Macro Vision

June 20, 2024

Expenditure Control: A fundamental support to the fiscal framework

- In the first months of 2024, the accumulated increase of around 8% in real terms in revenues shows that so far, the government has been successful in its agenda to recover revenues. However, the resistance to the approval of new revenue measures and the higher-than-expected increase in expenditures reinforce the limits of a strategy focused almost exclusively on revenues and increase the risks of an early change in the fiscal framework's spending limit. In this report, we present the diagnosis of the rise in expenditures and possible proposals to control their trajectory ahead.
- The rise in expenditures since 2022 is driven by (i) private sector social security (INSS), (ii) other expenditures linked to the minimum wage such as the BPC, and (iii) increases in health and education expenditures with the elevation of their respective minimum limits. Besides the return of the policy of real adjustments to the minimum wage, the rise in the first two groups results from a significant increase in the number of beneficiaries, especially in modalities that were not impacted by the Pension Reform (EC 113/19), such as disability benefits and the BPC. The dynamic seems related to simplifications and automations adopted to facilitate their granting, which require proof or medical examination. However, these initiatives have not yet generated greater efficiency in identifying possible irregularities, only more beneficiaries.
- We propose three groups of expenditure control measures: (i) administrative measures focusing on implementing a cut in discretionary expenditures in the short term, (ii) a constitutional amendment proposal (PEC) to ensure the sustainability of expenditures, focusing on revising the minimum health and education limits, unlinking the minimum wage from non-contributive social benefits, and ending the annual Salary Bonus, and (iii) a bill to fix distortions on federal mandatory expenditures, focusing on identifying fraud in social security benefits and subsidies, reducing disfigurements in military pensions, and privileges of a minority of the public sector, and using the FGTS resources as a complement to the unemployment insurance. Together, the measures proposed here could save up to BRL 145 billion (in today's values) in 2026 (1.3% of GDP).

1) Revenues and expenditures growing above expected

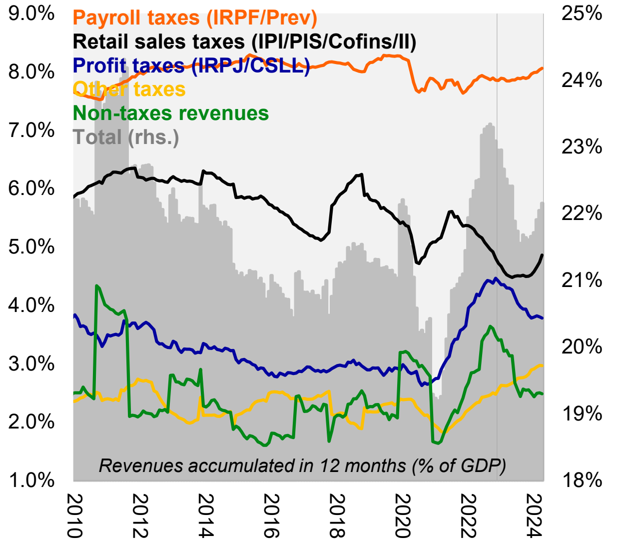
In 2023, the government approved the fiscal framework (LC 200/2023) as a substitute for the spending cap (EC 95/16), based on a spending limit and challenging primary result targets. The limit is the approved federal primary expenditure as in the 2023 budget[1], adjusted each year between 0.6% and 2.5% in real terms, calculated as a maximum percentage of 70% of the real growth of primary revenues accumulated in the 12 months until June of the previous year. If strictly followed, the limit not only prevents an explosive growth in expenditures but also generates a small reduction in what they represent as a percentage of GDP (from 0.1 to 0.2 percentage points per year).

[1] The main exceptions to the spending limit involve constitutional transfers such as contributions from the federal government to Fundeb (Basic Education Maintenance and Development Fund) and the FCDF (Constitutional Fund of the Federal District), in addition to extraordinary credits, expenditures with increasing the capital of state-owned-companies and non-recurring expenditures of the Electoral Court, among others.

Given the modest adjustment speed on the expenditure side, achieving primary targets requires complementary revenue measures. The currently targeted primary targets are zero results for 2024 and 2025[2], starting from a result of 1.4% of GDP in 2023, excluding the payment of court-ordered debts.

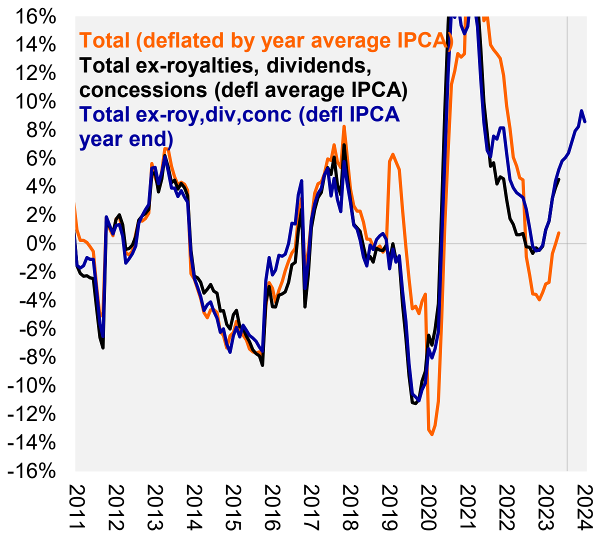
In the first months of 2024, the government has been significantly successful in its revenue recovery agenda. In the accumulated data up to May, the central government's total revenue is growing by around 8.0% in real terms compared to the same period last year. Part of the increase comes from the resilience of economic activity, but part comes from various revenue-increasing measures, mainly based on reducing distortions and litigation in the tax system. We expect these measures to generate increments of 1.0% of GDP and the consolidated public sector's primary deficit to be 0.6% of GDP in 2024, even accounting for 0.2% of GDP in measures to support Rio Grande do Sul.

Higher revenue reflecting resilient economic activity and revenue-increasing measures



Sources: National Treasury, Itaú

Revenue is growing by around 8.0% in real terms



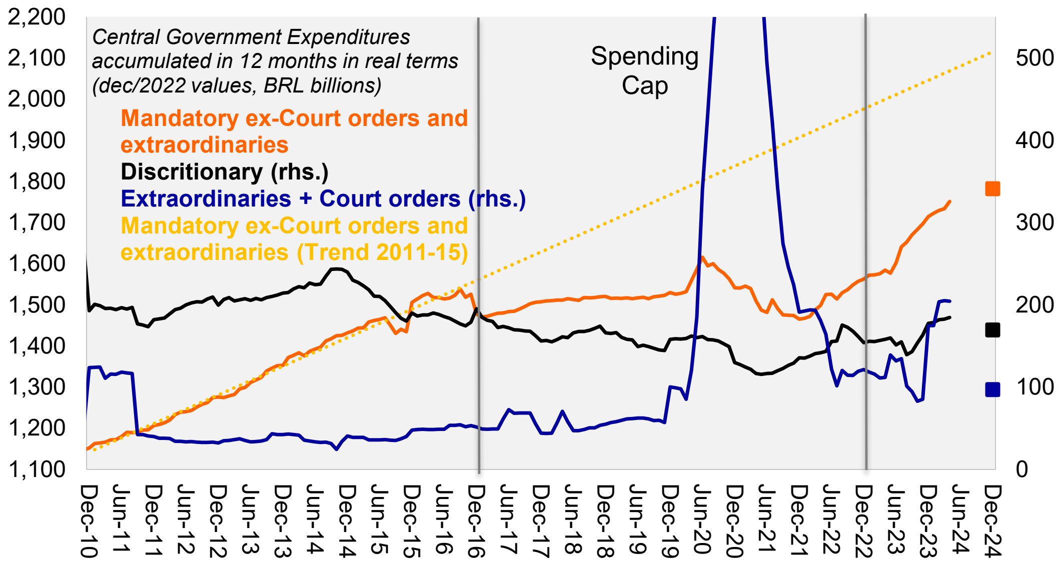
Sources: National Treasury,Itaú

Furthermore, the economic team has been demonstrating commitment to the principles of the Fiscal Responsibility Law (FRL) by defending the need for compensatory measures in case of revenue waivers. Recently, the government indicated that it intends to continue reviewing the so-called tax expenditures, which have a significant fiscal impact (4.6% of GDP or BRL 536 billion in 2024) and, generally, little evidence of economic efficiency. However, resistance to new and sudden changes in tax rules is growing, considering a country with a tax burden that is not only high for its income level but also complex, as shown by the debate on compensatory measures for payroll tax relief for sectors and municipalities.

However, the relative success in the revenue agenda is not yet seen in expenditure control. Since the end of the spending cap, mandatory expenditures, which remained stable in real terms during the previous regime, have resumed a rapid growth pace (see chart). Discretionary expenditures show a small recomposition, while other spending reflect the necessary payment of court-ordered debts that created an unaccounted skeleton in public debt statistics.

[2] Deviations of 0.25 p.p. of GDP, the exclusion of expenditures with the calamity in Rio Grande do Sul and with court orders that exceed around 0.4% of GDP (around BRL 45 billion) are allowed

Mandatory expenditures are growing at high pace again after the end of Spending Cap

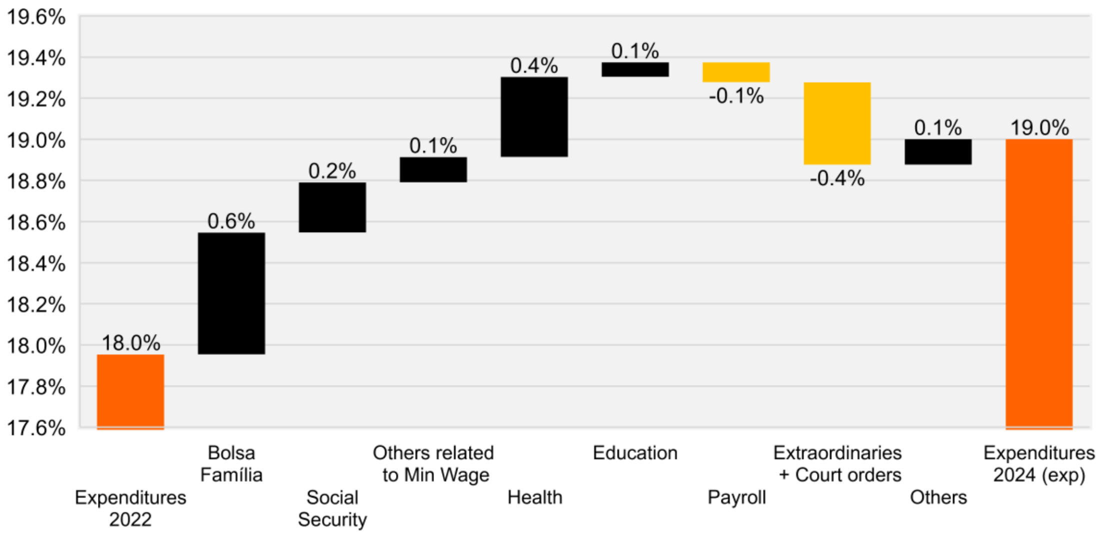


Sources: National Treasury, Itaú

2) Expenditures: Diagnosing the Recent Rise

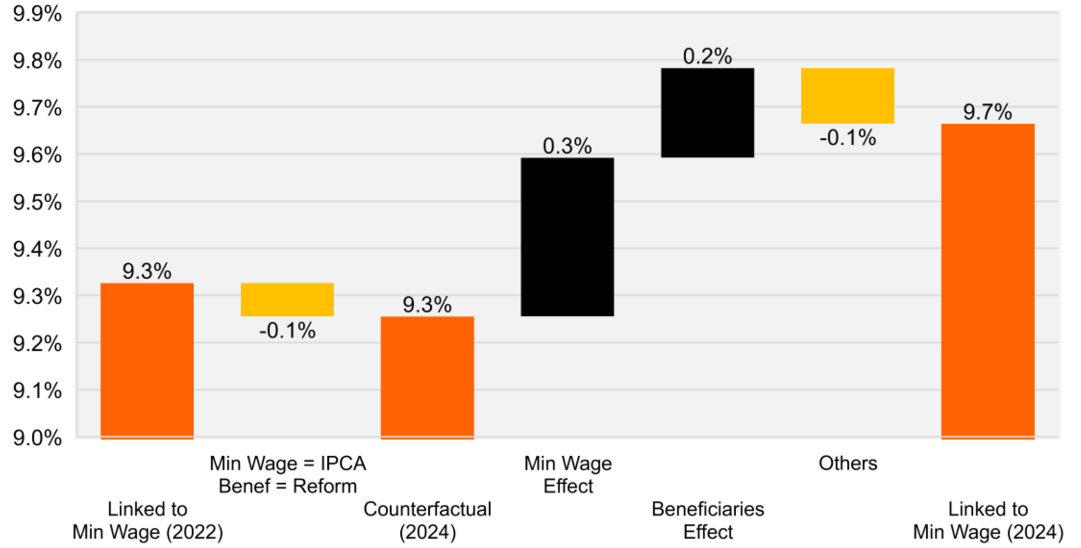
The rise in expenditures since 2022 is driven by (i) private sector social security (INSS), (ii) other expenditures linked to the minimum wage such as the BPC, and (iii) increases in health and education expenditures with the increase in their respective minimum limits (see chart). The first group, excluding court-ordered debt payments, likely rose from 7.6% of GDP in 2022 to 7.9% of GDP in 2024, while the second group, related to the annual salary bonus, unemployment insurance, and continued provision benefits (BPC), is expected to rise by 0.1 percentage points of GDP from 2022 to 2024. We estimate that 0.2 percentage points of this increase are due to a significant rise in the number of beneficiaries, while 0.3 percentage points are associated with the return of the policy of real increases in the minimum wage. Finally, health and education expenditures rose by 0.5 percentage points of GDP with the return of the linking of their minimum limits to revenues after the end of the spending cap, which indexed them only to past inflation.

Rise in expenditures since 2022 is driven by Social Security, others linked to the minimum wage and Health & Education



Sources: National Treasury, Itaú

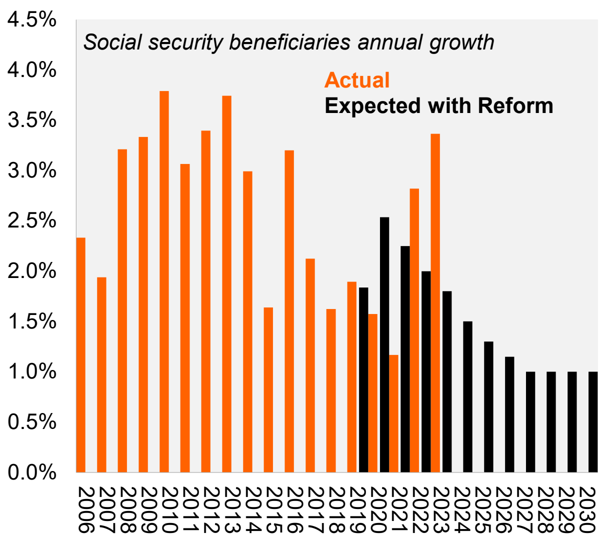
Rise in expenditures linked to minimum wage is driven by the policy of real increases in minimum wage and the significant rise in the number of beneficiaries



Sources: National Treasury, Itaú

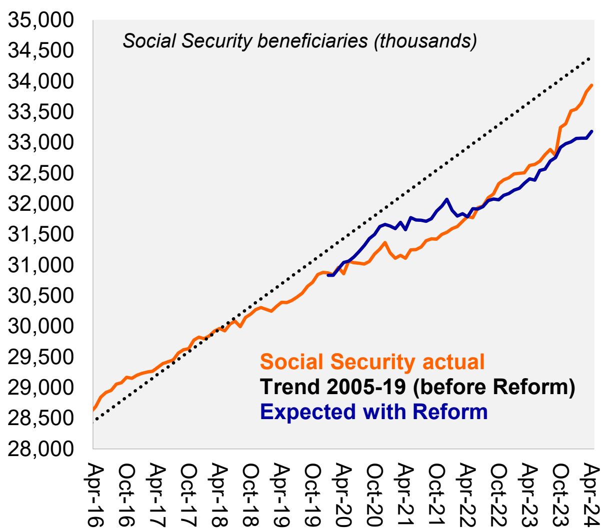
The increase in the number of social security beneficiaries is far above what was expected after the approval of the 2019 reform (EC 103/19). The approved rules implied a gradual reduction in the annual growth of beneficiaries from 3.5% in a no-reform scenario to 1.0% by 2030. However, since 2022, the growth rate has exceeded 3% year-on-year. The number of beneficiaries is higher than the implied trajectory with the reform since the second half of 2023, being about 600,000 people below the trend of 2005-19 (pre-reform).

Rise in the number of beneficiaries is above expectations



Sources: Ministry of Social Security, Itaú

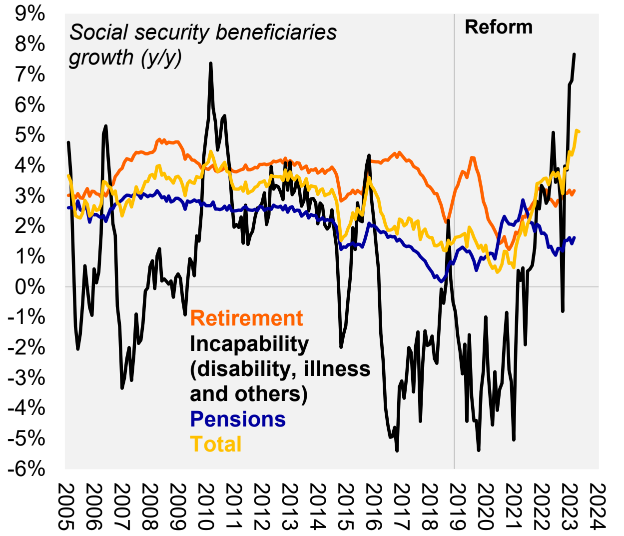
Number of beneficiaries is above expectations and getting closer to the pre-reform trend



Sources: Ministry of Social Security, Itaú

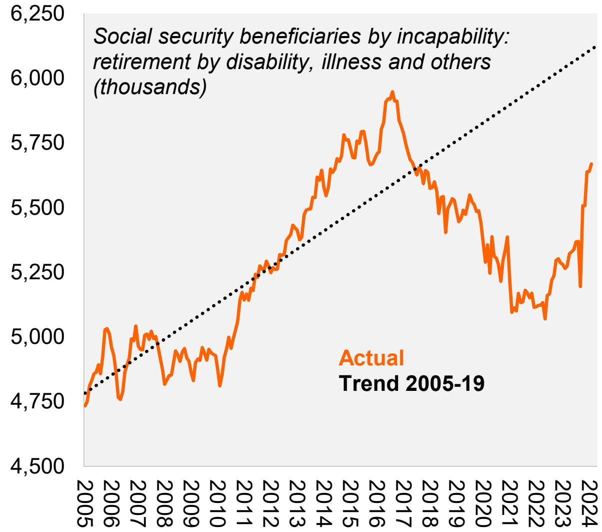
However, by type of benefit, the increase is being driven by disability benefits (see first chart), which did not undergo significant changes with the reform. The growth of the benefits most affected by the reform (retirements and pensions) should be closer to pre-reform levels. That is, it does not seem that the reform is having a smaller impact than expected, but that other factors are causing the increase in these expenditures. The growth of illness, accident, and reclusion benefits, as well as disability pensions, is not only at the maximum of the historical series but also reverting the downward trend in beneficiaries observed between 2016 and 2022 (see second chart).

Growth in the social security beneficiaries at historical highs, driven by benefits by incapability



Sources: Ministry of Social Security, Itaú

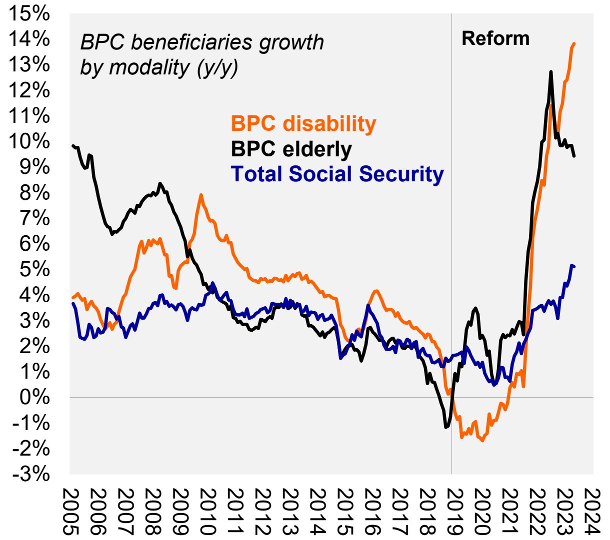
Number of benefits by incapability are rising again after continuous decline between 2016 and 2022



Sources: Ministry of Social Security, Itaú

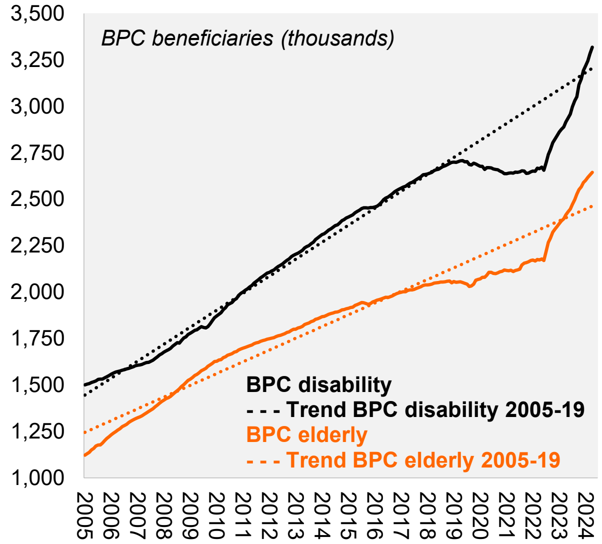
In the BPC benefits[3], there is also a significant growth in the number of beneficiaries, deviating from the historical trend (see charts). The dynamic started in the second half of 2022 and remains at pressured levels at the margin, although with some moderation in the elderly modality. It is worth noting that although these benefits are non-contributory, they are linked to the minimum wage.

BPC beneficiaries are growing above 10% y/y



Sources: Ministry of Social Security, Itaú

Number of BPC beneficiaries is above historical trend



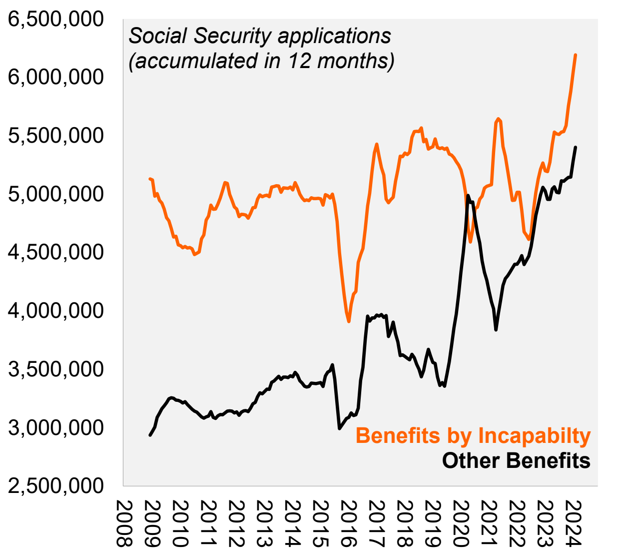
Sources: Ministry of Social Security, Itaú

This dynamic seems related both to the increase in application requests (first chart) and the reduction in the time for granting benefits that required proof or medical examination (second chart). Recently, simplifications were adopted to facilitate new applications and expedite the granting of these benefits without changing the legislation. In the case of the BPC, a 2021 decree allowed deductions of a national average value of health expenditures for calculating gross monthly family income, simplifying the income proof for accessing the benefit.

[3] The BPC is a non-contributory benefit that guarantees a monthly minimum wage for people aged 65 or over, or of any age with certain types of disabilities and whose per-capita family income must be less than ¼ of the minimum wage.

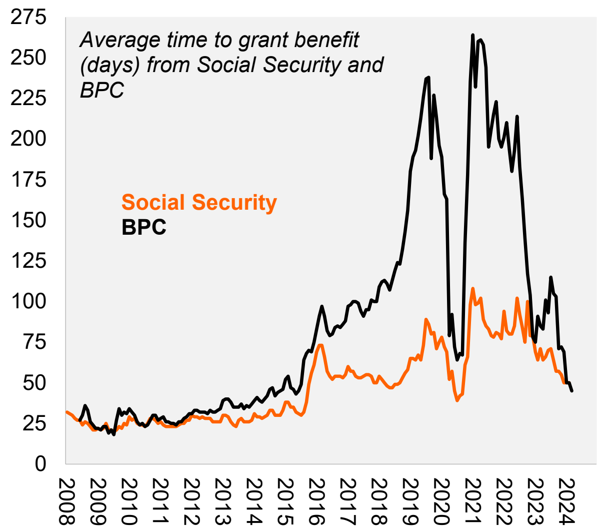
Additionally, in the disability modality, prior medical and social evaluations were relaxed, authorizing social evaluation by video conference, and also applying a national average of the evaluated parameters, avoiding the applicant's displacement and dispensing attending more than one appointment. In the case of disability benefits, the so-called "Atestmed" was instituted in 2023, a standardized request that allows the benefit to be granted for up to 180 days, with a medical examination only occurring in cases automatically identified with signs of non-compliance or requiring a more detailed analysis based on past experiences, which in theory would help control fraud.

Social Security applications at historical highs



Sources: Ministry of Social Security, Itaú

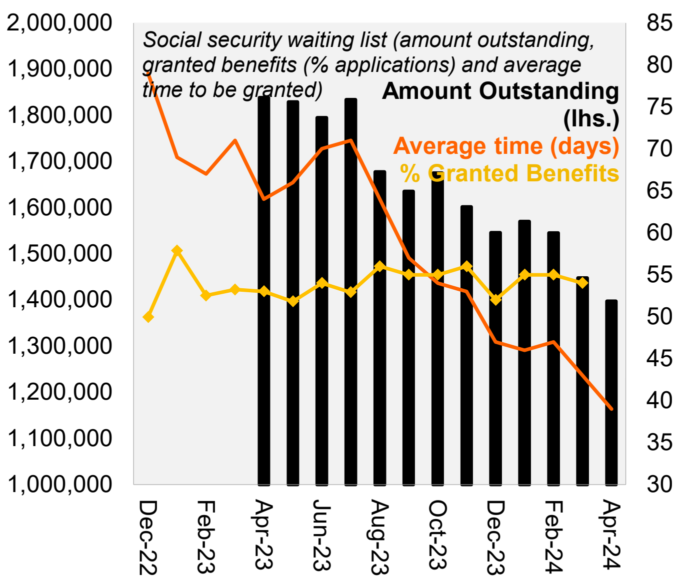
Significant reduction in average time to grant benefits



Sources: Ministry of Social Security, Itaú

In the case of disability benefits, however, the increase in applications and automation and consequent reduction in the waiting list for accessing the benefit are not leading to a reduction in the percentage of benefits granted. In other words, the gains in agility have not yet been accompanied by greater identification of irregularities.

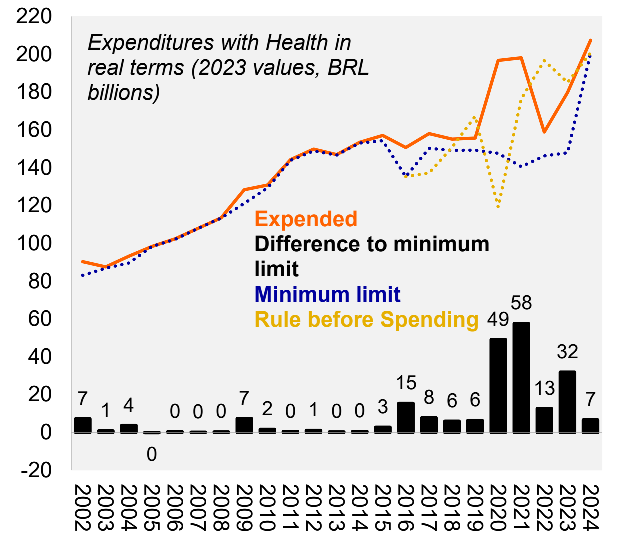
Reduction in the waiting list are not leading to a reduction in the percentage of benefits granted



Sources: Ministry of Social Security, Itaú

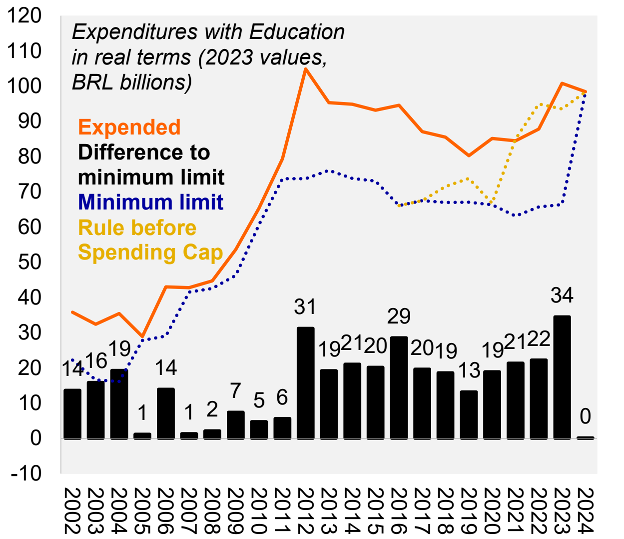
In the case of health and education expenditures, the recent rise is due to the return of linking the minimum constitutional limits to revenue metrics. In the case of health, the change in the minimum limit to 15% of net current revenue implied an increase of about BRL 50 billion in real terms in the limit (and 0.4% of GDP in effective spending) compared to 2022, while in education, the return to linking to 18% of net tax revenue led to an increase of BRL 33 billion in the limit (and 0.1% of GDP in effective spending).

Minimum limit of expenditures with Health may increase around BRL 50 billion in 2024



Sources: National Treasury, Itaú

Minimum limit of expenditures with Education may increase around BRL 30 billion in 2024

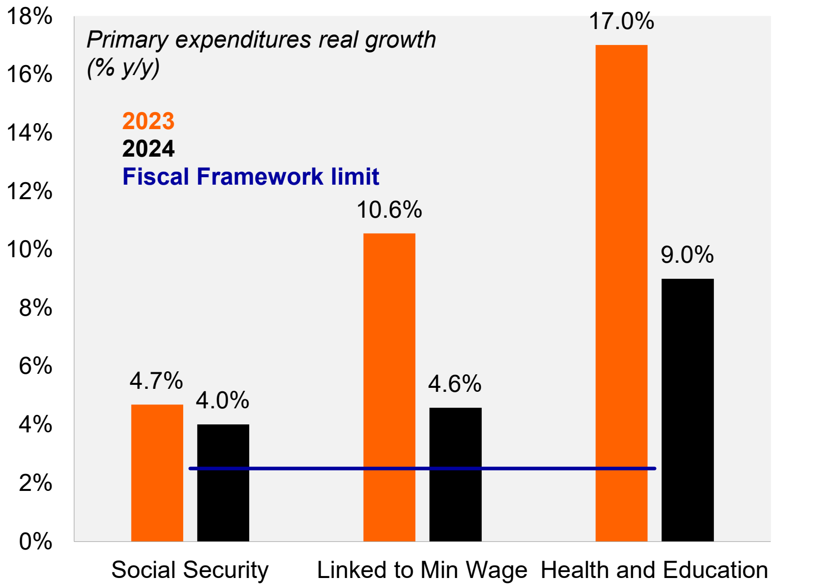


Sources: National Treasury, Itaú

3) Risks of the Recent Rise for the Fiscal Framework's Spending Cap

The real growth of these three groups of expenditures is well above the maximum of 2.5% allowed for total expenditure growth (in real terms) by the fiscal framework rules, implying pressure for cuts in other expenditures (see chart)

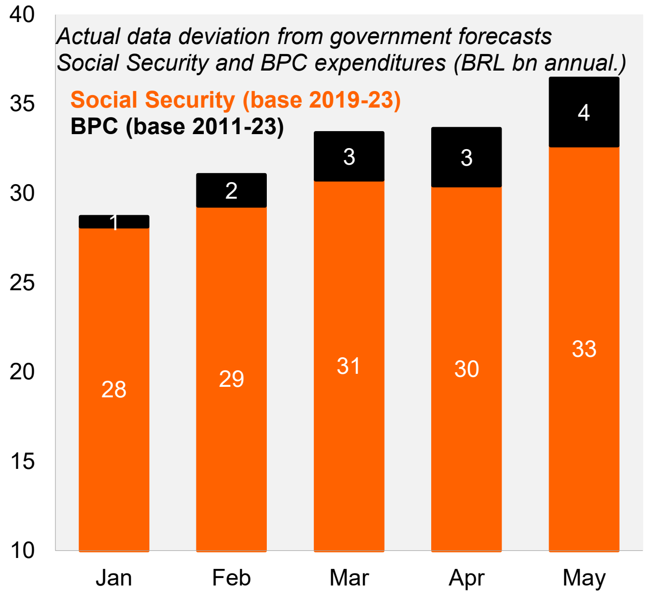
Growth of Social Security, others linked to minimum wage and Health & Education expenditures is above fiscal framework rules



Sources: National Treasury, Itaú

Specifically, annualizing the trend in the first five months of the year for social security and BPC expenditures, there is a need for BRL 37 billion in cuts in other expenditures. The significant amount can be partially reversed if there is a greater detection of irregularities, but we assess that it is unlikely to be enough to completely offset the need for cuts in other lines by the end of the year. We emphasize that the rule limiting expenditure growth in the fiscal framework is such that if some expenditures grow above the limit, others must decrease regardless of revenue performance.

Considering Social Security and BPC expenditures until May, there is a need for BRL 37 billion in cuts in others expenditures



Sources: National Treasury, Itaú

An early explicit or implicit change in the limit would mean an even greater credibility damage after the recent change in primary result targets. The expenditure rule ensures by construction that they will not have an explosive trajectory and that the primary result, excluding extraordinary events, will have a slight improvement each year. We note that exclusions of certain expenditures from the expenditure limit calculation or reclassifications of others as financial and/or not subject to the limit would be equally negative as changes in the parameters of maximum real growth of expenditures (2.5% per year). Thus, an explicit or implicit change already in the first year of the fiscal framework's validity would suggest an even more challenging trajectory for public debt, preventing a virtuous cycle of economic growth above expected, controlled inflation, and sustainable interest rate reduction**.**

In summary, we consider it essential to implement spending-saving initiatives to signal the sustainability of the fiscal framework in complement to the revenue initiatives underway.

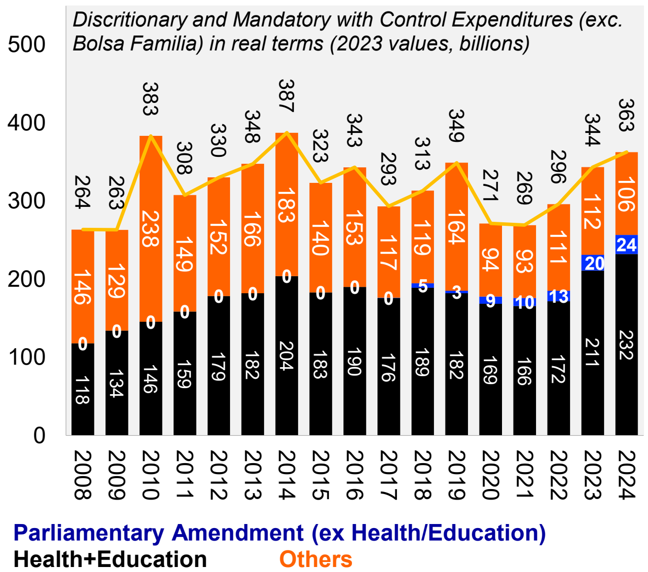
4) Spending Control Proposals: Potential Savings of BRL 145 billion (1.3% of GDP) in 2026

Next, we will focus on three groups of proposals: (i) administrative measures without the need for congressional approval, (ii) measures to ensure the sustainability of future spending trajectories that require a constitutional amendment, and (iii) measures that correct distortions and possible irregularities with the approval of a bill (see summary table at the end of the report).

Firstly, administrative measures seeking to implement a contingency plan this year and cuts to avoid exceeding the spending cap in 2024, totaling BRL 38 billion (0.3% of GDP). The amount would be enough to reverse the identified need for expenditures and avoid breaching the fiscal framework this year.

An announcement of a budget freeze in the next bimonthly review on July 22 is essential. If discretionary expenditures excluding health and education return to their average level of 2020-2021 (see chart), it would be possible to cut about BRL 26 billion (0.2% of GDP) in expenditures divided between legislative amendments and executive branch expenditures. Additionally, there is a small space of BRL 3.5 billion from half the remaining difference between the health limit and spending in this function according to our projections. Operationally, cutting these expenditures could be facilitated considering the multi-year execution of various investment projects and the restrictions on committing parliamentary amendments close to the municipal election.

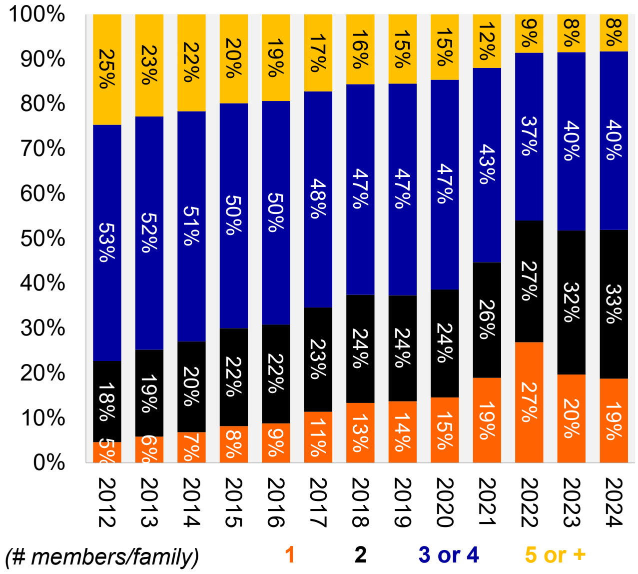
A budget freeze could reduce discretionary expenditures and parliamentary amendment to 2020-21 level



Sources: National Treasury, Itaú

Furthermore, it would be possible to continue to review possible irregularities in the Bolsa Família program. Normalizing the proportion of single-person families receiving the benefit to 2019 levels (see chart) would lead to a drop of 1.1 million benefits with stricter controls and conditionalities. If implemented and not compensated by the entry of new families or an increase in the average benefit, it would be possible to save BRL 7 billion (0.1% of GDP).

High share of single-person families in the Bolsa Familia suggests there is a room to further review



Sources: Ministry of Social Development, Itaú

Secondly, the presentation of a constitutional amendment proposal (PEC) to ensure the sustainability of future spending trajectories on health and education, non-contributory benefits linked to the minimum wage, and the annual salary bonus, totaling BRL 66 billion (0.6% of GDP).

For health and education, the proposal would involve harmonizing their limits with the fiscal framework rule. With the limits growing by 70% of revenue growth (in the same metric as the fiscal framework) and with an upper limit of 2.5% in real terms, there would be a space of about BRL 12 billion in 2026 (0.1% of GDP) compared to the scenario where these expenditures remain linked to their respective revenue metrics. If the change occurs for calculating the 2024 limit, there would be an additional space of BRL 5 billion in the same period. Moreover, it would be important for the proposal to include calculating the limits jointly, providing greater flexibility for public managers in a context of disparate needs and population aging.

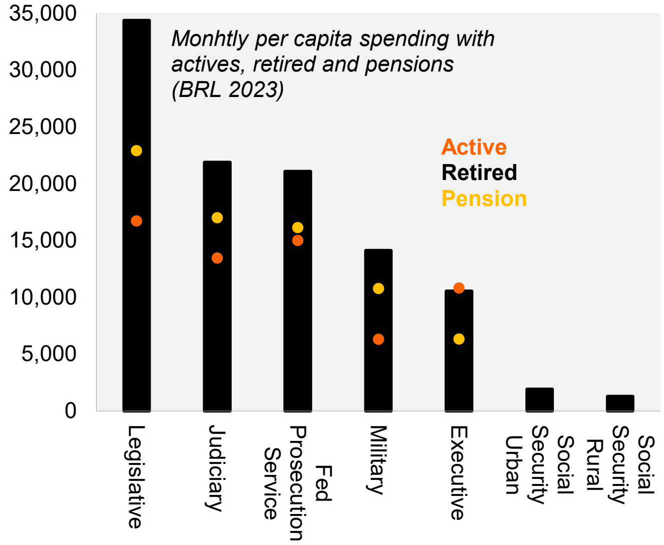
As for unlinking, one approach is to incorporate new benefits from rural pensions and BPC (given that are non-contributory) into the Bolsa Família program. The principle is to maintain formal linkage only for those who contributed for a minimum period while moving new rural pension and BPC beneficiaries to Bolsa Família, making it closer to a minimum income program. This aims to separate the decision to incorporate productivity gains of people who contributed to social security throughout their lives from the decision to increase the value of welfare benefits. A complementary proposal would be to regulate the income criteria for BPC access, where currently families with a per capita income below ¼ of the minimum wage are eligible, but which generates constant litigation. Together, the two measures could reduce spending by about BRL 27 billion (0.2% of GDP) in 2026.

Finally, the PEC could propose ending the annual salary bonus. The bonus is a social benefit of a minimum wage for formal private-sector workers earning up to two minimum wages per month, costing BRL 27 billion (0.2% of GDP) annually. The benefit has issues (i) of targeting, as about 40% of labor market jobs in Brazil are informal, thus having a low impact on reaching the relatively poorer segment, and (ii) of incentives, as it is a direct income transfer without qualification conditions, for example. The original proposal for the Pension Reform sought to limit the benefit payment to those earning up to one minimum wage, but this change was defeated in the Senate at the time.

Thirdly, the submission of a bill with six measures to correct distortions and review possible irregularities, totaling BRL 41 billion (0.4% of GDP).

The first measure of the bill would be a military pension reform seeking to reduce discrepancies in their retirement and pension rules compared to civilians. The pillars of this reform would be: (i) the end of parity (retirement adjustments equivalent to those of active personnel) and full retirement salary (benefit equivalent to the last active salary), making the benefit proportional to the contribution period, (ii) the end of integral and accumulable survivors pensions, making them proportional to the number of children as in the general private sector regime, and (iii) revocation of the additional military availability compensation for those that didn't join the military service since the benefit's creation in 2019. The measures are justified by the absence of significant changes for the category in the last Reform and the high per capita expenditure of their pensions compared to civilians in both the public executive and private sectors (see chart). The proposal could be accompanied by measures for other powers that also have high per-capita expenditures, such as the Legislative and the Judiciary. A reform converging military retirees' and pensioners' per capita expenditure to that of the executive in 10 years would bring potential savings of BRL 5 billion in 2026 (0.05% of GDP).

High monthly per capita spending with public servers from Legislative, Judiciary, Prosecution Service and Militaries

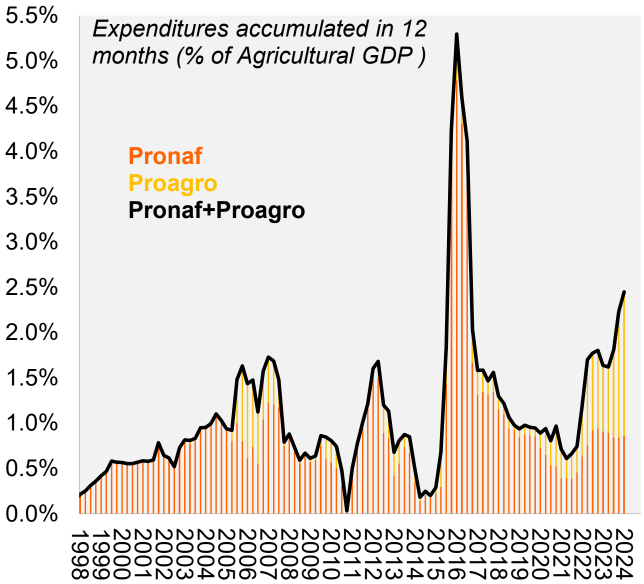


Source: Ministry of Planning and Budget, Itaú

The second measure would be the review of some social security and BPC benefits. As explained in the first section, the number of these benefits deviated from the medium-term trend, with one plausible explanation being the acceleration and simplification of the granting process. The proposal would be a detailed review of disability pensions, incapacity aids, and BPCs that have been without review for more than six months through productivity incentives for servers in the spirit of the last such initiative, Law 13.846/19. The estimated potential savings of BRL 14 billion in 2026 (0.1% of GDP) are equivalent to returning the number of beneficiaries to the trend line.

A third measure is the review of subsidies linked to the agricultural sectors. Subsidy expenditures have nearly doubled since 2019, rising from BRL 11 billion to BRL 22 billion, driven by Pronaf (National Program for Strengthening Family Agriculture) and Proagro (Agricultural Activity Guarantee Program). The 2025 Budget Guidelines Law (PLDO) already brought an initial effort focused on Proagro, but benefits to the agricultural sector as a proportion of the sector's own GDP have increased significantly in recent years (see chart). A policy review aimed at bringing these subsidies to the 2018-2020 average would bring potential savings of BRL 9 billion (0.1% of GDP).

Subsidies linked to the agricultural sectors at high levels



Sources: National Treasury, Itaú

A fourth measure would be the regulation of public sector super salaries already underway in PL 6726/16. The project makes more transparent which benefits can be excluded from the public sector's constitutional salary cap and has an estimated impact of BRL 3.5 billion.

Moreover, unemployment insurance can be reformed focusing on those in greatest need and coordinating resources with the Severance Pay Fund (FGTS). Recent work by the World Bank suggested (i) a benefit with a decreasing value (and consequent replacement rate) and a duration longer than the current maximum of five months, (ii) reducing the necessary contribution period for the first request and increasing it for subsequent requests, facilitating access to the benefit for workers with intermittent history and hardening it for those who use the benefit repeatedly, and (iii) designating FGTS as an income support source after dismissal from a certain month. A reform that uses the third monthly installment of unemployment insurance as an FGTS withdrawal has potential savings of about BRL 10 billion (0.1% of GDP).

Finally, the bill could advance in measures increasing budget flexibility and transparency of non-budgetary funds without mechanically implying expenditure reduction. Allowing the accounting of parliamentary amendment expenditures and 100% of Fundeb for health and education limits' calculation would help increase budget flexibility. Moreover, it would be important to require regular publication of transparency reports of various existing off-budget funds, especially the recently created ones such as FGO/Pronampe, FGI, and FGEDUC, to avoid future fiscal risks.

In summary, we present various alternatives for reducing expenditures to maintain the fiscal framework's credibility. We emphasize that advancing on the expenditure adjustment side is a complementary effort, not a substitute for revenue recomposition that are already being implemented by the economic team. However, we believe that ensuring a credible debt sustainability trajectory involves breaking the cycle of increasing expenditures that has characterized our fiscal policy for decades.

Thales Guimarães
Pedro Schneider

Controlling expenditures: a complement to the fiscal framework Comparison to the scenario without reform in 2026		BRL bn	% GDP
Total	**Description**	**145**	**1.3%**
(1) Administrative Measures		**38**	**0.3%**
a. Discritionary expenditures cut (budget freeze)	To deal with higher Social Security expenditures in the short-term and RS-related uncertainty. Return to 2020-21 real level and halve the difference between health limit and expected expenditure.	16	0.1%
b. Congress amendments cut (ex Health and Education)	Return to 2020-21 real term level.	15	0.1%
c. Normalization of single-member families share in Bolsa Familia	Reduce share of single-member families from 19% to 14% (2019 level), consistent with reduction of ~1.1m beneficiaries.	7	0.1%
(2) Constitutional Amendment Project to ensure expenditures sustentability		**66**	**0.6%**
a. Health and Education limits	Jointly considered and harmonized wiht fiscal framework rule (70% revenues, limited to 2.5% real) with ordinary law.	12	0.1%
b. Delink and higher efficiency of non-contributive benefits	(i) New BPC beneficiaries and rural retirees to receive the same as Bolsa Família (BRL 700); (ii) New per capita income criteria to new BPC beneficiaries.	27	0.2%
c. End of salary bonus *(abono salarial)*	Impact starting in 2026.	27	0.2%
(3) Bill of law to correct distortions		**41**	**0.4%**
a. Military pensions reform	(i) End of parity and integrality; (ii) End of integral and cumulative survivors pensions ; (iii) Reversal of additional compensation by military availability.	5	0.0%
b. Anti-fraud Social Security and BPC	Strict review in pensions by incapability, illness and BPC, that are more than 6 months without review and productivity bonus to public servers.	14	0.1%
c. Subsidies review (Pronaf and Proagro)	Reverse recent increase in subsidies to agricultural sector back to 2018-2020 levels as share of agro GDP.	9	0.1%
d. Regulate super-wages in public sector	PL 6726/16 regulates which benefits could surpass federal public servants wage cap.	4	0.0%
e. Unemployment insurance reform, coordinating FGTS resources	Designate FGTS as source of support after the 3rd month in unemployment	10	0.1%
f. Regulate health and education limits (higher flexibility, no cuts)	Allow the inclusion of 100% of parliamentary amendment to these limits and 100% of federal expenditures with Fundeb	35	0.3%
g. Higher transparency in off-budget funds (Pronampe/FGO, FGI, FGEDUC)	Demand regular transparency for off-budget funds	-	-

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