stabilize less plausible, given that in the most pessimistic scenario, the new cap on growth would be equal to or perhaps slightly lower than the country's potential growth.

When and at what level does gross debt stabilize?

	Fiscal Framework 2.5%				New Limit 1.5%			
GDP / Real Rate	4%	5%	6%	7%	4%	5%	6%	7%
1.0%	Doesn't converge	Doesn't converge	Doesn't converge	Doesn't converge	Doesn't converge	Doesn't converge	Doesn't converge	Doesn't converge
2.0%	2056 ; 116%	Doesn't converge	Doesn't converge	Doesn't converge	2038 ; 95%	2053 ; 124%	Doesn't converge	Doesn't converge
2.5%	2039 ; 93%	2060 ; 129%	Doesn't converge	Doesn't converge	2029 ; 84%	2034 ; 93%	2041 ; 109%	2056 ; 151%
3.0%	2030 ; 84%	2037 ; 94%	2048 ; 117%	2087 ; 224%	2027 ; 81%	2029 ; 85%	2033 ; 93%	2037 ; 105%
3.5%	2027 ; 81%	2029 ; 85%	2034 ; 92%	2040 ; 107%	2026 ; 80%	2028 ; 83%	2029 ; 87%	2032 ; 93%

Source: Itau

Ideally, the change and reinforcement of the fiscal framework would become effective in 2025, taking advantage of the fact that the annual budget law (LOA) has not yet been approved. Along with this change, the government could announce a significant budget freeze in expenditures (approximately BRL 35 billion) to confirm that the measures to increase budgetary flexibility (such as those involving education fund Fundeb, congressional amendments and subsidies) in the fiscal package approved in December will in fact lead to lower expenditures. Moreover, such a substantial amount would signal more prudent budget execution, given the risks of further underestimation of mandatory expenditures (as in 2024, particularly regarding Social Security and BPC pensions to the elderly and disabled) and the materialization of extraordinary revenues for the year. Finally, the announcement would be an important buffer in case the proposed complementary measures outlined below are diluted or delayed in Congress.

The change to 2025 and 2026 could improve the primary result forecast by at least 0.4% of GDP (BRL 45 billion) in 2026, bringing the primary result closer to zero at the beginning of the next presidential administration. In our estimates, the forecasted deficit in 2026 would shrink to 0.3% of GDP from 0.7%. Importantly, the measures do not invalidate and are complementary to any additional government efforts in the revenue agenda, particularly the reduction of tax benefits and compensations, which also have the potential to improve forecasts for the primary result. However, we believe that adjusting revenues would not be as effective in achieving the desired credibility gains.

The complementary measures that would enable compliance with the new cap involve additional structural changes to spending dynamics and/or greater focus. Below we list 10 measures that would enable compliance with the modified expenditure rule in a credible manner by 2030, noting that they are not substitutes for the measures that have already been approved and will be implemented by the government, especially those that seek to make social benefits more rational.

First, it would be important to restrict real growth in the minimum wage (or expenditures linked to it) and in minimum expenditures on healthcare and education to the lower limit of the framework (0.6%). In the case of the minimum wage, one alternative is to separate the rule to adjust the floor in the formal labor market (which would be maintained) from the rule that indexes government spending (as is the case in other countries in the region such as Mexico and Chile). In addition to this change, it would be beneficial to link the nominal portion of the adjustment to the same inflation rate that is used to adjust the spending cap, to avoid mismatches between June inflation (the benchmark for the cap) and November inflation (the benchmark for the minimum wage), which could generate pressure in the future. Regarding healthcare and education expenses, an associated structural measure would be to determine the caps together, increasing budgetary flexibility to contemplate an ageing population and heterogeneous population growth across the country.

Second, there would be a ban on acts that increase mandatory expenses above inflation (excluding those mentioned above) while the primary result is negative. This would lead, for example, to delayed salary adjustments for public servants, proposed in provisional measure MP 1286/24 and which are currently set to be implemented after the approval of the 2025 budget, with an impact of BRL 16 billion in 2025.

Third, proposals to sharpen the focus of unemployment insurance could be resumed, reducing government payments to those who switch jobs frequently and announcing an immediate transition of the wage annual bonus to up to 1.5 minimum wages and a gradual transition to up to 1.0 minimum wage. These measures would provide more focus to public spending, reducing the costs associated with the formal labor market.

Fourth, effective regulation of so-called super salaries, partial elimination of state-owned companies that depend on the Treasury, and gradual reduction of congressional amendments would combine fiscal savings with more efficient public spending. With the regulation of super salaries (established by constitutional amendment EC 135/24), the benefits and compensation payments that can be excluded from the constitutional salary cap could be restricted. As for the 17 state-owned companies that depend on Treasury disbursements, their cost has increased, in real terms, by approximately BRL 9 billion since 2019, reaching BRL 34 billion last year. Moreover, some have no proven efficiency or operate in sectors whose jurisdiction overlaps with states and municipalities (federal university hospitals and urban trains, for example). As for congressional amendments, their existence is worthy and they are an important tool of congressional participation, but their magnitude became quite significant (0.4% of GDP in 2024) and their share in the public budget has expanded (to approximately 20% of unbounded discretionary expenses) in a context of fiscal constraint and weak evidence of economic efficiency.[1]

Finally, it is possible to extract gains by better targeting subsidies and on the low-income housing program Minha Casa Minha Vida (MCMV), whose expenditures are above pre-pandemic levels. In the case of subsidies, complementary amendment EC 135/24 allowed the budget for these expenses to be more suitable to their execution—this situation tends to facilitate initiatives that seek greater efficiency in the lines linked to the agricultural sector, as initially presented in the 2025 budget law, and as suggested by their increased share in agricultural GDP since 2019. MCMV expenditures have doubled since 2019, suggesting that these outlays could be a target of gradual review initiatives.

[1] See https://blogdoibre.fgv.br/posts/emendas-de-relator-e-narrativas-falaciosas and https://portalibre.fgv.br/sites/default/files/2024-05/td15-uma-avaliacao-da-problematica-das-emendas-parlamentares_0.pdf

Additional measures needed to comply with the cap on annual real spending growth of 1.5%

Proposals to regain the fiscal anchor (BRL bln)	Legislation	2025	2026	2027	2028	2029	2030
Additional adjustment with 1.5% limit		**21**	**45**	**72**	**101**	**132**	**165**
Measures I to X		**31**	**78**	**107**	**119**	**150**	**177**
(I) Restrict real growth in the minimum wage to 0.6%	Simple Law	0	15	31	46	61	77
(II) Postpone salary adjustment for public servants for 3 years	Simple Law	17	17	17	0	0	0
(III) Change the unemployment insurance rules	Simple Law	5	11	12	12	13	13
(IV) Change the beneficiaries of wage bonus in 2026	PEC	0	10	11	11	12	12
(V) Minimum expenditures on healthcare and education to increase 0.6%	PEC	6	13	20	28	37	47
(VI) Effective regulation of super salaries	Simple Law	0	4	4	4	4	5
(VII) Partial extiction of SOEs that depend on the Treasury*	Simple Law	1	4	5	8	10	10
(VIII) Gradual reduction of congressional amendments**	Simple Law	1	2	3	4	6	6
(IX) Better targeted subsidies***	Administrative	0	1	1	2	3	3
(X) Better targeted Minha Casa Minha Vida (MCMV)***	Administrative	1	1	2	3	4	4

* Assumption that expenditures return, in real terms, to 2019 levels in 5 years

** Assumption that expenditures return, in % GDP, to 2020-24 average in 5 years

*** Assumption that expenditures return, in real terms, to half of 2019-2024 gap 5 years

Source: Itau

In short, implementing lower growth in expenditures would reduce the likelihood of extreme alternative scenarios, helping to facilitate a benign cycle of falling risk premiums and strengthening exchange rate, which would alleviate the pressure on the central bank to increase interest rates. This scenario would also be compatible with a perception of more sustainable GDP growth, contributing to a benign cycle of improving fiscal expectations and lower inflation and interest rates.

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