

Brazil—Fiscal Policy**One-Off Is Not Enough**

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- The better-than-expected 2017 primary budget deficit (1.8% of GDP in 12-month up December versus 2.8% up June) was not followed by a reduction of the same magnitude in the structural primary deficit (1.7% of GDP in the 12 months leading up to December versus 1.9% in June). This happened because the primary balance improvement was due to an increase in non-recurring revenue and a reduction in non-recurring spending (the payment of fiscal maneuvers).
- For 2018, we believe that a significant improvement in the primary result will only be possible if there is relevant increase in non-recurring revenue (privatization and concession revenue), given that increased tax collection in response to the economic recovery is partly accounted for in this year's budget (the revised budget considers a 3% GDP growth).
- Considering non-recurring revenue (e.g., the state-owned utility company's privatization and the transfer of rights in pre-salt operations), which require Congressional approval, the central government's primary deficit could be narrowed to 1.0% of GDP. We call this a best-case scenario for an effective primary balance but not for structural primary balance.
- Our baseline scenario — only considering the elasticity of overall revenue to the economic recovery, without any additional help from the approval of the fiscal package announced last August and/or a significant increase in non-recurring revenue — is the 2018 central government primary deficit at 2.0% of GDP (BRL140 billion), slightly better than the target of 2.3% of GDP (BRL159 billion). The structural primary result, in our view, will widen to a 2.3% of GDP deficit, while the business cycle (economic recovery) will contribute with a surplus of around 0.3% of GDP.

Effective primary balance better than structural balance

The central government's¹ primary balance in 2017 was BRL36 billion better than expected, a deficit of BRL124.4 billion (1.9% of GDP) instead of the BRL159.0 billion (2.5% of GDP) target. This was due to: (iii) better-than-expected non-recurring revenue (energy concession and tax amnesty program); (ii) a reduction in spending with past fiscal maneuvers (already expected for 2017); and (iii) a reduction in investment spending due to budget cuts (see table below). The economic recovery also contributed to this improved result in 2H17, but its importance was secondary in comparison to the contribution of the non-recurring revenue.

This effective lower primary deficit of the central government, and consequently, of the total public sector² was not followed by a reduction of similar magnitude in the structural primary result, mainly because part of the improvement was due to an increase in non-recurring revenue and due to a reduction of non-recurring spending (the payment of fiscal maneuvers).

¹ National Treasury, BCB and Social Security System of private sector

² Regional government contribution represents about 1:9 ratio compared with the contribution of the central government



Table 1. 2017 Central Government Primary Balance
(BRL billions)

Prices of 2017	2016	2017	Δ
Total Federal Revenues	1379.8	1401.9	22.1
Tax Collection	860.2	847.4	-12.8
Contribution for RGPS	375.4	379.7	4.3
Non-recurring revenues	144.3	176.2	31.9
Concessions	23.3	32.2	8.9
Financial Compensation Quotas	24.4	36.6	12.1
Others	38.4	47.5	9.1
Transfers by Revenues Sharing	237.6	231.7	-5.9
Net federal Revenues	1142.2	1170.2	
Total Federal Expenditures	1309.6	1296.3	-13.3
Social Security Benefit (RGPS)	532.1	564.7	32.6
Payroll	270.2	287.9	17.7
Other Mandatory Expenses	210.1	187.9	-22.2
Discretionary Expenses	297.1	255.7	-41.4
Primary Balance	167.4	126.1	

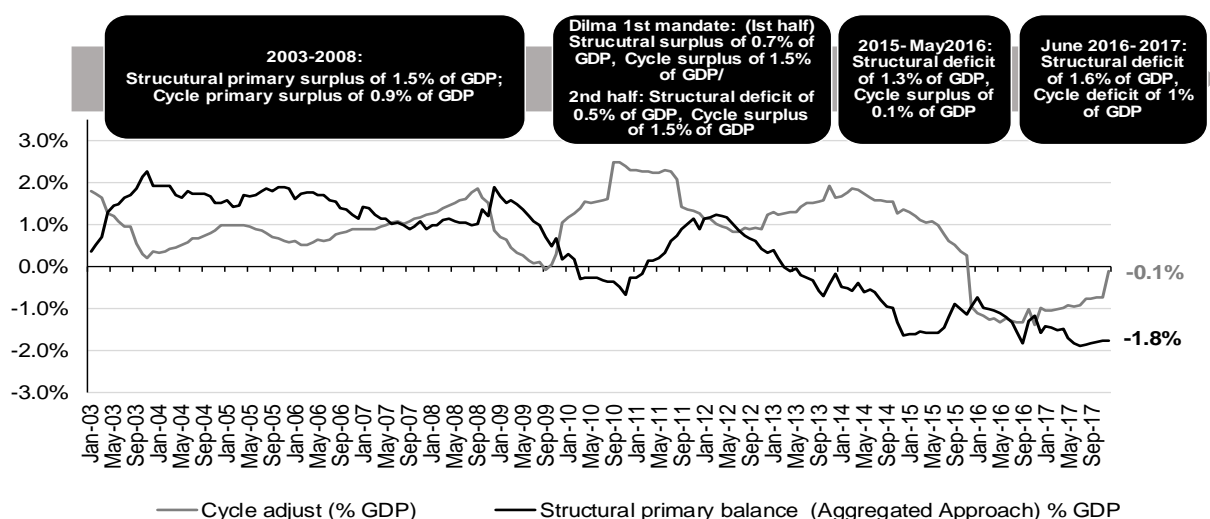
Table 2. Revenue and Spending highlights

	Δ
Tax Collection	-12.8
Tax on Asset Repatriation	-46.8
Tax Amnesty Program (REFIS)	24.7
Economic recovery	9.3
Non-recurring revenues	31.9
Fiscal Maneuver Spending	-31.5
Investment Spending	-12.4

Sources: National Treasury and Santander estimates.

The main motivation to measure the structural primary result is to obtain a more accurate assessment of the fiscal picture. Our chosen approach for estimating the structural primary balance³ is discounting one-off (non-recurring) revenue and expenditures and factors not correlated with the business cycle, as well as the effect of the output gap on the primary result. In this sense, the structural primary balance is an improvement over the cyclically adjusted primary balance. For more details, please see the report [The match point](#), published June 14, 2016.

Chart 1. Structural Balance and Cyclical Component (% of GDP)



Sources: National Treasury and Santander estimates.

According to our model, the elasticity of overall revenue with respect to the output gap is 1.4, which is in line with economic theory. This means that each percentage point of GDP growth above or below potential GDP growth will generate revenue growth larger than 1%. Regarding cyclically adjusted expenditures, the expenditure elasticity to GDP is 0, which is also in line with economic theory. In general, expenditures are discretionary, with a portion independent of the economic cycle (e.g., health, education and security spending) and a portion opposite to the economic cycle (e.g., social assistance spending, which increases during economic slowdown/contraction and decreases during economic expansion).

³ Bornhorst F., Dobrescu G., Fedelino A., Gottschalk J., and Nakata T., When and how to adjust beyond the business cycle? A guide to Structure Fiscal Balances, April 2011. Fiscal Affairs Department, IMF. <https://www.imf.org/external/pubs/ft/tmn/2011/tmn1102.pdf>



It is fair to say that from 2013 onward, there was a shift in the fiscal stance to an expansionary policy. Furthermore, because of the increase in mandatory spending (fixing targets for education and health spending as share of GDP) and the effect of the economic recession on social assistance spending, the several attempts from 2015 onward to narrow the gap between revenue and spending were not effective. Recently, the effective primary result and the structural primary result narrowed. However, in our opinion, it is still premature to treat the reduced structural primary result as a trend.

Most likely scenario for 2018

Last August, the 2018 primary target for the central government was revised to a BRL159 billion deficit (from a BRL129 billion deficit). In order to meet the revised primary target, the government announced a tax increase of around BRL14 billion (from which BRL6 billion would come from taxing high net worth private investment funds, BRL4 billion from the end of payroll tax breaks, and BRL2 billion from increased civil servants' social security contribution) and spending cuts of around BRL6 billion (BRL5 billion from the postponement of civil servant's annual wage adjustment). All these measures depend on Congressional approval, and none have been approved as of yet. The two most relevant measures: the income tax on tailor-made investment funds and the postponement of civil servants annual wage adjustment, cannot be implemented this year, in our opinion. Because of this, the Ministry of Planning announced at the beginning of February a budget cut for this year of BRL16 billion, trying to cover the gap of the fiscal package not implemented and the possibility of the non-privatization of Eletrobras, from which the government expects revenue of BRL12 billion).

That said, we believe that significant improvement in the primary balance in 2018 depends more on non-recurring revenue (coming from privatization and concession revenue). Although we believe that the economic recovery will lead to a tax collection increase, this effect is partly accounted for in the budget (the revised budget considers 3% GDP growth). **Non-recurring revenue, such as that coming from the state-owned utility company's privatization and the transfer of rights in pre-salt operations (the sale of future oil rights), could substantially help improve the effective primary result. Both require Congressional approval, and discussions are still in the preliminary stages in the Lower House. We estimate that with this non-recurring revenue, the central government's primary deficit could be narrowed to 1.0% of GDP.**

We note, however, that a continuous increase in non-recurring revenue will not mean an improvement in the structural primary result, in addition to the effect of the output gap. **In our opinion, the structural primary result will widen to a deficit of 2.3% of GDP in our baseline scenario, while the business cycle will contribute with a surplus of around 0.3% of GDP, resulting in an effective central government primary deficit of 2.0% of GDP (BRL140 billion), slightly better than the target of 2.3% of GDP (BRL159 billion).**



Table 3. Budget Exercise (BRL billions)

	2017	Revised Budget 2018	2018/ 2017	Santander Forecast	Santander/ 2017	Optimistic Exercise (Non-recurring revenues)
Total Federal Revenues	1383.1	1460.7	5.6%	1467.0	6.1%	1539.0
Tax Collection	834.2	880.9	5.6%	893.6	7.1%	893.6
Contribution for RGPS	374.8	403.3	7.6%	409.1	9.2%	409.1
Non-recurring revenues	74.8	85.5	14.3%	73.4	-1.9%	145.4
Concessions	32.1	A 20.2	-36.9%	B 8.0	-74.9%	C 80.0
Natural resource exploration	36.0	51.5	42.8%	51.5	42.9%	51.5
Dividends	5.5	8.9	60.6%	8.9	60.6%	8.9
Other revenues	85.6	76.8	-10.3%	76.8	-10.3%	76.8
Transfers by Revenues Sharing	228.5	243.9	6.7%	243.9	6.7%	243.9
Net Federal Revenues	1154.6	1216.8	5.4%	1223.2	5.9%	1295.2
Total Federal Expenditures	1279.0	1371.6	7.2%	1363.5	6.6%	1366.5
Payroll	284.0	302.6	6.5%	302.6	6.5%	305.6
Social Security Benefit (RGPS)	557.2	592.4	6.3%	606.3	8.8%	606.3
Salary Allowance and Unemployment Benefit	54.5	56.9	4.4%	56.9	4.4%	56.9
MP 540 (end of payroll exemption)	13.9	12.3	-11.3%	12.3	-11.3%	12.3
Other Mandatory Expenses	253.1	278.5	10.0%	278.5	10.0%	278.5
Discretionary Expenses	116.2	128.9	10.9%	106.9	-8.0%	106.9
Primary Balance	124.4	154.8		140.3		71.4
Primary Target	159.0	159.0		159.0		159.0
Primary Expenditures¹	1254.6	1338.3		1330.2		1333.2
Primary Expenditures Ceiling	1308.6	1347.9		1347.9		1347.9

Sources: National Treasury and Santander estimates. ¹Primary spending is total federal spending excluding constitutional transfers, mandatory transfers due to earmarked revenue, nonrecurring spending (for unforeseeable and urgent situations such as weather or ecological disasters), electoral spending, and state-owned companies' capitalization. NB. The official budget considers revenue from the privatization of Eletrobras, while Santander's forecast neither this revenues nor revenue from the transfer of oil rights. In our optimistic scenario we consider revenue of BRL70 billion from the transfer of rights (the sale of future oil rights – pre-salt). **We do not see primary expenditures surpassing the expenditures ceiling in 2018, but Santander's forecast assume that a budget cut of around BRL22 billion is needed to fulfill the spending cap law).**



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