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The next government's fiscal challenge

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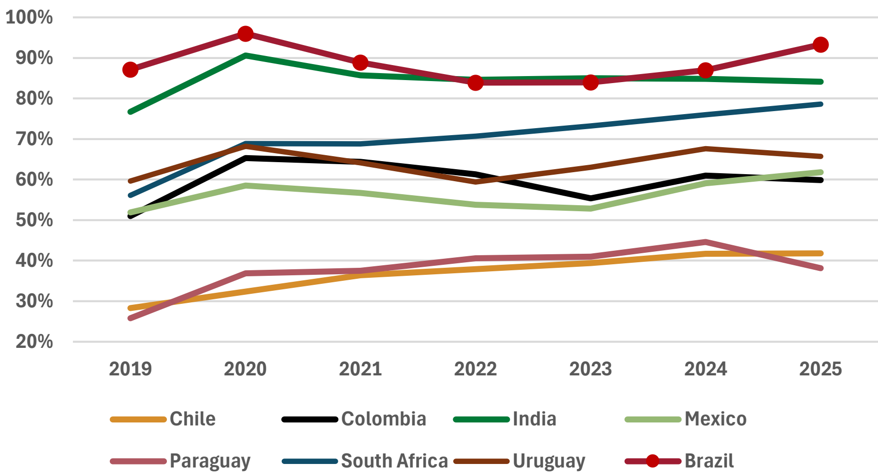
The winner of the October presidential election will inherit a challenging fiscal landscape. Brazil's gross public debt reached 81.9% of GDP in June, after increasing by 10 percentage points over the past four years, a level and pace of growth that stand out among emerging economies (Figure 1).

Figure 1: General Government Gross Debt (% GDP)

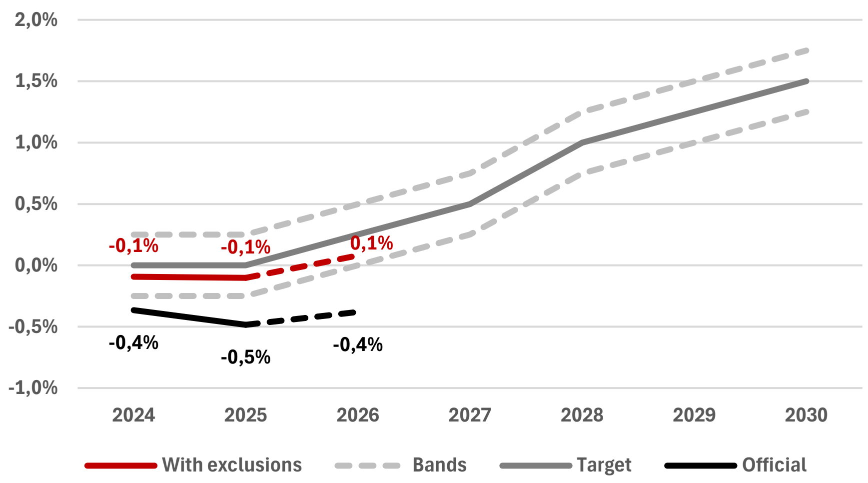


Source: BOCOM BBM, FMI

The increase in public debt occurred alongside the introduction of the new fiscal framework, which was designed to replace the spending cap with a more flexible rule that imposes some restraint on expenditure growth while prioritizing fiscal adjustment through revenue increase. Despite the implementation of a broad set of revenue-enhancing measures in recent years, including initiatives aimed at correcting tax distortions and curbing tax avoidance, the public sector continued to post primary deficits unfavorable to debt dynamics.

Among the factors behind this outcome is the growth in expenditure, which has not adhered to the 2.5% limit established by the fiscal framework and has created incentives for a significant share of spending to remain outside the rule. As a result, total primary expenditure has increased by an average of around 5% per year over the past four years. This year, for example, the government projects an effective primary deficit of BRL 52 billion; however, when legally permitted exclusions are taken into account, the result turns into a primary surplus of BRL 10.8 billion (Figure 2).

Figure 2: Primary Result: official, with exclusions and target (% GDP)



Source: BOCOM BBM, National Treasury, PLDO 2027

In addition, several expenditure items that are subject to the fiscal framework's spending growth limit are adjusted according to their own indexation rules. Pension and social assistance benefits, for example, are linked to the minimum wage, which follows a path of real increases. Furthermore, constitutionally mandated expenditures tied to revenue collection, such as the minimum funding requirements for healthcare and education, rise in line with increases in government revenues. These pressures are compounded by population aging and the expansion of access to the 'Benefício de Prestação Continuada' (BPC), factors that tend to increase the number of beneficiaries of both the pension and social assistance systems and intensify pressures on public finances.

On the revenue side, net primary revenue has increased by approximately 1.3 percentage points of GDP since 2023. With the exception of 2010, this represents one of the highest levels of revenue collection observed over the past two decades. This outcome also suggests, however, that securing additional revenues of a similar magnitude is likely to become progressively more difficult in the coming years (Figure 3).

Our estimates indicate that net primary revenue would need to increase by an additional 2 percentage points of GDP by 2030 in order to make compliance with the primary balance targets feasible. Such a path, however, would prolong the current fiscal imbalances, impose increasing costs on economic activity and, even so, would not prevent gross public debt from exceeding 90% of GDP over the next four years. On the other hand, a simple revision of the fiscal rule's parameters is unlikely to be sufficient, as it would need to be accompanied by measures to contain the growth of mandatory expenditures.

Figure 3: Net Primary Revenues (% GDP)

Source: BOCOM BBM, National Treasury

In a context of elevated public indebtedness and structurally higher interest rates in the global economy, the next administration will face the challenge of advancing reforms that slow the growth of these expenditures and restore a sustainable trajectory for public debt.

ECONOMIC FORECASTS	2020	2021	2022	2023	2024	2025	2026F	2027F
GDP Growth (%)	-3.3%	4.8%	3.0%	2.9%	3.4%	2.3%	1.7%	1.0%
Inflation (%)	4.5%	10.1%	5.8%	4.6%	4.8%	4.3%	5.0%	4.5%
Unemployment Rate (eoy ,%)	14.2%	11.1%	7.9%	7.4%	6.2%	5.1%	5.5%	6.2%
Policy Rate (eoy, %)	2.0%	9.3%	13.8%	11.75%	12.3%	15.0%	13.75%	12.00%
External Accounts								
Trade Balance (US$ bn)	36	42	52	92	66	60	81	75
Current Account Balance (US$ bn)	-25	-40	-42	-28	-66	-69	-59	-58
Current Account Balance (% of GDP)	-1.7%	-2.4%	-2.2%	-1.3%	-3.0%	-2.9%	-2.4%	-2.3%
Fiscal Policy								
Central Government Primary Balance (% of GDP)	-9.8%	-0.4%	0.5%	-2.1%	-0.4%	-0.5%	-0.4%	-0.3%
Government Gross Debt (% of GDP)	86.9%	77.3%	71.7%	74.4%	76.1%	78.7%	83.2%	87.2%