

## TAX BREAKS AFFECT REGIONAL GOVERNMENT RESULT

Ítalo Franca\*  
italo.franca@santander.com.br  
+5511 3553 5235

- Today, the Brazil Central Bank (BCB) unveiled the consolidated public sector's fiscal balance for October. For the month, the public sector posted a primary surplus of BRL27.1 billion, in line with our forecast (BRL26.2 billion) and matching the market median (BRL27.1 billion). Even in a favorable month with respect to seasonality, regional governments registered a deficit of BRL3.9 billion (close to our call of BRL4.3 billion), due to the impact of reduced revenue, after legislation capped the VAT (ICMS) tax on essential goods. In nominal terms, the state's revenue dropped 12.2% YoY in the month.
- According to data published by the Treasury on November 29, the central government posted a primary surplus of BRL30.8 billion in October—the best result for the month since 2016, and since 2012 in YTD terms. Expenditures rose 3.1% YoY in real terms: we observed a decrease in discretionary outlays (-BRL4.6 billion compared to October 2021), a drop in payroll expenditures (-2.2% YoY), and social security benefits increasing 6.4% YoY. Revenue went up 4.4% YoY, particularly thanks to taxes on corporate revenue. In YTD terms, the result totals a primary surplus of BRL64.4 billion, compared to a deficit of BRL53.1 billion in the same period in 2021 (in nominal terms). In the 12-month reading in real terms, the result remained close to a surplus of BRL85.7 billion, or 1.0% of GDP. We forecast a BRL45 billion surplus this year (0.5% of GDP), with the risk tilted to upside.
- In the 12-month reading, the public sector primary surplus reached BRL173 billion (1.8% of GDP) in October, boosted by regional governments' positive public sector results (BRL86.2 billion, or 0.9% of GDP). The public sector's primary surplus seems to have peaked in July, falling by 0.7 p.p. For regional governments, the peak was in May, at 1.4% of GDP. For the public sector, we forecast a BRL100 billion (1.0% of GDP) surplus. While that would still be a solid performance, we believe that fiscal expansion is in the pipeline (totaling ~2 p.p.) and that the fading of commodity and activity cycles will likely prompt a return to a primary deficit in 2023 (1.4% of GDP).
- Interest payments totaled BRL41.6 billion in October, compared to BRL60.4 billion in same month of last year. The decrease was influenced by the result of FX swap operations (a gain of BRL12.8 billion in October 2022 and a loss of BRL12.9 billion in October 2021). In the 12-month period up to October, the nominal result totaled BRL400 billion (4.2% of GDP), up 0.15pp from September.
- Debt registered mixed results last month. Gross debt fell to 76.8% of GDP (-0.3 p.p. in the month), with an increased nominal GDP. Net debt remained flat at 58.3% of GDP. Voluntary deposits in the BCB (not included in debt statistics) shrank 0.2pp, to 0.8% of GDP.
- Our 2022 gross-debt-to-GDP forecast is currently at 78.2%, though a nominal GDP revision by IBGE and the upside bias in primary result poses a downside risk for 2022 estimate. For the medium term, we continue to forecast deterioration in the nominal (headline) budget results due to higher debt costs (associated with the high Selic rate), implying a still steep upward trajectory for government debt.
- In our scenario, we assume a once-and-for-all increase in the spending cap of BRL150 billion (1.5% of GDP), which is consistent with our estimate for a consolidated primary fiscal deficit of 1.4% of GDP next year.

**IMPORTANT DISCLOSURES/CERTIFICATIONS ARE IN THE "IMPORTANT DISCLOSURES" SECTION OF THIS REPORT.**

U.S. investors' inquiries should be directed to Santander Investment Securities Inc. at (212) 583-4629 / (212) 350-3918.

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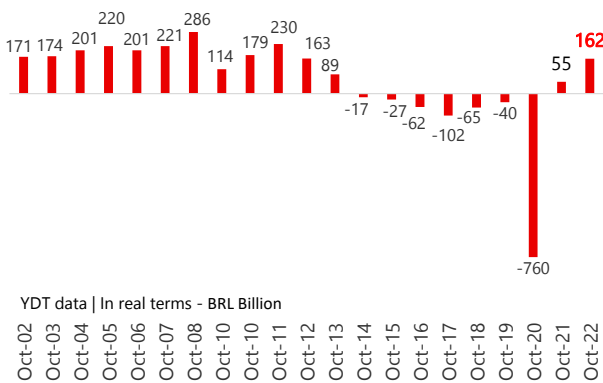


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In the 12-month reading, the public sector primary surplus reached BRL173 billion (1.8% of GDP) in October, boosted by regional governments' positive public sector results (BRL86.2 billion, or 0.9% of GDP). The public sector's primary surplus seems to have peaked in July, falling by 0.7pp compared to October result. While still a solid performance, we believe that fiscal expansion is in the pipeline (totaling ~2pp), and that the fading of commodity and activity cycles will likely prompt a return to a primary deficit in 2023 (1.4% of GDP).

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**Figure 1 – Consolidated Public Sector Result**



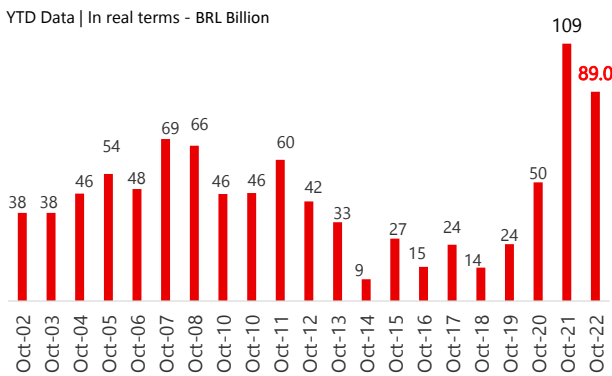
Sources: Brazilian Central Bank, Santander.

**Figure 2 – Nominal Interest Result – BRL billion**



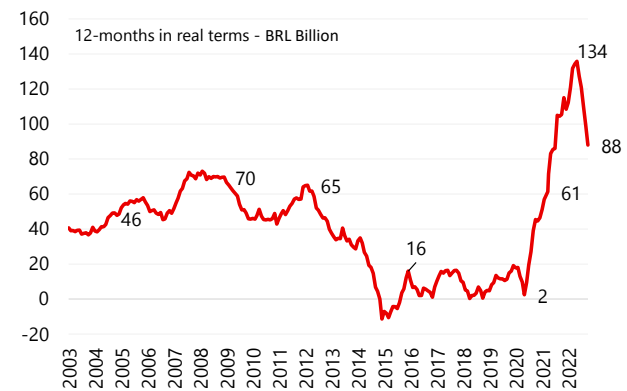
Sources: Brazilian Central Bank, Santander.

**Figure 3 – Regional Gov.– Primary Result – YTD Data**



Sources: Brazilian Central Bank, Santander.

**Figure 4 – Regional Gov. – Primary Result – 12-m**



Sources: Brazilian Central Bank, Santander.

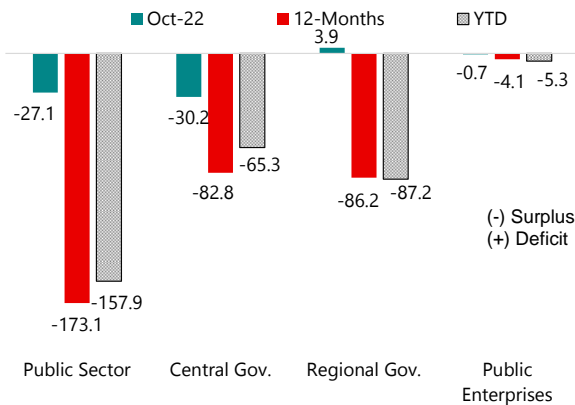


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The official forecasts for compliance with the so-called "golden rule" (fiscal rule) for 2022 point to a surplus of BRL15 billion. We expect that this fiscal rule will not be binding in 2022 due to higher revenue, especially with a higher level of extraordinary proceeds.

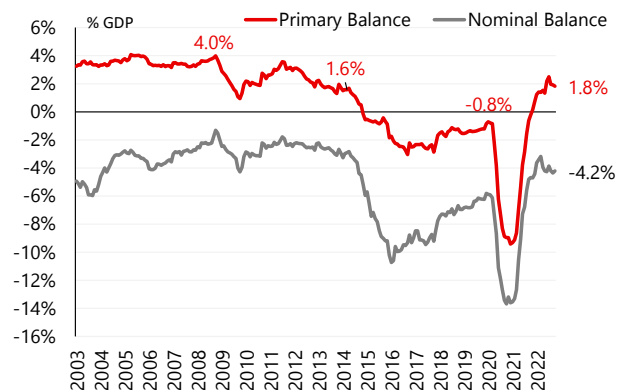
Debt registered mixed results last month: Gross debt fell to 76.8% of GDP (-0.3 p.p. in the month), with the increase in nominal GDP, and net debt remained flat, at 58.3% of GDP. Voluntary deposits in the BCB (not included in debt statistics) shrank 0.2pp, to 0.8% of GDP. We continue to forecast a deterioration in the nominal (headline) budget results due to higher debt costs (associated with the high Selic rate), implying a still step upward trajectory for government debt in the medium term. For the long term, since we assume the commodity cycle will not, by definition, be permanent (the cycle typically lasts five years), we continue to see a risky path toward debt stabilization, in the context of less efficacious fiscal rules, along with popular pressure to increase expenditures during a period of high inflation. We consider in our scenario that the *Auxílio Brasil's* BRL600 monthly benefit will be maintained from 2023 onward, with the approval of a constitutional amendment to open a fiscal margin allowing a breach of the constitutional spending cap.

Figure 5 – Primary Result (BRL billion)



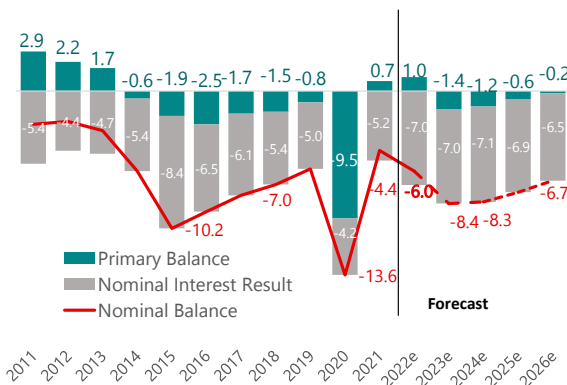
Sources: Brazilian Central Bank, Santander.

Figure 6 – Consolidated Public Sector (12m % GDP)



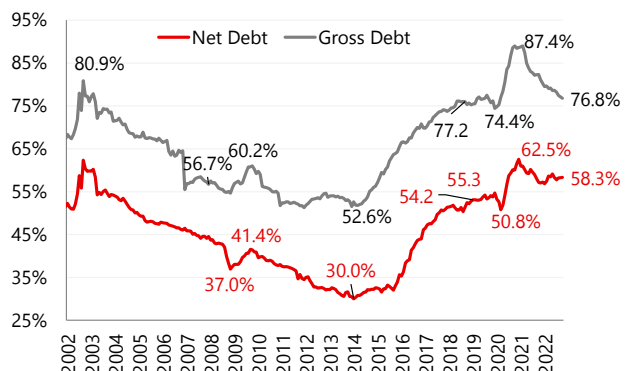
Sources: Brazilian Central Bank, Santander.

Figure 7 – Fiscal Balance (% GDP)



Sources: Brazilian Central Bank, Santander.

Figure 8 – Public Sector Debt (12m % GDP)



Sources: Brazilian Central Bank, Santander.



## CONTACTS / IMPORTANT DISCLOSURES

### Brazil Macro Research

Ana Paula Vescovi*	Chief Economist	anavescovi@santander.com.br	5511-3553-8567
Mauricio Oreng*	Head of Macro Research	mauricio.oreng@santander.com.br	5511-3553-5404
Jankiel Santos*	Economist – External Sector	jankiel.santos@santander.com.br	5511-3012-5726
Ítalo Franca*	Economist – Fiscal Policy	italo.franca@santander.com.br	5511-3553-5235
Daniel Karp Vasquez*	Economist – Inflation	daniel.karp@santander.com.br	5511-3553-9828
Tomas Urani*	Economist – Global Economics	tomas.urani@santander.com.br	5511-3553-9520
Lucas Maynard*	Economist – Economic Activity	lucas.maynard.da.silva@santander.com.br	5511-3553-7495
Felipe Kotinda*	Economist – Commodities	felipe.kotinda@santander.com.br	5511-3553-8071
Gabriel Couto*	Economist – Special Projects	gabriel.couto@santander.com.br	5511-3553-8487
Fabiana Moreira*	Economist – Credit	fabiana.de.oliveira@santander.com.br	5511-3553-6120
Gilmar Lima*	Economist – Modeling	gilmar.lima@santander.com.br	5511-3553-6327

### Global Macro Research

Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@santander.pl	48-22-534-1888
Rodrigo Park *	Economist – Argentina	rpark@santander.com.ar	54-11-4341-1272
Ana Paula Vescovi*	Economist – Brazil	anavescovi@santander.com.br	5511-3553-8567
Juan Pablo Cabrera*	Economist – Chile	jcabrera@santander.cl	562-2320-3778
Guillermo Aboumrad*	Economist – Mexico	gjaboumrad@santander.com.mx	5255-5257-8170
Piotr Bielski*	Economist – Poland	piotr.bielski@santander.pl	48-22-534-1888
Mike Moran	Head of Macro Research, US	mike.moran@santander.us	212-350-3500

### Fixed Income Research

Juan Arranz*	Chief Rates & FX Strategist – Argentina	jarranz@santanderrio.com.ar	5411-4341-1065
Mauricio Oreng*	Senior Economist/Strategist – Brazil	mauricio.oreng@santander.com.br	5511-3553-5404
Juan Pablo Cabrera*	Chief Rates & FX Strategist – Chile	jcabrera@santander.cl	562-2320-3778

### Equity Research

Miguel Machado*	Head Equity Research Americas	mmachado@santander.com.mx	5255 5269 2228
Alan Alanis*	Head, Mexico	aalanis@santander.com.mx	5552-5269-2103
Andres Soto	Head, Andean	asoto@santander.us	212-407-0976
Walter Chiarvesio*	Head, Argentina	wchiarvesio@santanderrio.com.ar	5411-4341-1564
Mariana Cahen Margulies*	Head, Brazil	mmargulies@santander.com.br	5511-3553-1684

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