Independent Fiscal Institution

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HIGHLIGHTS

- Bacen removed fiscal uncertainty from its risk balance sheet but stressed the need for reforms capable of generating convergence of fiscal results towards targets.
- The international outlook brings risks to the domestic inflation scenario.
- A 50 bps cut should be seen at future Bacen meetings.
- Recent figures suggest a sharp deterioration in the Federal Government's primary balance.
- Primary revenues are decelerating in 2023, reversing the movement seen in 2021 and 2022.
- Primary expenditure growth has intensified since May.
- Monetary tightening and uncertainties have increased the share of fixed-rate bonds in the composition of debt.
- The improvement in the domestic environment has allowed the Treasury to increase its issuance of fixed-rate bonds.
- Sensitivity analysis suggests that reducing the Selic rate will ease interest expenses and help reduce debt.
- The Brazilian tax system requires changes in the direction of simplification, neutrality, and tax justice.
- The two guiding pillars of PEC 45/2019 are 1) not to increase the tax burden and 2) to restore the current level of consumption tax collection.
- PEC 45/2019 will have to be reviewed by the Federal Senate concerning the exceptions made and their impact on the standard national reference rate.
- The studies carried out so far point to a standard rate for the new dual VAT of between 20% and 30% on consumer transactions in the different scenarios.

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Improved scenario, fiscal anchoring and tax reform

The Independent Fiscal Institution (IFI), fulfilling its mission, established by Resolution 42/2016 of the Federal Senate, presents its 79th Fiscal Follow-up Report (RAF/August/2023).

This report opens with an analysis of the improvement in the macroeconomic scenario in light of a critical reading of the minutes of the 256th session of the Central Bank's Monetary Policy Committee (Copom). The meeting was held on August 1 and 2, 2023. The idea is to shed light on the monetary authorities' perception of a more benign environment for Brazilian inflation. Although there was disagreement over the magnitude of the cut in the basic interest rate, all Copom members converged in the sense that the institutional advances underway, particularly the fiscal framework and tax reform, and the behavior of the IPCA, allowed the beginning of the monetary easing cycle.

However, despite removing doubts about the new fiscal anchoring framework from the balance of risks, they warn that it is essential to persist in adjusting public accounts, maintaining the zero-deficit target for the 2024 budget and redoubling efforts to consolidate structural reforms, which could boost the disinflation process and the continuity of cuts in the Selic rate in the coming months. This analysis is accompanied by the breakdown of the IPCA for a proper understanding of the elements most sensitive to monetary policy actions, as well as other risks associated with changes in the external scenario (inflation persistence, monetary tightening, and global growth slowdown). (Page 4).

Secondly, a worrying fact is analyzed: the recent significant worsening in the central government's primary result due to the acceleration in the rate of expansion of expenditure combined with the simultaneous slowdown in revenue. This could make it even more challenging for the Federal Government to reach the fiscal target for 2024, stipulated in the draft of the new fiscal framework being considered by the Chamber of Deputies (Page 7).

On a third aspect, this month's RAF analyzes the prospects for relief in interest expenses on the public debt as a result of the reversal of the contractionary monetary policy by Bacen, facilitating debt management by the National Treasury, with the possibility of even reducing the stock of gross debt, depending on the performance of the other conditioning factors that influence government indebtedness (Page 12).

Finally, this Fiscal Follow-up Report presents, as a special topic, a first approach to the issue that will certainly dominate the decision-making agenda of the National Congress over the next four months: tax reform. This is done in three stages: 1) comparison of the principles that guide the configuration of a good tax system and the current situation in Brazil; 2) analytical description of the central lines of PEC 45/2019, approved by the Chamber of Deputies and under analysis by the Federal Senate; 3) presentation, based on three recently published studies, of the discussion on the calibration of the National Standard Reference Rate, which will regulate the implementation of Brazilian dual VAT (IBS+CBS). (Page 16).

In this way, IFI seeks to contribute to the advancement of the Brazilian fiscal agenda. Have a good reading!

Marcus Pestana
IFI Executive Director

Vilma da Conceição Pinto
IFI Director

The Central Bank's balance of risks and the strategy of reducing monetary tightening

Vilma Pinto

At the last meeting of the Central Bank's Monetary Policy Committee (Copom), it was decided to reduce the Brazilian economy's basic interest rate by 50 basis points (bps). This reduction was expected by the market, with the only uncertainty being the size of the cut. For the next few meetings, however, Copom has signaled that it expects to continue cutting rates by the same amount, taking into account the risks surrounding the scenario outlined.

In the IFI's last Fiscal Follow-up Report (RAF), we assessed whether the economic environment was favorable to the start of the monetary easing cycle. The main conclusion of that analysis was that, following the decision by the National Monetary Council (CMN) to set the 2026 inflation targets at 3.0% and confirm the 2024 and 2025 targets also at 3.0%, all with a tolerance interval of 1.5 percentage points (p.p.) up or down, an environment was created that was favorable to the start of the cycle of reducing monetary tightening, despite uncertainties regarding the magnitude of those cuts.

With the release of the minutes from the most recent meeting of the Monetary Policy Committee (Copom), conducted by the Central Bank of Brazil in early August 2023, these uncertainties began to dissipate. At this meeting, the Committee decided to reduce the basic interest rate for the Brazilian economy by 50 basis points (bps), signaling that it will continue to cut by the same amount at future meetings. In the words of the minutes of the meeting: "(...) the members of the Committee unanimously agreed with the expectation of cuts of 0.50 percentage points in the next meetings (...)" (Bacen, 2023, p. 6).

Although there was unanimity regarding the signaling for future meetings, the decision taken by Copom for the current cut was not unanimous. Four out of the nine members of the Committee voted for a cut of only 25 bps and the rest - five members, including the chairman - voted for a cut of 50 bps. The decision to cut the rate by 50 bps was due to a better inflation situation.

The inflation target is based on the Extended National Consumer Price Index (IPCA, in the original acronym). However, in the composition of this indicator, there are items that are more sensitive to the actions of monetary policy and others that are determined by other factors. Therefore, to better assess the effectiveness of this disinflationary process, it is important to evaluate the behavior of services inflation and core inflation, and also the re-anchoring of expectations for longer terms.

Table 1 shows the composition of the IPCA, breaking down administered prices, which suffer little influence from monetary policy decisions, free prices and the average of the various inflation cores monitored by the Central Bank, which are therefore more sensitive to the Central Bank's inflation control mechanisms.

TABLE 1. COMPOSITION OF THE IPCA IN MAY, JUNE AND JULY (% PER MONTH AND PER YEAR)

Description	In the month			In 12 months		
	May	June	July	May	June	July
IPCA	**0.23%**	**-0.08%**	**0.12%**	**3.90%**	**3.20%**	**3.99%**
Administered prices	**0.71%**	**0.06%**	**0.46%**	**-0.90%**	**-1.30%**	**3.64%**
Gas	-1.93%	-1.14%	4.75%	-26.50%	-26.80%	-9.28%
Residential electricity	0.91%	1.43%	-3.89%	-1.30%	1.20%	3.20%
Health insurance	1.20%	0.38%	0.78%	17.50%	14.50%	14.11%
Pharmaceuticals	0.89%	-0.32%	0.22%	7.50%	6.50%	6.18%
Free prices	**0.07%**	**-0.13%**	**0.01%**	**5.70%**	**4.80%**	**4.14%**
Food	0.00%	-1.07%	-0.72%	4.60%	2.90%	0.66%
Services	-0.06%	0.62%	0.25%	6.50%	6.20%	5.64%
Industrialized	0.30%	-0.60%	0.12%	5.20%	4.00%	4.22%
Core average	**0.37%**	**0.20%**	**0.18%**	**6.70%**	**6.00%**	**5.60%**

Source: Bacen and IBGE. Prepared by: IFI.

It is possible to observe that after a month of slight deflation in the monthly IPCA rate, the full index returned to a positive variation, reaching a rate of 0.12% in the month of July. Administered prices were the most significant contributors to the rise in inflation in July. The gasoline item showed a growth of 4.75% in July, reflecting the restoration of tax rates imposed on this commodity. As a result, the 12-month accumulated rate for administered prices jumped from -1.3% in June to 3.64% in July.

In turn, the average of the cores monitored by the Central Bank - measures that seek to remove the influence of more volatile items from total inflation - has shown a marginal deceleration, creating a scenario of a gradual reduction in the accumulated rate over twelve months. Free prices returned to near-zero growth on the margin after a period of negative variation. Within this group, the highlight is the deceleration in the margin for food at home and services, which showed monthly rates of -0.72% and 0.25% in July, compared to -1.07% and 0.62% in June, respectively.

In addition, the minutes of the Copom meeting also considered and pointed out some additional risks that could affect the expectation of a reduction in monetary tightening planned for the next few meetings. In the field of fiscal policy, although Copom removed the residual uncertainty about the approval of the New Fiscal Framework (Supplementary Bill [PLP] No. 93 of 2023) from the balance of risks, the Committee's discussions highlighted the persistence of uncertainty about overcoming fiscal challenges. According to Bacen, maintaining the fiscal commitment made and adopting the necessary measures to fulfill it can help the disinflation process occur more quickly.

In this respect, three crucial points stand out. The first is that we are approaching the date for presenting the budget proposal for 2024 (end of August) and, so far, neither the Budget Guidelines Bill (PLDO) – which guides the preparation of the Annual Budget Bill (PLOA) – nor PLP 93/2023 have been approved. The Budget Guidelines proposal contains the zero-deficit target set by the federal executive branch for the primary result in 2024, and PLP 93/2023 contains the new rule limiting primary spending, which will replace the current expenditure ceiling. The failure to approve these measures in time for the budget to be presented is a problem for prospective budget planning since the LOA bill, known as the PLOA, will have to be based on guidelines that are still under discussion in Congress.

Another factor of fiscal uncertainty corresponds to the instruments that will be used by the government to achieve the 2024 fiscal targets. As can be seen in Table 2, the zero-deficit scenario is still not seen as feasible by the market, considering the current structure of income and expenditure and the possibilities of increasing and/or limiting primary expenditure as a result of the New Fiscal Framework.

TABLE 2. SCENARIOS FOR PRIMARY RESULT IN 2024 (R$ BILLION AND % OF GDP)

	IFI	Central Bank's Market Bulletin [Focus Bulletin]	Fiscal Prism	National Treasury
Primary result (R$ billion)	-105.0	n.d.	-84.8	-150.8
Primary result (% of GDP)	-0.9%	-0.8%	-0.8%	-1.3%
Fiscal effort required to reach the center of the 2024 target (% of GDP):	-0.9%	-0.8%	-0.8%	-1.3%
Fiscal effort required to reach the lower limit of the 2024 target (% of GDP):	-0.7%	-0.6%	-0.5%	-1.1%

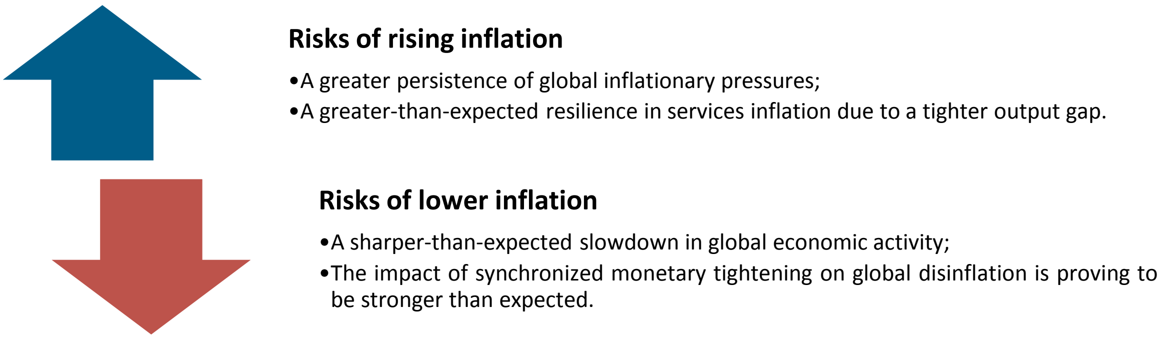
Source: STN Fiscal Projections Report (Jun-2023), Fiscal Prism [Monthly Report of the Fiscal Prism System], FOCUS Bulletin and IFI. Prepared by: IFI.

The lack of a clear indication of the sources of funds that will subsidize the achievement of zero deficit targets for the central government in 2024 is still a concern for the Central Bank. Despite this, it is important to mention the signs of structural measures to increase the Federal Government's primary revenues. The current tax reform proposal discusses maintaining the tax burden on consumption, but the Ministry of Finance[1] has already expressed the possibility of a second phase of tax reform, focusing on taxes related to income and without the restriction of maintaining the tax burden.

Despite these signs, the fiscal challenges are still persistent, since the primary result has decelerated within the margin and, consequently, public indebtedness, both gross and net, has increased compared to 2022.

Also, although the tone of the statement was more moderate, in the assessment of the balance of risks for the inflationary scenario and for inflation expectations, in the Copom minutes, in addition to the factors already explored in this section of the RAF, some upside and downside risks to inflation were also highlighted. The figure below shows the risks mentioned in the minutes of the meeting. These components are briefly analyzed below.

FIGURE 1. HIGHLIGHTS OF THE BALANCE OF RISKS FOR THE INFLATION SCENARIO



Source: Bacen [Central Bank of Brazil] (2023). Prepared by: IFI.

The external scenario was highlighted in the Central Bank's balance of risks. Inflationary pressures and moderate growth in advanced economies highlight the potential impact that this more adverse economic environment could have on the ongoing monetary easing process.

According to the International Monetary Fund's (IMF) *World Economic Outlook*[2], global growth is expected to fall from 3.3% in 2022 to 3.0% in 2023 and 2024. The IMF projections for the advanced economies, meanwhile, are for growth of 2.7% in 2022, slowing to 1.5% and 1.4% in 2023 and 2024, respectively. This is a challenging scenario since the rise in interest rates to control inflation tends to put pressure on economic activity. According to IMF projections, global inflation is expected to fall from 8.7% in 2022 to 6.8% in 2023 and 5.2% in 2024. Core inflation is expected to fall more gradually and the forecast for inflation in 2024 has been revised upwards by the IMF.

The Central Bank signaled that the speed of the next cuts should remain at 50 bps. As a result, the Selic rate forecast for the end of the year, currently at 12%, has a downward bias. However, the extension of the cycle of cuts will depend on the continuity of this process of decelerating inflation, the absence of new external shocks and the materialization of the fiscal measures needed to comply with the New Fiscal Framework. Our scenario envisages the Selic reaching 9.5% by the end of 2024.

[1] In the STN's projections report for the first half of 2023, a list of possible revenue-raising measures was presented. According to the report, the measures already underway would contribute around 0.9 p.p. to next year's primary, but a further 1.4 p.p. of additional measures would still be needed to meet the center of the 2024 target. Among the list of possibilities, the STN mentions that "Other possibilities are revenue gains from the regulation of fixed-odds betting, the improvement of import inspection mechanisms and gains from the reform of income taxation." (Page 38 of the report). Available at: https://sisweb.tesouro.gov.br/apex/f?p=2501:9::::9:P9_ID_PUBLICACAO:47466.
[2] Available at: https://www.imf.org/-/media/Files/Publications/WEO/2023/Update/July/English/text.ashx.

Recent figures suggest a sharp deterioration in the Federal Government's primary result

Alexandre Andrade and Vilma Pinto

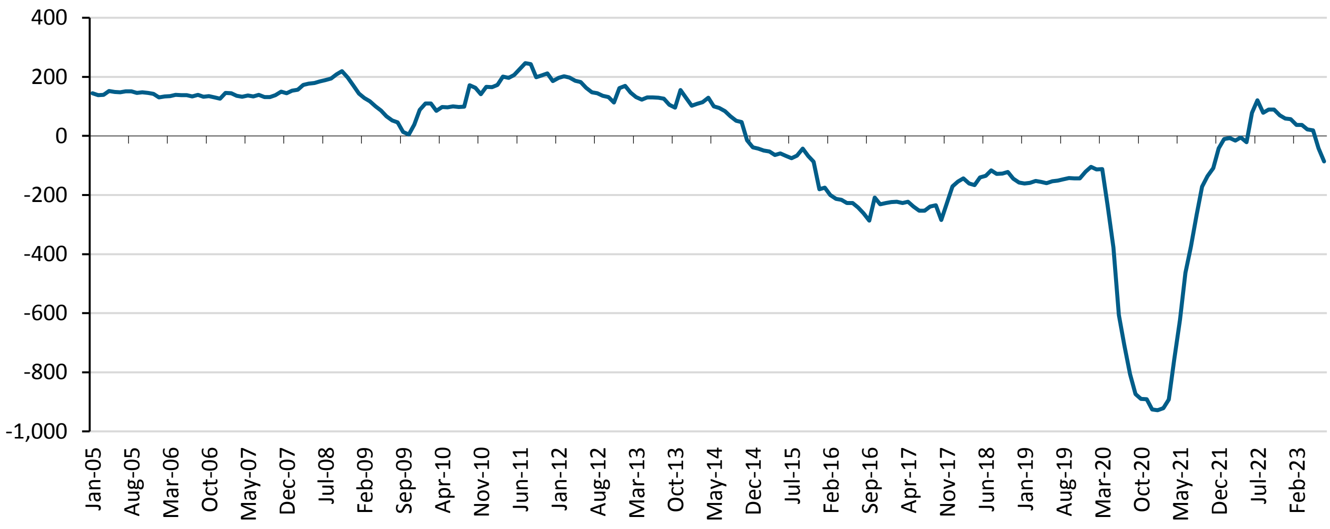
The figures already indicated a worsening in the central government's primary result in the first months of the year. From May onwards, however, the evidence is that this worsening has become more pronounced, with an increase in the rate of expansion of expenditure, at the same time as revenues show signs of slowing down.

Through the systems Siga Brasil, of the Federal Senate, and Tesouro Gerencial, of the National Treasury Secretariat (STN), the IFI anticipates monthly information on the primary result of the central government one month ahead of that produced by the National Treasury Secretariat (STN) in the National Treasury Result Bulletin (RTN), according to the above-the-line method[3]. Comparing the figures brought forward to July with the official information from the STN allows for a clearer analysis of the trajectory of the federal government's public accounts in 2023.

In the first seven months of 2023, the central government, which includes the National Treasury, the Central Bank and the INSS, is projected to record a primary deficit of R$ 67.0 billion, compared to a surplus of R$ 73.2 billion in the first seven months of 2022. In the 12 months to July, the central government's primary result is estimated to have been negative by R$ 86.1 billion at current values.

The result in July shows a deepening of the deterioration that had been observed in the central government's primary result in previous months. Chart 1 shows the 12-month evolution of the primary result at July 2023 prices. From May onwards, the worsening in the trajectory of the primary result became clear. This was due to the loss of momentum in revenues and the increase in the pace of primary expenditure, as will be detailed later in this text. Also in the 12-month comparison, the primary deficit should reach 0.8% of GDP in July, compared to a deficit of 0.4% of GDP in June and a surplus of 1.2% of GDP in July 2022.

CHART 1. 12-MONTH EVOLUTION OF THE CENTRAL GOVERNMENT'S PRIMARY RESULT (R$ BILLION AT JULY 2023 PRICES)



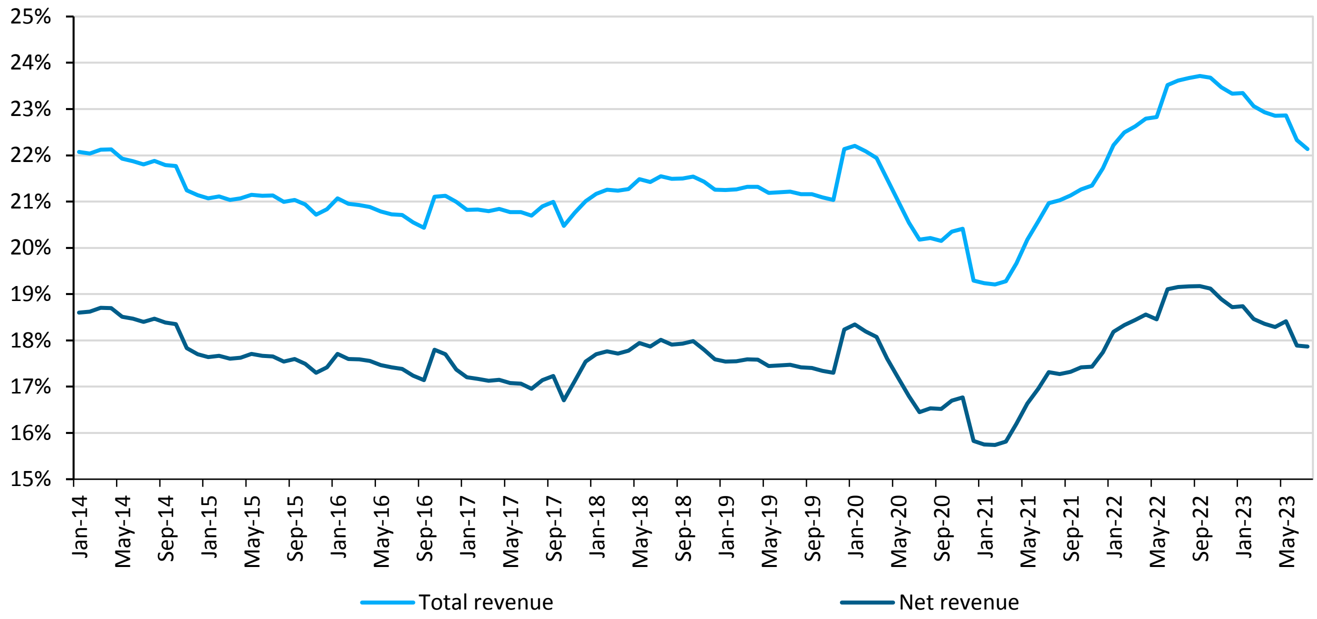
Source: National Treasury Secretariat, Siga Brasil and Tesouro Gerencial. Prepared by: IFI.

[3] The primary result calculated using the "above-the-line" method considers the difference between the government's non-financial income and expenditure. Another way of calculating the primary result is by the "below-the-line" method, which consists of obtaining the primary result by the debt differential, discounting the net payment of nominal interest. The two criteria are equivalent after methodological and statistical discrepancy adjustments.

The slowdown in fiscal results is in line with the executive branch's revised projections for this year's result. In the government's report for the Bimonthly Budget Update, the Executive has revised downwards the projection for the central government's primary deficit in 2023. In the 3rd bimonthly assessment[4], published in July, the projection was revised from a deficit of R$ 136.2 billion to R$ 145.4 billion. On the expenditure side, there was an upward revision of R$ 7.2 billion in relation to the 2nd bimester report[5] due to (i) financial support for states and municipalities (+ R$ 4.6 billion) to compensate for the reduction in ICMS collection resulting from Complementary Law (LC) No. 194; (ii) an upward revision of R$ 2.4 billion in RGPS expenses; and (iii) a change of R$ 1.2 billion in the projection for expenses with subsidies, grants and Proagro. The Executive branch's projection for the central government's net revenue, meanwhile, was revised downwards by R$ 2.0 billion.

The central government's primary revenues are losing growth momentum throughout 2023. Considering the series accumulated over 12 months and deflated at July 2023 prices, the 16.2% expansion recorded in December 2022 was reduced to 7.1% in July 2023. Chart 2 shows the evolution of total primary revenue and net transfers by revenue breakdown, as a proportion of GDP. In the year to July 2023, the reduction in total revenue was 1.2 p.p. of GDP, from 23.3% in December 2022 to 22.1% in July 2023. The decrease in total revenue was more pronounced from June onwards. Net revenue fell by 0.9 p.p. (from 18.7% of GDP to 17.9% of GDP).

CHART 2. 12-MONTH EVOLUTION OF TOTAL AND NET PRIMARY REVENUES OF THE CENTRAL GOVERNMENT - % OF GDP



Source: National Treasury Secretariat. Prepared by: IFI.

Table 3 summarizes the behavior of the central government's primary revenues between January and July of the last three years. Total revenue experienced a real reduction of 5.4% in the year-to-date of 2023. The most significant loss of revenue was concentrated in revenue not collected by the Federal Revenue Office, which recorded a real drop of 30.9% in the period. This reduction, in turn, is explained by the collection of dividends and participations (R$ 18.9 billion less in 2023 than in 2022) and the exploitation of natural resources (R$ 16.1 billion less in 2023 than in 2022). Under this heading, the performance of the average price of oil on the international market explains the reduction. In 2022, according to the *Energy Information Administration* (EIA), the average price of a barrel of Brent fell from $100.8 in 2022 to $79.8 in the first seven months of this year. Oil prices affect the government's collection of royalties and shares.

[4] Available at: https://sisweb.tesouro.gov.br/apex/f?p=2501:9::::9:P9_ID_PUBLICACAO:47533.
[5] Available at: https://sisweb.tesouro.gov.br/apex/f?p=2501:9::::9:P9_ID_PUBLICACAO:47037.

TABLE 3. CENTRAL GOVERNMENT REVENUES (2021 TO 2023) - JANUARY TO JULY (CURRENT R$ BILLION, REAL % CHANGE AND % OF GDP)

	Jan-Jul/21			Jan-Jul/22			Jan-Jul/23		
	Current R$ bi	Real % change	% GDP	Current R$ bi	Real % change	% GDP	Current R$ bi	Real % change	% GDP
Total revenue	**1,067.7**	**-31.3%**	**21.0%**	**1,367.1**	**15.3%**	**24.2%**	**1,350.3**	**-5.4%**	**22.1%**
Revenue collected by the Federal Revenue Office, *except RGPS*	*677.7*	*-28.8%*	*13.3%*	*827.6*	*10.1%*	*14.7%*	*848.8*	*-1.9%*	*13.9%*
Tax incentives	*-0.1*	*-*	*0.0%*	*-0.1*	*-*	*0.0%*	*0.0*	*-*	*0.0%*
RGPS revenues	*242.9*	*-43.3%*	*4.8%*	*290.4*	*7.7%*	*5.1%*	*322.4*	*6.3%*	*5.3%*
Revenue not collected by the Federal Revenue Office,	*147.2*	*-15.4%*	*2.9%*	*249.1*	*52.1%*	*4.4%*	*179.1*	*-30.9%*	*2.9%*
Transfers	**196.4**	**-29.7%**	**3.9%**	**264.5**	**21.3%**	**4.7%**	**250.3**	**-9.4%**	**4.1%**
Net revenue	**871.4**	**-31.6%**	**17.1%**	**1,102.6**	**14.0%**	**19.5%**	**1.100.1**	**-4.5%**	**18.0%**
GDP (in current R$ billions)			**5,089.1**			**5,640.4**			**6,099.1**

Source: National Treasury Secretariat, Central Bank, Siga Brasil and Tesouro Gerencial. Prepared by: IFI.

Revenues collected by the Federal Revenue Office fell by 1.9% in real terms in the seven months to 2023. With the exception of Income Tax, whose collections rose 0.7% on this basis of comparison, the other taxes fell, especially the Social Contribution on Net Profit (CSLL). Also in relation to income tax, the increase in the accumulated figure for 2023 is explained by the payment of Withholding Income Tax

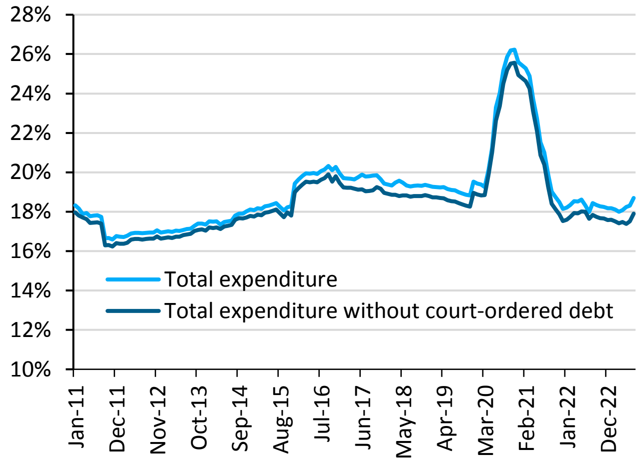
(IRRF). Corporate Income Tax (IRPJ) registered a real contraction of 7.0% in the first half of the year. In general terms, the behavior of administered revenues [i.e., collected by the Federal Revenue Office] reflects the slowdown in domestic economic activity, as evidenced by the Central Bank's Economic Activity Index (IBC-Br), for example.

Also according to Table 3, net revenue saw a real contraction of 4.5% in the first seven months of 2023. In part, the deterioration in the primary result over the year is due to the performance of net revenue.

Moving on to an analysis of the behavior of primary expenditure, Chart 3 shows the 12-month evolution of primary expenditure by the central government and primary expenditure excluding the payment of court-ordered debt, as a proportion of GDP. An expenditure series was calculated that isolated the payment of court-ordered debt in order to assess whether or not this expenditure was causing a distortion in the evolution of expenditure.

The two curves shown in Chart 3 reveal an intensification in the rate of increase in primary expenditure from May 2023 onwards. In the 12-month comparison, primary expenditure reached 18.1% of GDP in April, rising to 18.2% of GDP in May, then to 18.3% of GDP in June before rising to 18.7% of GDP in July. As will be explored further below, the increase in expenditure over the last three months is related to the increases in the minimum wage and the salary of civil servants, as well as the increase in the issuance of RGPS benefits.

CHART 3. 12-MONTH EVOLUTION OF TOTAL PRIMARY EXPENDITURE AND OF PRIMARY EXPENDITURE EXCLUDING COURT-ORDERED DEBT PAYMENTS - % OF GDP



Source: National Treasury Secretariat. Prepared by: IFI.

In recent years, between 2016 and 2019, primary expenditure has been relatively controlled, as a proportion of GDP, due to the enactment of EC No. 95 of 2016, which instituted an expenditure ceiling for the Federal Government. Between 2019 and 2022, with the exception of expenses arising from the pandemic, the absence of a real increase in the minimum wage and civil service salaries helped to keep primary expenditure under control.

At the end of 2021, two constitutional amendments (ECs No. 113 and No. 114) were approved, which helped to expand the fiscal space in the Federal Government's expenditure ceiling in 2022. As shown in RAF No. 60, of January 2022, the space opened up in the expenditure ceiling totaled R$ 113.1 billion, of which R$ 69.6 billion corresponded to the recalculation of the expenditure ceiling and R$ 43.5 billion to the reduction in spending on court judgments and court-ordered debt payments subject to the expenditure ceiling. This space helped accommodate a series of expenses, most notably the expansion of the conditional cash transfer program for families, called Brazil Aid at the time, the General Rapporteur's amendments and social security benefits.

In 2022, EC No. 126 was enacted, also with the aim of expanding the fiscal space, now to 2023. The instrument used two mechanisms: (i) increasing the expenditure ceiling by R$ 145 billion, and (ii) removing items from the calculation of expenses subject to the ceiling, such as investments made with excess revenue, salary floors for nursing professionals, etc. These two mechanisms opened up a gap of R$ 168.3 billion in the comparison between the bill (PLOA) and the actual budget law (LOA), which was sanctioned with the effects of EC 126. Taking into account the latest bimonthly assessment of the Executive Branch's primary revenue and expenditure, relating to the 3rd bimester, the constitutional caveats now total R$ 172.3 billion.

The fiscal space opened up by EC No. 126 in the Federal Government's expenditure ceiling for 2023 made a series of expenses possible, such as the expansion of the budget for the conditional cash transfer program for families, which has been renamed the Bolsa Família Program, adjustments to the minimum wage above inflation (which affects primary expenses indexed to this variable), adjustments to the salaries of civil servants, expansion of the budget for public investments and budget restoration of other programs.

Table 4 summarizes some of the Federal Government's primary expenditure over the last three years, from January to July. In the year to 2023, expenditure grew by 8.6% in real terms. The sharp contraction observed in 2021 is related to the reduction in spending aimed at combating the effects of the pandemic. Expenses that will grow in 2023 include (i) social security benefits under the RGPS (+6.6%); (ii) payroll (+1.3%); (iii) allowances and unemployment benefits (+8.3%); (iv) BPC (+9.9%); (v) Fundeb (+11.2%); (vi) judicial sentences and court-ordered payment of costs and capital (+91.8%); and (vii) mandatory flow control expenses (+38.5%).

TABLE 4. CENTRAL GOVERNMENT PRIMARY EXPENDITURE (2021 TO 2023) – JANUARY TO JULY (IN CURRENT R$, REAL % CHANGE AND % OF GDP)

Breakdown	Jan-Jul/21			Jan-Jul/22			Jan-Jul/23		
	Current R$ bi	Real % change	% GDP	Current R$ bi	Real % change	% GDP	Current R$ bi	Real % change	% GDP
Total expenditure	**944.5**	**-54.4%**	**18.6%**	**1,029.4**	**-1.7%**	**18.3%**	**1,167.0**	**8.6%**	**19.1%**
Social security benefits (RGPS)	*437.5*	*-38.1%*	*8.6%*	*477.2*	*-1.7%*	*8.5%*	*530.7*	*6.6%*	*8.7%*
Payroll (active and inactive)	*190.4*	*-44.1%*	*3.7%*	*187.4*	*-11.3%*	*3.3%*	*198.4*	*1.3%*	*3.3%*
Allowances and unemployment benefits	*31.5*	*-49.9%*	*0.6%*	*46.9*	*34.0%*	*0.8%*	*53.5*	*8.3%*	*0.9%*
Continuous Cash Benefit (BPC)	*39.5*	*-40.6%*	*0.8%*	*45.2*	*3.0%*	*0.8%*	*51.9*	*9.9%*	*0.9%*
Extraordinary credits (except PAC)	*68.0*	*-85.2%*	*1.3%*	*14.7*	*-80.2%*	*0.3%*	*1.1*	*-93.1%*	*0.0%*
Compensation to the RGPS for Payroll Exemptions	*4.7*	*-52.7%*	*0.1%*	*3.1*	*-40.6%*	*0.1%*	*0.0*	*-100.0%*	*0.0%*
Fundeb	*11.4*	*-28.1%*	*0.2%*	*19.1*	*50.1%*	*0.3%*	*22.1*	*11.2%*	*0.4%*
Court judgments and court-ordered debt payments (cost and capital)	*17.5*	*-29.4%*	*0.3%*	*9.2*	*-52.5%*	*0.2%*	*18.4*	*91.8%*	*0.3%*
Subsidies, grants and Proagro	*5.2*	*-76.8%*	*0.1%*	*12.5*	*115.4%*	*0.2%*	*12.3*	*-6.3%*	*0.2%*
Mandatory	**895.7**	**-54.2%**	**17.6%**	**955.1**	**-3.8%**	**16.9%**	**1.088.8**	**9.1%**	**17.9%**
Mandatory with flow control	***79.4***	***-43.8%***	***1.6%***	***125.4***	***42.3%***	***2.2%***	***181.4***	***38.5%***	***3.0%***
Discretionary	**48.8**	**-57.6%**	**1.0%**	**74.3**	**36.9%**	**1.3%**	**78.2**	**1.2%**	**1.3%**
GDP (in current R$ billions)	**5,089.1**			**5,640.4**			**6,099.1**		

Source: National Treasury Secretariat, Central Bank, Siga Brasil and Tesouro Gerencial. Prepared by: IFI.

Three important comments. In relation to Fundeb, the Federal Government's supplementation to the fund is in a transition period. EC No. 108 determines an increase from 10% to 23% of this supplement, to be completed by 2026. The high increase in legal expenses and court-ordered debt payments in 2023 is explained by differences in the payment schedule in 2022 and 2023.

The real increase of 38.5% in mandatory expenditure with cash flow control is because this item concentrates payments made under the Auxílio Brasil [Brazil Aid] and Bolsa Família [Family Grant] programs. As mentioned above, EC No. 126 made it possible to expand the Bolsa Família, as well as providing for the payment of R$ 600 per family from 2023 onwards.

Finally, the increase in social security benefit payments under the RGPS in 2023 (+6.6%, in real terms) would have been 4.8% if court-order debt payments were removed. In other words, growth would have been just as robust. Between January and July, court-ordered debt payments by the RGPS totaled R$ 19.5 billion, a 94.0% increase compared to the same period in 2022.

Also with regard to expenditure on social security benefits in 2023, the information contained in the Social Security Statistical Bulletin (BEPS) indicates that payments are growing, mainly due to the increase in the number of benefits issued, even though the average value of the benefit registered a real increase of 0.2% in the first half of 2023 (Table 5).

TABLE 5. BENEFITS ISSUED AND AVERAGE VALUE OF BENEFITS UNDER THE RGPS (2021 TO 2023) - ACCUMULATED FROM JANUARY TO JUNE (BENEFICIARIES - THOUSAND, R$ AT JULY 2023 PRICES AND VARIATION RATES)

	Jan-Jun/2021		Jan-Jun/2022		Jan-Jun/2023	
	Unit	Var.%	Unit	Var.%	Unit	Var.%
Number of social security benefits issued RGPS (thousand) - average	**35,941.3**	**0.7%**	**36,586.8**	**1.8%**	**37,892.6**	**3.6%**
Urban beneficiaries	*26,308.2*	*0.8%*	*26,868.1*	*2.1%*	*27,998.4*	*4.2%*
Rural beneficiaries	*9,633.2*	*0.2%*	*9,718.7*	*0.9%*	*9,894.2*	*1.8%*
Average value of the RGPS benefit (R$ at July 2023 prices)	**1,936.8**	**-1.2%**	**1,887.3**	**-2.6%**	**1,891.5**	**0.2%**
Urban beneficiaries	*2,141.5*	*-1.3%*	*2,084.0*	*-2.7%*	*2,070.6*	*-0.6%*
Rural beneficiaries	*1,377.4*	*-1.1%*	*1,343.6*	*-2.5%*	*1,384.5*	*3.0%*

Source: Ministry of Social Security. Prepared by: IFI.

In short, the recent worsening of the central government's primary result is the consequence of a combination of weakening revenues and expenditure expanding at a faster rate than in previous years. The increase in mandatory expenditure is mainly due to the increases in the minimum wage and civil service salaries. Adjustments to the minimum wage put pressure on some expenditure items, such as social security benefits, salary allowances and unemployment benefits, as well as the BPC. The tendency is for this upward trend in spending to continue. In the absence of a recovery in primary revenues, the outlook is for a worsening in the trajectory of the central government's primary result in the second half of the year.

Considering that the fiscal framework about to be approved by Congress preserves primary spending and makes compliance with fiscal targets dependent on revenue performance, any frustrations in growth and/or difficulties in materializing revenues intended by the Executive could compromise the credibility of fiscal policy in the future.

Effects of interest rate cuts on gross debt dynamics

Alexandre Andrade

The monetary easing cycle will have consequences for the public accounts by relieving the public sector's interest costs, making it easier for the Treasury to manage the debt and may even reduce the stock of gross debt in the coming months, depending on the evolution of the other factors conditioning the debt.

The aim of this text is to analyze the composition of the general government's gross debt (DBGD on the original acronym)[6] by index and to carry out a sensitivity analysis in relation to the economy's basic interest rate (Selic). Selic fluctuations affect public accounts through a number of channels, such as the composition of debt by index and public sector interest expenditure.

According to the Central Bank, in June, the last month with available information, the DBGG was stable at 73.6% of GDP, compared to May, and 0.6 p.p. higher than in April. From January to June, the gross debt rose by 1.0 p.p. of GDP and this was mainly due to the slowdown in nominal GDP growth, as shown in the analysis of the factors conditioning the gross debt.

As discussed in previous editions of this RAF, the implicit gross debt rate[7], which was on a downward trend until March 2021, has since risen due to the monetary tightening cycle that began at that time. Another index that influenced the increase in the implicit debt rate was inflation. From 2021 onwards, the increase in the value of these two indexes (Selic and IPCA) affected the remuneration paid by the Treasury on the bonds issued and, consequently, the dynamics of the average cost of the debt.

The tightening of monetary policy in 2021 has also led to greater risk aversion on the part of government bond holders, which affects their preference for liquidity. In the context of a rise in the basic interest rate, agents tend to acquire a greater relative share of bonds with post-fixed remuneration or linked to the Selic rate. Chart 4 shows the evolution of the share of debt securities by index. The most representative securities were considered, namely foreign exchange securities, price-indexed securities, Selic-indexed securities[8] and fixed-rate securities.

Immediately before 2021, in the second and third quarters of 2020, the increase in the relative share of Selic-indexed securities in the DBGG stock was due to the growth in the Central Bank's repo operations. These operations are an instrument used by the monetary authority to control the economy's liquidity, thus ensuring compliance with the Selic rate target set by the Monetary Policy Committee (Copom).

In those two quarters, at the beginning of the pandemic, in order to finance the non-recurring expenses that arose in that context, the Treasury mainly used resources from the Single Account[9]. The counterpart was an increase in liquidity in the economy, which forced the Central Bank to increase its repo operations. By way of illustration, as a proportion of GDP, repo operations, which are part of the DBGG, jumped from 15.9% of GDP in March 2020 to 21.6% of GDP in September

[6] The DBGG, an indicator calculated by the Central Bank, has a wider scope than the Federal Public Debt, an indicator published by the National Treasury Secretariat (STN). The DBGG covers the general government, i.e. it includes, in addition to the Federal Government, states and municipalities, disregarding state-owned companies (financial and non-financial) and the Central Bank of Brazil, and consolidates all public sector liabilities (securities debt, external debt, internal and external bank debt of all federal entities, among others).

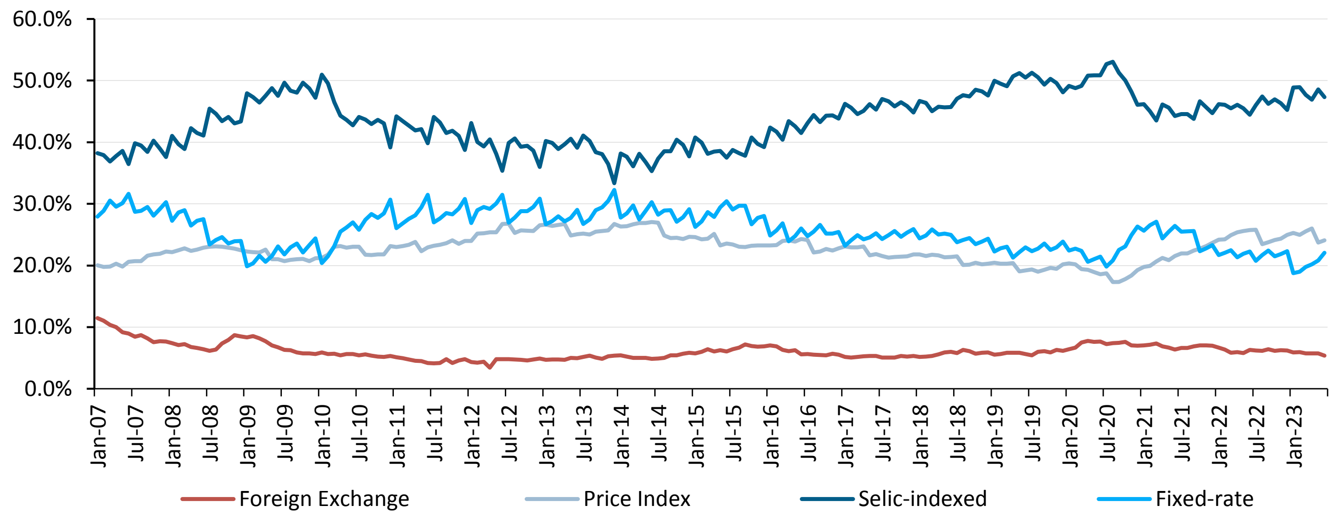
[7] The implicit rate is a measure of the average cost of the debt stock and corresponds to the ratio between interest payments and the debt stock. It is calculated and published by the Central Bank at the following site: https://www.bcb.gov.br/estatisticas/tabelasespeciais.

[8] It is important to mention the difference in methodologies used by the Central Bank and the STN when calculating fiscal and debt indicators. For example, according to the Central Bank's series, the share of government securities with remuneration linked to the Selic rate in relation to the DBGG stock was 47.3% in June 2023. According to the STN's methodology, the relative share of floating-rate securities in the Federal Public Debt (DPF) was 30.6% in the same month. Some considerations must be made. Firstly, the DBGG, calculated by the Central Bank, is a more comprehensive indicator than the STN's DPF. Secondly, in the stock of securities with remuneration linked to the basic interest rate, the Central Bank considers, in addition to Treasury Bills (LFTs), other securities, such as those in the monetary authority's portfolio for repo operations.

[9] The National Treasury's Single Account is held at the Central Bank and contains all the Federal Government's available funds. More information at: https://www.gov.br/tesouronacional/pt-br/execucao-orcamentaria-e-financeira/programacao-financeira/gestao-da-conta-unica.

of that year. As of October 2020, repo rates fell because of measures adopted by the STN and the Central Bank to improve public debt management[10]. At the same time, there was a slight drop in LFTs in the debt stock, as evidenced by the STN's information published in the Monthly Debt Report (RMD) for the Federal Public Debt (DPF).

CHART 4. SHARE OF SECURITIES BY INDEX IN DBGG (%)



Source: Central Bank. Prepared by: IFI.

In March 2021, when the monetary tightening began, Selic-indexed securities made up 43.5% of the DBGG stock, according to the Central Bank. The increase in the basic interest rate in the following months and the uncertainties in the economic environment caused this share to rise gradually. In June 2023, the proportion reached 47.3%.

The share of bonds linked to price indices in the DBGG grew in 2021, although the movement began in the last quarter of 2020, when inflation began to rise with the recovery of economic activity. In September 2020, price-indexed securities accounted for 17.3% of DBGG balances, rising to 19.8% in January 2021 and then to 23.7% in December of the same year. By the end of 2022, this proportion had reached 25.0%, dropping to 24.1% in June 2023 (Chart 4).

Chart 4 also shows a recovery in the share of fixed-rate securities in the DBGG stock from March 2023 onwards, due to a reduction in the perception of risk regarding the conduct of fiscal policy over the next few years. That month, the government presented the draft of the new fiscal framework. In the following months, the improvement in the external environment, with signs of inflationary control in the central economies, and the resumption of the tax reform proposal supported this improvement in the local environment, creating conditions for fixed-rate bond issues by the National Treasury. Between January and June, the holdings of fixed-rate bonds increased from 18.8% to 22.0% in the DBGG portfolio.

[10] For further clarification, see RAF No. 48 of January 2021 and RAF No. 50 of March 2021, available at the following sites: https://www12.senado.leg.br/ifi/relatorio-de-acompanhamento-fiscal.

To illustrate the movements of some of the curves shown in Chart 4, Chart 5 shows the evolution of the Selic rate target and the 12-month variation in the IPCA, two important public debt indexers. Between March 2021 and August 2022, the Selic rose 11.75 p.p. from 2.00% p.a. to 13.75% p.a. The chart considers information up to June 2023 and, therefore, does not include the 0.5 p.p. cut promoted by Copom at the August 2023 meeting.

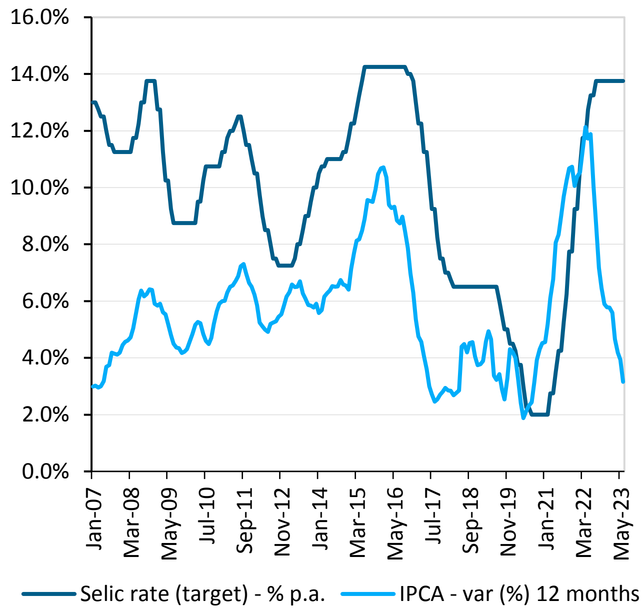
Inflation, as measured by the IPCA, in turn, began to rise in the last quarter of 2020, when economic activity in Brazil and around the world started to recover more strongly as mobility restrictions were relaxed. This inflationary process is also explained by some supply shocks, such as the dismantling of production chains throughout the pandemic, especially in industry, as well as the invasion of Ukraine by Russia in February 2022.

In June 2022, the IPCA reached 11.9% in the 12-month period and then fell in the following months. At first, between July and September last year, the exemption of federal taxes on fuel and the change in ICMS legislation on fuel, electricity, communications and public transport helped inflation to fall. From the last quarter of 2022 onwards, the slowdown in economic activity due to the restrictive monetary policy contributed to the fall in the IPCA (Chart 5).

The increase in the Selic and IPCA rates in 2021 and 2022 affected the interest expenses on securities with remuneration linked to these indexes. Chart 6 shows the evolution of interest expenses on the government securities included in the DBGG, by index, accumulated over 12 months as a proportion of GDP. Expenditure on Selic-indexed securities increased from 0.8% of GDP in April 2021 to 4.4% of GDP in June 2023. The start of monetary easing in August, which is expected to continue in the coming months, including 2024, should lead to a reversal of this expenditure from the second half of 2023.

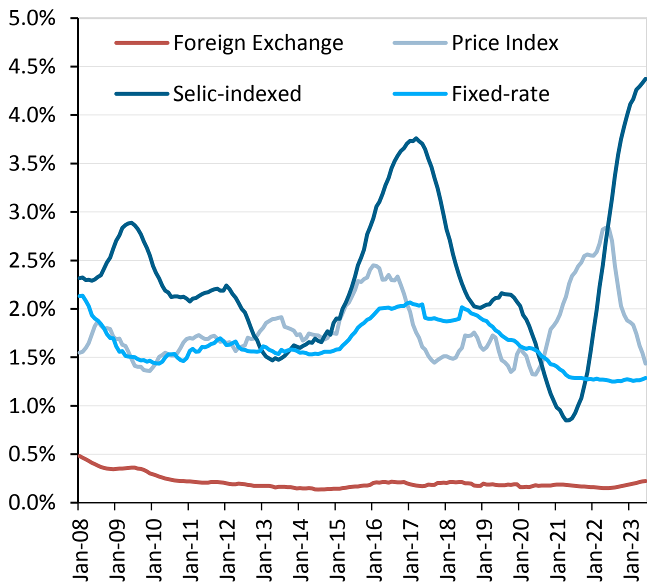
The interest expense on inflation-linked securities reached 2.8% of GDP in June 2022, subsequently decreasing in the following months due to the reasons already outlined in this text. By June 2023, this expense had fallen to 1.4% of GDP and the trend is for further falls in the months ahead as the IPCA continues to fall and converge on the center of the target set by the National Monetary Council (CMN), of 3.25% for 2023, and 3.00% from 2024 onwards (Chart 6).

CHART 5. EVOLUTION OF THE SELIC RATE TARGET (% P.A.) AND THE 12-MONTH CHANGE IN THE IPCA (CONSUMER PRICE INDEX)



Source: Central Bank and IBGE. Prepared by: IFI.

CHART 6. INTEREST EXPENSE ON SECURITIES BY INDEX IN THE DBGG ACCUMULATED OVER 12 MONTHS (% OF GDP)



Source: Central Bank. Prepared by: IFI.

Until July, the IFI's expectation was that the cycle of interest rate cuts would begin in September at a pace of 0.25 p.p. per meeting until the end of 2023. In June, the last month in which the IFI revised its macroeconomic and fiscal projections, the expectation was that the Selic rate would be reduced to 12.75% p.a. in 2023 and 10.50% p.a. in 2024. Copom, however, started the cycle in August with a 0.5 p.p. rate cut. The IFI's projection for the Selic rate is now 12.00% p.a. at the end of 2023 and 9.50% p.a. at the end of next year.

In this context, in order to assess the sensitivity of the reduction in the Selic rate on gross debt dynamics, the IFI carried out an exercise considering the macroeconomic projections released in June and an alternative monetary easing cycle for the coming months, with three additional cuts of 0.5 p.p. at the Copom meetings in September, November and December. In that case, the basic interest rate would be reduced to 11.75% p.a. at the end of 2023 and to 9.25% p.a. next year. These numbers represent the median projections from the Focus Report of the Central Bank, updated on August 11, 2023. The values considered in this exercise do not consist of an update of the IFI's projection for the Selic rate in 2023 and 2024.

The projections for the other relevant variables (real economic growth, implicit GDP deflator and the primary result of the consolidated public sector) were those published by the IFI in June. The values are reported in Table 6. The simulation seeks to demonstrate the effects of the Selic (and the implicit nominal and real gross debt rates) on the dynamics of the DBGG, keeping the other variables unchanged. The real implicit rate is calculated by the IFI by deflating the nominal implicit rate by the implicit GDP deflator.

In June, with a Selic rate of 12.75% p.a. at the end of 2023 and 10.50% p.a. at the end of 2024, the IFI estimated the implicit nominal and real interest rates on the gross debt at 11.2% p.a. and 5.6% p.a., respectively, at the end of 2023, and 10.2% p.a. and 4.9% p.a. in 2024. With these parameters (and the others shown in Table 6), gross debt would reach 76.4% p.a. in 2023 and 79.7% p.a. next year.

Now, considering a hypothetical scenario with the Selic rate at 11.75% p.a. in December this year and 9.25% p.a. at the end of 2024, the estimates for the implicit nominal and real debt rates would be 10.5% p.a. and 5.3% p.a., in that order, in 2023 and 9.2% p.a. and 4.2% p.a. in 2024.

In the alternative scenario, the new values for the Selic rate and the implicit rate would cause the gross debt projection to fall from 76.4% of GDP to 76.2% of GDP in 2023, a difference of 0.2 percentage points. In 2024, the change would be from 79.7% of GDP to 79.0% of GDP, a difference of 0.7 percentage points.

TABLE 6. MACROECONOMIC AND FISCAL ASSUMPTIONS FOR THE GROSS DEBT SCENARIO (2023 AND 2024)

Breakdown	2022	2023		2024	
		June/23 parameters	Aug/23 parameters	June/23 parameters	Aug/23 parameters
Primary result of the consolidated public sector	1.3%	-1.2%	-1.2%	-1.3%	-1.3%
Nominal GDP (R$ billion)	9,915	10,673	10,673	11,341	11,341
GDP - real growth	2.9%	2.3%	2.3%	1.2%	1.2%
Implicit GDP deflator	8.3%	5.2%	5.2%	5.0%	5.0%
Selic (% p.a.) - end of period	13.75%	12.75%	11.75%	10.50%	9.25%
Nominal implicit rate (% p.a.) - end of period	10.8%	11.2%	10.5%	10.2%	9.2%
Real implicit rate (% p.a.) - end of period	2.4%	5.6%	5.3%	4.9%	4.2%
DBGG (% of GDP)	**72.9%**	**76.4%**	**76.2%**	**79.7%**	**79.0%**

Source: IFI.

In short, this simple exercise shows that the interest cut will relieve the public sector's interest expense in the coming months and, consequently, could cause the gross debt, as a proportion of GDP, to fall. The behavior of the other variables that influence the debt trajectory was kept unchanged. It is also important to mention the high contribution of GDP growth to the reduction in debt over the last two years, although this contribution has been decreasing in recent months, as evidenced by the data on the factors conditioning gross debt.

The reduction in the Selic rate should also slightly reduce the relative share of securities linked to it in the DBGG stock as the Treasury manages to increase its issuance of fixed-rate and inflation-linked bonds. The RMD data shows that this has been possible in the last three months. An important consequence of the reduction in basic interest rates is to make it easier for the Treasury to manage the public debt.

The Tax Reform: necessary change, its characteristics and the calibration of the standard rate

Marcus Pestana

One of the serious bottlenecks to be overcome to build a new cycle of vigorous and sustained economic growth in Brazil lies in the complexity and distortions of our current tax system. The National Congress has advanced discussions on tax reform, initially addressing taxes on the consumption of goods and services. The deliberation process on the new dual VAT should be completed by December 2023.

Tax Reform and the overcoming a systemic bottleneck for the resumption of sustained, vigorous and inclusive economic growth

Brazil has long been calling for a tax reform that corrects the distortions of the current national tax system and serves as a platform for boosting the Brazilian economy through its positive effects on increasing productivity, employment, output, competitiveness and efficiency. A fair and efficient tax system is characterized by some universal, established and consensual principles[11]:

i. **Equity**: Currently, around 45% of Brazil's tax burden is concentrated on consumption taxes, which are intrinsically regressive. This high proportion of indirect taxes, in a way, indicates that the poorest Brazilians pay proportionally more taxes than the richest. It is worth mentioning that the issue of regressivity should not only be looked at from the perspective of taxation but also from the perspective of public spending aimed at reducing inequalities.

ii. **Simplicity and transparency:** Simplicity is important to make the tax system more transparent and efficient. The Brazilian tax system is one of the most complex in the world, with thousands of overlapping laws, decrees, rules, ordinances, normative instructions and resolutions, born out of government action in the three federal spheres. There is no transparency, the taxpayer doesn't know exactly how much tax they pay.

iii. **Elasticity and stability:** A study carried out by the IBPT [Brazilian Institute of Planning and Taxation] in September 2022 showed that since the Federal Constitution was enacted in 1988, 466,561 tax rules have been enacted. There are 2.26 regulations per hour on working days issued by the various levels of government.

iv. **Low compliance costs:** The burden of maintaining federal, state and municipal revenues within the public budget is great and so are the administrative costs imposed on the private sector to comply with the almost 5,000 tax rules in force in Brazil, which have resulted from the permanent changes in the legal and regulatory framework relating to the tax system since the Federal Constitution was enacted in 1988.

v. **Efficiency and neutrality:** The issue of neutrality is related to equal tax treatment for different forms of consumption, with the aim of not altering the decisions of economic agents. In this sense, it is well known that the great complexity of Brazilian tax legislation, which is fragmented and lacks national uniformity, introduces countless distortions in the taxation of sectors, products and services, with obvious negative repercussions on the allocation of investments and the productivity of the economy.

vi. **Legal certainty:** An efficient tax system must reduce the level of litigation between taxpayers and the tax authorities. Research commissioned by the National Council of Justice (CNJ) and published by the Insper Institute in 2020[12],

[11] These include:
BIRD, R.M. Tax challenges facing developing countries. Atlanta: Georgia State University, 2008. (Working Paper, n. 08-02). Available at: https://www.nipfp.org.in/media/medialibrary/2013/04/wp_2008_Richard.pdf.
2. ORAIR, Rodrigo Octávio; Gobetti , Sérgio Wulf. Reforma Tributária e federalismo fiscal: uma análise das propostas de criação de criação de um novo Imposto sobre Valor Adicionado para o Brasil. [Tax reform and fiscal federalism: an analysis of proposals to create a new Value Added Tax for Brazil]. IPEA, 2019 (Text for discussion, no. 2530). Available at: https://repositorio.ipea.gov.br/handle/11058/9596.
3. ORAIR, R.; GOBETTI, S. Reforma tributária no Brasil: princípios norteadores e propostas em debate.[Tax reform in Brazil: guiding principles and proposals under debate]. Novos estudos CEBRAP, v. 37, n. 2, p. 213-244. Available at: https://www.scielo.br/j/nec/a/SPvDStxHz47863pCGcxWTHN/.
[12] Conselho Nacional de Justiça; Instituto de Ensino e Pesquisa. Diagnóstico do contencioso judicial tributário brasileiro: relatório final de pesquisa [Diagnosis of Brazilian tax litigation: final research report]. Brasília: CNJ, 2022. Available at: https://www.cnj.jus.br/wp-content/uploads/2022/02/relatorio-contencioso-tributario-final-v10-2.pdf.

showed that tax litigation in Brazil at that time involved resources equivalent to R$ 5.44 trillion, or 75% of the Gross Domestic Product (GDP), a level that is certainly a record in relation to other countries.

vii. **Tax moderation:** The magnitude of the tax burden follows the model of the State and the historical evolution of each country, derived from the social and political pact around the definitions of the State's role, the extent of its actions, its operating costs, and the way it is financed. According to the OECD, in 2021, Brazil had a total tax burden of 33.5% of GDP[13]. The OECD and the IBRE/Fundação Getulio Vargas Tax Policy Observatory reveal that the Brazilian tax burden is close to the average for OECD countries (34.1%), but much higher than the average for Latin American and Caribbean countries (21.7% of GDP) and emerging countries.

As we have seen, the Brazilian tax system does not fully comply with any of the principles that characterize a simple, fair and efficient tax system. This highlights the strategic and urgent nature of the tax reform currently underway in Congress.

The Substitute for PEC 45/2019 approved by the Chamber of Deputies and forwarded to the Federal Senate: objectives and content

Currently, the effort undertaken by the Brazilian National Congress is focused on changes to taxes on the consumption of goods and services (PEC 45/2019[14]). Peripherally, there are provisions dealing with Estate and Gift Tax - ITCMD (Art. 115, § 1.), Tax on vehicles - IPVA (Art. 155, § 6º.), contribution on public lighting (Art. 149-A), payroll relief and criteria for readjusting the Urban Real State Tax (IPTU) (Art. 156, § 10, III). A more in-depth approach to the taxation of income and wealth, tax expenditures and the financing of social security has been postponed. The substitute for PEC 45/2019, approved by the Chamber of Deputies, anticipates a clear signal for the future in its Article 18 by determining that a bill on income tax reform must be sent within 180 days of the enactment of the Constitutional Amendment and, in its sole paragraph, provides that the Federal Government's additional revenue from income tax reform may be considered as a source of compensation for the reduction in taxation on payroll and on the consumption of goods and services. It is clear, albeit underlying, the spirit and intention of the legislator to move forward in reversing the regressivity present in the current Brazilian tax system, shifting the center of gravity of taxation from taxes on consumption to taxes on income and wealth.

The Constitutional Amendment Bill 45/2019, currently being considered by the Federal Senate, has numerous positive points in terms of simplifying taxation in Brazil and providing the National Tax System with better rules. The advances are centered on eliminating the cumulative nature of taxes; shifting the taxable event from the origin to the destination; ending the tax war between federal entities; collecting taxes "on the outside" and not "on the inside" as it is today, ensuring transparency for taxpayers; drastically reducing special regimes and incentives involving products, services, sectors and regions; and establishing unified national rules and concepts (taxable event, calculation basis, hypotheses of non-taxation, taxable persons, immunities, specific, differentiated or favored regimes, non-cumulative rules, etc.). This, together with maintaining the autonomy of states and municipalities to set, by their own law, the rate of Goods and Services Tax to be in force in their respective territories, being the same for all goods and services, respecting the exceptions provided for by law.

More solid and reliable projections of the impacts of the proposed tax reform (on economic growth, employment, productivity, regional and sectoral development, relative prices, etc.) would require detailed complementary and ordinary legislation, as well as more in-depth studies. Even so, there is an understanding that the reform's guiding principles could generate positive impacts in the direction of a new cycle of economic development. Two central cornerstones anchor the proposed tax reform: a) under no circumstances will there be any increase in the tax burden; and b) the new system of taxation on the consumption of goods and services will restore the current level of revenue collected by the federal government, the states and the municipalities. This will be fundamental for calibrating the rate of Brazil's dual VAT made up of the Contribution on Goods and Services - CBS (federal) and the Tax on Goods and Services - IBS (state and municipal).

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[13] OCD. Global Revenue Statistics Database. Available at: https://www.oecd.org/tax/tax-policy/global-revenue-statistics-database.htm.

[14] Procedure file available at: https://www.congressonacional.leg.br/materias/materias-bicamerais/-/ver/pec-45-2019.

The reform currently underway proposes replacing the five existing taxes on consumption (IPI, PIS, Cofins - federal, ICMS - state, and ISS - municipal) with a dual value-added tax made up of the CBS, managed by the federal government, and the IBS, managed by states and municipalities, through the Federative Council, to be created. It is important to note that, in the eyes of the citizen-taxpayer, it will be as if there were a single value-added tax, providing clarity on how much tax is being paid for each specific consumption operation, considering that the rules for operating CBS and IBS will be uniform nationwide, and tax management will be integrated. The reform also provides for the creation of a Selective Tax - IS (Art. 153, item VIII) on goods and services harmful to health and the environment - which will only be detailed in complementary legislation and the result of which will have an impact on the CBS rate.

The Constitutional Amendment Bill 45/2019 also provides for the possibility of "cashback" (Art. 195. §17 and §18), a tax refund mechanism for lower-income taxpayers, as an additional accessory to the practice of tax justice.

From a federative perspective, the principle of autonomy in setting rates in state and municipal territories is maintained, but with uniform taxation and operational rules The Federative Council is established (Art. 156-B.), representing the set of states and municipalities, with the ability to collect the IBS, manage the tax, offset credits, distribute resources, coordinate oversight and administrative and judicial collection, and issue sub-legal norms of national repercussion. The following funds are created: National Fund for Regional Development (Art. 159-A), Fund for Sustainability and Economic Diversification of the State of Amazonas (Art. 92-B, §2º) and Compensation Fund for Fiscal or Financial-Fiscal Benefits (Article 125, Paragraph 3, Item II) in order to jointly support the transition from the so-called tax competition to the new desired model of regional development. It also provides for the creation of state and municipal Anti-Poverty Funds (Art. 5. amending the wording of Art. 82 of the Federal Constitution).

PEC 45/2019 maintained the pre-existing favored regimes in the Federal Constitution, namely: Simples Nacional [simplified taxation regime for small and micro-sized businesses], the Manaus Free Trade Zone, and the non-incidence or immunity regarding open and free audio and visual broadcasting services; books, newspapers, periodicals, and paper destined for their printing; services provided by political parties, labor unions, nonprofit health and education institutions, religious entities and temples, including charitable and benevolent organizations; and operations involving members and among cooperative societies related to their social objectives.

PEC 45/2019 provides for a reduced rate equivalent to 40% of the standard rate for education and health services; medical and accessibility devices for people with disabilities; medicines and basic menstrual health care products; public passenger transportation services; agricultural inputs and *in natura* agricultural products; food and personal hygiene products; national artistic, cultural, journalistic and audiovisual productions and sports activities; goods and services linked to national sovereignty, cybersecurity and information security; and urban rehabilitation activities in historic areas and critical urban recovery and conversion areas. Some specific products or services from a few of these sectors, to be specified in complementary legislation, may be exempt or subject to a zero rate. The reform bill currently under consideration by the Federal Senate creates the National Basic Food Basket (Art. 8) with a zero rate. Similar treatment will also prevail for Prouni higher education services and services provided under the Emergency Program for the Resumption of the Events Sector (PERSE).

PEC 45/2019 also provides for the possibility of a deferral regime with presumed credit for the purchaser of goods and services supplied by rural producers with annual revenues of less than R$ 3.6 million; suppliers of waste, materials for recycling, reuse and reverse logistics from individuals, cooperatives or popular organizations; movable goods resold by non-taxpaying individuals; and, members of cooperatives or operations between cooperatives linked to their social objectives.

Specific regimes are also created, depending on specific economic characteristics, not necessarily with reduced rates or favored treatment, for fuels and lubricants; financial services; health plans; lottery contests; real estate transactions; cooperatives; and public procurement. Although they do not fall within the typical characteristics of specific regimes, a specific regime was approved for the hotels, amusement parks, theme parks, restaurants and the regional aviation sector. The text of the substitute bill for PEC 45/2019 also mentions, in different sections, the favorable fiscal treatment of biofuels compared to fossil fuels, consistent with the goal of driving the energy transition towards a clean and renewable matrix.

A controversial aspect that should be given special attention by the Federal Senate when re-evaluating the text of the Tax Reform will be the provisions of Art. 19 which, contradicting the general spirit of the reform, allows the states and the Federal District to institute a new contribution on primary and semi-finished products made in their territory.

It is clear that each differentiated treatment with a reduced rate, exemption, immunity, non-taxation, favored regime, specific regime that represents lower taxation than the general treatment, impacts on the increase in the national standard reference rate that will fall on all other goods and services not distinguished with differentiated approaches. As the classic phrase by the American economist Milton Friedman emphasizes: "There's no such thing as a free lunch". If concessions, reductions, and benefits are granted to certain economic sectors, others will bear the cost, as one of the reform's pillars, in addition to avoiding an increase in the tax burden, is to restore the current levels of public sector revenue across the three spheres of power.

It is up to the Independent Fiscal Institution (IFI) to shed light on an aspect that is sometimes overlooked in the current debate: this is a medium and long-term structural reform. Its effects will not be as immediate as those of other structural reforms made in the country recently, such as the changes made to social security and labor legislation or to the regulatory frameworks for railroads and basic sanitation. The tax reform embodied in the text of PEC 45/2019 is not starting from scratch. Making a radical change to the tax system in a fully functioning economy is the same as changing the tire on a bicycle while pedaling. It's only natural that resistance should arise when the distributive conflicts embedded in the reform are made explicit. A long transition is therefore planned. It will certainly be a long and complex journey. However, it is to be expected that the impetus for the implementation of the reform will come from the pressing and inevitable need for profound changes in our tax system, as already evidenced in the discussion of the principles that make up a good tax system confronted with the analysis of the current reality in Brazil.

The full implementation of the new taxation model and its full impact on the lives of citizens and the Brazilian economy will only occur in 2033, when the ICMS, ISS, and IPI will be completely phased out. The transition, from the federative point of view, with the taxable event migrating entirely from origin to destination, will be even longer, and will be completed in 2078. In the short term, the period between 2023 and 2026 will be taken up by the approval of the Tax Reform Constitutional Amendment, all the complementary and ordinary laws regulating the reform, the maturing of the management and technological tools needed to collect the new taxes and the initial testing, in 2026, of the CBS and the IBS, for initial calibration of the rates and adjustments in the implementation of the reform. Only in 2027 will PIS and Cofins be abolished, the IPI rate will be zeroed, and the Selective Tax will come into force. The transition from ICMS and ISS to the new IBS model will cover the entire period between 2029 and 2032.

The calibration of the standard rate and the pillars of the reform

The central, short-term discussion that the Federal Senate will be addressing is the calibration of the national standard rate. This will be the subject of an annual deliberation, through a Resolution of the Federal Senate, with the technical support of the Federal Accounting Court and based on subsidies and information provided by the Federal Revenue Service and the Federative Council, with the aim of complying with the two guiding pillars of the reform: 1) under no circumstances increase the tax burden. The text of PEC 45/2019 includes a lock, with reference to data from the National Treasury Secretariat, which indicates an average collection of current consumption taxes (ISS, ICMS, PIS/Cofins, and IPI) from 2013 to 2022, of 12.45% of GDP; and 2) the full replacement of the current level of revenue for federal, state, and municipal governments, since in times of fiscal constraint, it is not feasible to envision revenue loss or a desirable reduction in the tax burden.

The reform provides for a) a standard reference rate, b) a favored rate (40% of the standard rate), c) zero rate, exemption, immunity, non-taxation, and d) the introduction of Selective Tax on goods and services harmful to health and the environment. The greater the reduction in revenue derived from (b) and (c), the higher the standard reference rate (a) must necessarily be. The higher the collection of the Selective Tax (d), the lower the standard reference rate (a).

The constitutional text cannot be used to set tax rates, only to lay down general principles and guidelines for the intended tax reform. Not even the complementary legislation provides for tax rates. Ideally, rates should be set by infra-legal instruments, taking constitutional and legal principles as a parameter. The Federal Senate will set the standard national reference rate by means of an annual resolution, fine-tuning it so that the objectives set are achieved. However, in light of the history of substantial increases in the tax burden over the last few decades in Brazil, it is only natural to ask for a presentation of the standard rate to be implemented.

It is up to the Independent Fiscal Institution (IFI), as an independent technical body, to state that it is totally impossible, at this time, to determine exactly what the standard equilibrium rate will be in order to achieve the guiding pillars of the reform embodied in the text of PEC 45/2019. It's not a trivial matter. This is due to four very simple reasons: a) only the complementary and ordinary legislation will be able to detail which goods and services will be subject to different rates from the national standard reference rate, crucial information for its fixation; b) as previously mentioned, the amount of resources collected by the Selective Tax will lead to a reduction in the standard rate, and only the sanctioning of the ordinary law that establishes its creation, expected for 2024 or 2025, will be able to support the projection of its impact on the standard CBS rate; c) certain current elements and information, which serve as the basis for projecting future taxation results in the new system, may contain distortions or masking due to the great complexity of the current system; and d) the compliance gap cannot be known at this time, as it measures the difference between potential revenue and actual revenue within the new rules of the game, based on the levels of evasion, tax avoidance, non-compliance, and delayed tax payments, including through legal proceedings, to be verified during the implementation of the new system. The compliance gap varies according to the specific conditions in each country. On this subject, it is worth checking out the European Commission's document on the compliance gap in European Union countries[15].

In this sense, the precise level of balance of the standard rate to achieve the intended objectives will only be possible once the rules of the new system have been detailed in the complementary and ordinary legislation and in the normative instruments, and once the new collection system has been experimentally tested in 2026, with a concrete assessment of the Brazilian compliance gap. In other words, "we will learn to swim by swimming". And the Federal Senate will, year by year, via resolution, calibrate the rate, based on the performance of actual collection and verification of the compliance gap, so that there is neither an increase in the tax burden nor a loss of collection – which, if it occurs for sub-national governments, will be compensated by the central government, maintaining the neutrality intended by the tax reform underway.

What is possible at the moment are studies estimating the impacts of the new tax framework on potential collection levels, the compliance gap and the standard equilibrium rate that meet the two pillars guiding the development of the reform underway. It is inevitable to arbitrate some of the variables necessary for such a challenging analysis and projection.

Over the last few months, as the process of discussing and deliberating PEC 45/2019 has accelerated, three studies on the subject have appeared, in chronological order of publication:

1) "Propostas de reforma tributária e seus impactos: uma avaliação comparativa" [Tax reform proposals and their impacts: a comparative assessment], by João Maria de Oliveira, researcher at the Institute for Applied Economic Research - IPEA[16];
2) "Simulando a alíquota do Imposto sobre o Valor Agregado (IVA) para o Brasil" [Simulating the Value Added Tax (VAT) rate for Brazil], by the Mauro Borges Institute of Statistics and Economic Studies, linked to the Government of Goiás.[17]

[15] Center for Social and Economic Research et al. VAT gap in the EU - Report 2022. Luxembourg: Publications Office of the European Union, 2022. Available at: https://op.europa.eu/en/publication-detail/-/publication/030df522-7452-11ed-9887-01aa75ed71a1.

[16] OLIVEIRA, J. M. de. Propostas de reforma tributária e seus impactos: Uma avaliação comparativa. Brasília: IPEA, 2023. Available at: https://www.ipea.gov.br/cartadeconjuntura/index.php/2023/07/propostas-de-reforma-tributaria-e-seus-impactos-uma-avaliacao-comparativa/.

[17] GOIÁS. Nota Executiva 004/2023 - Simulando a alíquota do Imposto sobre o Valor Agregado (IVA) para o Brasil [Executive Note 004/2023 - Simulating the Value Added Tax (VAT) rate for Brazil]. Goiânia: Instituto Mauro Borges, 2023. Available at: https://www.imb.go.gov.br/files/nota-executiva/004-NOTAEXECUTIVA.pdf.

3) "Alíquota-padrão da tributação do consumo de bens e serviços no âmbito da Reforma Tributária" [Standard rate for the taxation of consumption of goods and services within the scope of the Tax Reform], Ministry of Finance.[18]

The study conducted by João Maria de Oliveira, a planning and research technician at IPEA, made an effort to analyze the economic, regional, and sectoral impacts of changes in the structure of consumption taxes in Brazil. This analysis was based on the report of the Working Group (WG) of the Chamber of Deputies and the initial draft of the rapporteur's substitute bill, Deputy Aguinaldo Ribeiro, which would later be modified and approved in the Plenary. The data is compared with the original version of PEC 45/2019 and with PEC 110/2019, which originates from the Federal Senate. Using a computable general equilibrium model, the study aimed to assess the evolution of economic fundamentals (GDP, productivity, and employment) over time due to the tax changes introduced by different reform scenarios. These scenarios were compared against the hypothesis of no reform. The study estimated the **effective rate at 28.04%**, taking into account the exceptions, favored tax regimes, reduced rates and exemptions provided for in the initial version of the rapporteur's substitute bill in the Chamber of Deputies. The conclusions point to positive impacts of the reform on productivity, employment, and gross domestic product (GDP), with these results being greater in the environment generated by the original version of PEC 45/2019, intermediate when applying the parameters of PEC 110/2019 from the Federal Senate, and smaller when applying the data and guidelines from the initial version of the substitute bill, which was later amended and approved. Even so, in all three scenarios tested, the effects of the reform are quite positive for the evolution of the Brazilian economy.

Another effort to project the rate of the new Brazilian dual VAT was conducted by the team at the Mauro Borges Institute of Statistics and Socioeconomic Studies (IMB), a state institution of the Government of Goiás, through Executive Note 004/2023, "Simulating the Value Added Tax (VAT) rate for Brazil". Based on the IBGE database, estimates and arbitrations on the variation of the favored rate, the weight of the Selective Tax and the Compliance Gap; and by analyzing the text of the substitute for PEC 45/2019, approved by the Chamber of Deputies on July 6, 2023, the IMB study arrives at a **neutral rate for national VAT of 29.01%**, and then carries out a sensitivity analysis based on the flexibility of the hypotheses adopted, building a possible range for the general standard rate between **27.3 and 30.7%**. The document estimates the impact of the main exceptions introduced in the reform on the increase in the standard reference rate, calculating that maintaining the Manaus Free Trade Zone increases the rate by 0.81 p.p., the continuation of Simples Nacional is responsible for an increase of 2.43 p.p., the exemption of the basic food basket increases the standard rate by 1.05 p.p. and the reduced rates for education, health, agribusiness and others increase it by a further 2.98 p.p. In other words, the study projects that the Brazilian VAT rate could be around **21.74%,** if the rate were the same and there were no exceptions, opening up the possibility of a scenario where the neutral rate would vary between **20.03% and 23.43%**, after the sensitivity analysis.

Finally, on August 8, 2023, Minister of Finance Fernando Haddad handed the rapporteur of PEC 45/2019 in the Federal Senate, Senator Eduardo Braga, the technical note prepared by the team of the Extraordinary Secretariat for Tax Reform (SERT/MF) entitled "Alíquota-padrão da tributação do consumo de bens e serviços no âmbito da Reforma Tributária" [Standard rate for the taxation of consumption of goods and services within the scope of Tax Reform].

The document emphasizes the commitment that under no circumstances will there be an increase in the tax burden and reaffirms that the rates of the new taxes should be gradually increased by the exact amount needed to restore the current level of revenue, after deducting the revenues from the Selective Tax.

The study by the Ministry of Finance affirms something we've already said here, that the effective tax rates will only be known precisely after the transition period, i.e., in 2033, when the old taxes will have been abolished and the new ones will be in full force.

The text makes it clear that the dual format of the new Brazilian VAT, originally conceived in PEC 110/2019 of the Federal Senate, sought to make two objectives compatible: ensuring simplicity for taxpayers (uniform legislation on a national

[18] BRASIL. Alíquota-padrão da tributação do consumo de bens e serviços no âmbito da Reforma Tributária. Brasília: Ministério da Fazenda, 2023. Available at: https://www.gov.br/fazenda/pt-br/acesso-a-informacao/acoes-e-programas/reforma-tributaria/estudos/8-8-23-nt-mf_-sert-aliquota-padrao-da-tributacao-do-consumo-de-bens-e-servicos-no-ambito-da-reforma-tributaria-1.pdf.

scale and integrated management) and autonomy for the federated entities (ability of states and municipalities to set the rate to be in force in their territory, through their own law, being the same for all goods and services, except in the cases provided for in the Federal Constitution).

Using the Tax Gap model, designed to estimate the tax gap, the study projects the revenue potential and the equilibrium standard rate, comparing 1) the normative revenue that would be obtained with a single rate, full utilization of credits, and perfect compliance with tax obligations; and 2) the potential revenue that is expected under the rules provided in the legislation and the perfect functioning of the system in complying with tax obligations. The difference between the two would determine the policy gap. On the other hand, the compliance gap demonstrates the difference between the potential revenue and the expected actual revenue, considering issues related to evasion, avoidance, non-compliance, and the postponement of tax payments through legal proceedings.

For the purposes of the annual reviews that will result in the calibration of the standard rate and in order to maintain the current levels of collection of the five taxes to be abolished until the new system is fully operational in 2033, the average total collection for the ten-year period between 2013 and 2002 was taken as a reference, which indicates an aggregate collection level for the five taxes of 12.45% of GDP.

In constructing the projections made for the national standard reference rate, the SERT/MF team opted to arbitrate the compliance gap based on Hungary's figures, as it is an emerging country with a similar consumption tax rate to Brazil. The compliance gap was thus set at 10%, the average figure observed in Hungary in the two years preceding the pandemic. And they projected an alternative conservative scenario with a 50% higher compliance gap. There is no reason to imagine that the new system will perform worse in Brazil than it did in Hungary, since simplifying the rules and operation of the new Brazilian tax system should, on the contrary, produce a substantial reduction in tax evasion, avoidance, informality, delinquency and litigation between taxpayers and the tax authorities.

As previously mentioned, it is impossible to pin down, in an absolute and certain way, what the compliance gap will be and, therefore, the standard equilibrium rate. Only the concrete experience of the new system during the transition period will provide the necessary confidence for setting the taxation parameters that will meet the reform's objectives. However, theoretical studies, based on consistent information and methodologies, even if they arbitrate on some variables, will be extremely important to support the decision-making process within the National Congress.

In the case of the study conducted by SERT/MF, a potential revenue of R$ 969.168 billion was calculated in the baseline scenario. Subtracting the compliance gap from this amount would lead to the desired effective revenue of 12.45% of GDP. From there, one could deduce the standard rate within the rules established in the substitute for PEC 45/2019 that would ensure this result. This approach would be incremental, starting from the initial scenario with a uniform single rate and then gradually increasing it step by step based on each differentiated treatment applied.

The exercise carried out by SERT/MF, in a broadly feasible scenario, points to a range for setting the **base rate between 20.73% and 25.45%,** depending on the degree of concessions and favorable treatment for products, services and sectors, starting from the maintenance of the pre-existing regimes in our Constitution and taking into account the Selective Tax. The incremental impacts of increasing the reference rate, in the feasible scenario (with a 10% compliance gap), indicate that the contribution of the favored rate of 50% for agricultural and basic necessity products was +1.67 percentage points, the reduced rate of 50% for private education services was +0.32 percentage points, the reduced rate for private healthcare services added +0.62 percentage points, the reduced rate of 50% for other goods and services listed in PEC 45/2019 increased by +0.37 percentage points, the expansion of the favored treatment of reducing the rate from 50% to 40% for exempted products and services resulted in +0.67 percentage points, the zero rate for half of the basic necessity products added +0.67 percentage points, and other favorable adjustments increased the standard rate by +0.35 percentage points.

The figures presented in the three studies mentioned, despite the differences in assumptions, methodologies and results, and even though they are only the results of theoretical simulation exercises that will not necessarily be sanctioned by concrete experience in the transition period, will certainly serve as a basis for in-depth discussions between federal senators and deputies in the final deliberation process on tax reform, weighing up the costs and benefits of each favored or differentiated treatment and its general repercussions for society and taxpayers.

The efforts made by the technicians involved in the three studies project a standard rate of **between 20.03% and 30.7%** in the various alternative scenarios and within the guidelines and provisions of PEC 45/2019, approved by the Chamber of Deputies. It would be one of the highest VAT rates in the world. **This reflects the weight that taxes on the consumption of goods and services already have today in the total taxes collected in our regressive tax matrix.** The Ministry of Finance, in the document submitted to the Federal Senate, demonstrates that the standard rate for a product in the current regime, involving only ICMS with incidence at the modal standard rate and combined with PIS/Cofins through the non-cumulative regime - without ISS or IPI - and calculated with an "out-of-the-total" rate, comparable to the VAT system, reaches an astonishing 34.4% rate.

IFI Projections

SHORT TERM

IFI Projections	2023			2024		
	July	August	Comparison	July	August	Comparison
GDP - real growth (% p.a.)	2.28	2.28	=	1.22	1.22	=
GDP - nominal (R$ billion)	10,647.66	10,647.66	=	11,294.10	11,294.10	=
IPCA - accumulated (% in the year)	5.20	5.20	=	3.88	3.88	=
Exchange rate - end of period (R$/US$)	5.02	5.02	=	5.09	5.09	=
Employment - growth (%)	0.75	0.75	=	0.68	0.68	=
Payroll - growth (%)	4.28	4.28	=	1.22	1.22	=
Selic - end of period (% p.a.)	12.00	12.00	=	9.50	9.50	=
Real interest ex-ante (% per year)	6.37	6.37	=	5.77	5.77	=
Public Sector Consolidated Primary Balance (% of GDP)	-1.20	-1.20	=	-1.33	-1.33	=
of which Central Government	-0.80	-0.80	=	-0.93	-0.93	=
Net Nominal Interest (% of GDP)	7.01	7.01	=	6.09	6.09	=
Nominal Balance (% of GDP)	-8.20	-8.20	=	-7.43	-7.43	=
General Government Gross Debt (% of GDP)	76.40	76.40	=	79.78	79.78	=

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