Santander

ECONOMICS **July 14, 2016**

BRAZIL – Fiscal Policy

Fiscal X-Ray

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- **We believe the government's strategy to tackle the fiscal adjustment will result in a downward trend for expenditure ratio to GDP from 2017 onward, and the economic recovery will result in an upward trend for revenue ratio to GDP from 2017 onwards. However, we expect a slow reversal of the current central government's primary deficit.**
- **In our opinion, a faster fiscal adjustment process would require a positive surprise on the revenue side, likely as a result of an economic rebound, given that structural reforms will not promote relevant savings in the short term, and an increased tax burden is not yet a part of the government's strategy.**
- **Due to a larger budget deficit in the short term, and a long-term process of reversing the primary deficit to a surplus, we foresee gross- and net-debt-to-GDP ratios heading north until 2020 and reaching 84% and 47% of GDP, respectively.**
- **We believe the continued upward trajectory for both gross- and net-debt-to-GDP ratios may not trigger a revision of the sovereign credit risk, if, and only if, the government fulfills the promises made regarding the implementation of structural reforms.**

Introduction

In our view, there is no room to increase the tax burden in the short term, as the recessionary environment drains economic taxable resources. The revenue dynamics and economic cycle are linked and the GDP contraction of 3.8% last year drained 1.9% of GDP in revenue, according to our analysis. Also, the federal government's strategy seems to have a different approach. According to initial statements from the new administration, they intend to focus on the fiscal adjustment with structural reforms in the next two years, which we see as good news.

However, such structural measures have a higher degree of difficulty in terms of gaining Congressional approval (they require, in general, constitutional amendments that need a three-fifth majority and have to be voted on twice in both the Lower House and Senate), and, most importantly, they do not produce an immediate impact on fiscal imbalances (for further details, see our report, *The Clash of Titans: Desirable versus Feasible*, dated May 12, 2016). Therefore, we believe that a primary surplus in the medium term is possible as a result of an eventual resumption of economic growth and/or a successful privatization agenda, rather than a tax burden increase or significant savings from spending cuts in the short term.

We are revising our fiscal forecasts to reflect a larger budget deficit in the short term, given that the government's strategy will bear fruit only some years down the road. We are downwardly revising our primary balance for 2016 to a deficit of 2.5% of GDP from a deficit of 2.3% of GDP, and our primary balance for 2017 to a deficit of 2.3% of GDP from a surplus of 0.1% of GDP. Please see below all revised forecasts for fiscal figures.

Revision of Fiscal Forecasts

	2015	2016	2017	2018	2019	2020
Primary Balance (GDP %)	-1.9	~~-2.3~~ -2.5	~~0.1~~ -2.3	~~2.0~~ -1.4	~~2.0~~ -0.4	~~2.5~~ +0.6
Nominal Balance (GDP %)	-10.3	~~-8.8~~ -9.1	~~-7.1~~ -9.6	~~-4.1~~ -7.9	~~-3.7~~ -6.6	~~-3.1~~ -5.8
Net public sector debt (GDP %)	36.0	~~42.0~~ 42.3	~~43.3~~ 44.0	~~42.8~~ 45.3	~~41.6~~ 46.2	~~38.6~~ 46.7
Gross public sector debt (GDP %)	66.2	~~74.2~~ 74.4	~~75.9~~ 79.6	~~75.4~~ 81.8	~~74.2~~ 83.4	~~71.2~~ 84.0

Sources: National Treasury and Santander estimate.

In this report, we present our assumptions for primary balance and debt ratio to GDP dynamics in the upcoming years. We also present the breakdown of our fiscal forecasts.

First, the government fiscal target for the next 18 months is a significant primary deficit, which has negative consequences in the short term. The Congressional Budget Commission approved the new fiscal target for 2016 (on May 25), with the central government (National Treasury +BCB+ Social Security) targeting a primary balance deficit of BRL170.5 billion this year (2.75% of GDP). For 2017, the government proposed a primary deficit of BRL139 billion (2.05% of GDP). Both primary targets are far from our estimate for the primary balance required to stabilize the debt-to-GDP ratios – a surplus of approximately 2-3% of GDP (for further details, see our report, *The Fiscal Maze III: Insurgent*, dated October 29, 2015). The primary target for the total public sector, including regional states and state-owned companies, is for a deficit of BRL163.9 billion (2.65% of GDP) for 2016, and a deficit of BRL143.5 billion (2.1% of GDP) for 2017. According to the government's new economic team, the reasons for such significant primary deficit amounts of the central government primary balance were: the impact of economic recession on tax collection, due expenses and committed expenses.

2016 Budget Target (BRL million and % of GDP)

	2014 (effective)	2015 (effective)	2015/2014	2016 Budget Target (new Law)	2016 Budget Target (new Law)/ 2015 (effective)
Total Revenues	1,224,041	1,251,038	2.2%	1,286,900	**2.9%**
Tax collection	764,724	798,826	4.5%	785,500	-1.7%
Social security revenues	337,503	350,272	3.8%	356,900	1.9%
Concession/Dividends/Others	141,359	130,197	-7.9%	145,800	12.0%
Fiscal effort (tax increase/asset sales)					
Transfer to Reginal Governments	210,165	215,759	2.7%	209,000	-3.1%
Net Revenues	**1,013,875**	**1,035,280**	**2.1%**	**1,077,900**	**4.1%**
Total Expenditures	**1,031,086**	**1,150,265**	**11.6%**	**1,248,400**	**8.5%**
Mandatory Spendings	731,100	828,750	13.4%	979,700	**18.2%**
Non-Mandatory Spendings	299,986	321,515	7.2%	248,800	**-22.6%**
Aid for Regional government + Committed investments expenses net from Foreign asset repatriation revenue				19,900	
Fiscal Balance of central gov't (primary balance)	**(17,211)**	**(114,986)**		**(170,500)**	
Fiscal Balanceof central gov't (primary balance) % GDP	**-0.37**	**-1.95**		**-2.75**	

Source: Ministry of Planning.

In our opinion, the primary deficit expected in 2016 is realistic. Nominal spending growing at 8.5%, given that mandatory spending will be impacted by the expected inflation plus population growth, seems fair in our view (for further details, see our report, *The new (no) fiscal target*, dated May 26, 2016). Therefore, we believe that to overdeliver, i.e., to present a smaller primary deficit in 2016, depends on government underestimating revenue or on a revenue surprise, which we do not see as feasible in the short term.

On the political front, the 2017 primary target represented a victory for the economic team over the political wing, which was fighting for wide spending growth in order to accommodate the political demands. However, in our opinion, the 2017 fiscal target is bad news on the fiscal front, because it postpones any opportunity to see the debt-to-GDP ratio dynamic stabilizing in the upcoming years.

At first glance, the fiscal target for the federal government in 2017 at BRL139 billion, equivalent to 2.05% of GDP, seems an improvement over the target for 2016 (BRL170.5 billion, or 2.75% of GDP). However, this figure embodies two optimistic assumptions:

(1) for federal spending, which increases at 5.9% – far below the consensus expectation for inflation in 2016 of 7.2% (according to the Focus survey) – and

(2) for revenue, including unspecified revenue amounting to BRL55.4 billion (0.8% of GDP).

Without both optimistic assumptions, the primary deficit would actually be impacted by BRL202.3 billion (2.98% of GDP) according to our calculations, which is worse than the 2016 fiscal target.

2017 Fiscal target announced by the gov't

	2016 Budget Target (new Law)	2016 Budget Target (new Law)/ 2015 (effective)	2017 Budget Target (Gov't proposal)	2017 Budget Target/ 2016 Budget Target (new Law)
Total Revenues	1,286,900	**2.9%**	1,412,400	**9.8%**
Tax collection	785,500	-1.7%		
Social security revenues	356,900	1.9%		
Concession/Dividends/Others	145,800	12.0%		
Fiscal effort (tax increase/asset sales)			55,400	
Transfer to Reginal Governments	209,000	-3.1%	229,800	**10.0%**
Net Revenues	**1,077,900**	**4.1%**	**1,182,600**	**9.7%**
Total Expenditures	**1,248,400**	**8.5%**	**1,321,600**	**5.9%**
Mandatory Spendings	979,700	**18.2%**	1,067,600	**9.0%**
Non-Mandatory Spendings	248,800	**-22.6%**	254,000	**2.1%**
Aid for Regional government + Committed investments expenses net from Foreign asset repatriation revenue	19,900			
Fiscal Balance of central gov't (primary balance)	**(170,500)**		**(139,000)**	
Fiscal Balanceof central gov't (primary balance) % GDP	**-2.75**		**-2.05**	

Source: Ministry of Planning.

2017 Fiscal target simulation (w/o optimistic assumptions)

	2016 Budget Target (new Law)	2016 Budget Target (new Law)/ 2015 (effective)	2017 Budget Target (Gov't proposal)	2017 Budget Target/ 2016 Budget Target (new Law)
Total Revenues	1,286,900	**2.9%**	1,357,000	**5.4%**
Tax collection	785,500	-1.7%		
Social security revenues	356,900	1.9%		
Concession/Dividends/Others	145,800	12.0%		
Fiscal effort (tax increase/asset sales)				
Transfer to Reginal Governments	209,000	-3.1%	229,800	**10.0%**
Net Revenues	**1,077,900**	**4.1%**	**1,127,200**	**4.6%**
Total Expenditures	**1,248,400**	**8.5%**	**1,329,546**	**6.5%**
Mandatory Spendings	979,700	**18.2%**	1,067,600	**9.0%**
Non-Mandatory Spendings	248,800	**-22.6%**	261,946	**5.3%**
Aid for Regional government + Committed investments expenses net from Foreign asset repatriation revenue	19,900			
Fiscal Balance of central gov't (primary balance)	**(170,500)**		**(202,346)**	
Fiscal Balanceof central gov't (primary balance) % GDP	**-2.75**		**-2.98**	

Source: Ministry of Planning.

As in past years, the government is indicating a mandatory spending increase of 9% y/y for 2017, in line with nominal GDP, while the non-mandatory spending (which includes investments) is seen up 2.1% y/y, representing a very mild increase.

Regarding the fiscal effort, the Finance Minister Henrique Meirelles mentioned that it could come from concessions, eventual tax hikes, and as a result of an economic recovery in 2017. It is important to highlight that the government expects revenue (excluding the fiscal effort) to rise about 5.4%, which seems to already account for part of the impact of an economic recovery. **All in all, we see downside risks for the 2017 fiscal target, and believe that the primary balance might be worse than the government's first estimate.**

Therefore, we are revising our fiscal forecasts to reflect a larger budget deficit in the short term, given that we expect the government's strategy to bear fruit only some years down the road.

2017 Fiscal X-Ray

According to our forecasts for GDP growth and inflation (IPCA), we expect a slow reversal of the central government current primary balance trend, registering a primary surplus from 2020 onwards. Our assumptions for GDP growth are -3.7% in 2016, +2% in 2017, around +3% in 2018, 2019 and 2020, and our assumptions for IPCA are 7% in 2016, 5.2% in 2017, and around 5% in 2018, 2019 and 2020.

Budget Evolution

	2016 Fiscal Balance Santander	2016 / 2015	2017 Fiscal Balance Santander	2017 / 2016	2018 Fiscal Balance Santander	2018 / 2017	2019 Fiscal Balance Santander	2019 / 2018	2020 Fiscal Balance Santander	2020 / 2019
Total Revenues	1,303,200	**4.2%**	1,401,695	**7.6%**	1,534,532	**9.5%**	1,693,854	**10.4%**	1,869,967	**10.4%**
Tax collection	800,500	**0.2%**	853,333	**6.6%**	937,206	**9.8%**	1,039,024	**10.9%**	1,151,905	**10.9%**
tax increase(*)			22,000							
Social security revenues	356,900	1.9%	375,459	5.2%	406,059	8.2%	450,173	10.9%	499,080	10.9%
Concession/Dividends/Others	145,800	3.1%	150,903	3.5%	191,267	26.7%	204,656	7.0%	218,982	7.0%
Transfer to Reginal Governments	212,844	-1.4%	224,082	5.3%	241,702	7.9%	260,328	7.7%	281,799	8.2%
Net Revenues	**1,090,356**	**5.4%**	**1,170,580**	**7.4%**	**1,292,830**	**10.4%**	**1,433,525**	**10.9%**	**1,588,168**	**10.8%**
Total Expenditures	**1,248,400**	**8.5%**	**1,329,546**	**6.5%**	**1,402,671**	**5.5%**	**1,472,805**	**5.0%**	**1,546,445**	**5.0%**
Mandatory Spendings	**954,520**	**16.2%**	**1,033,712**	**8.3%**	**1,103,850**	**6.8%**	**1,164,629**	**5.5%**	**1,230,876**	**5.7%**
Payroll	270,392	14.7%	291,052	7.6%	314,773	8.1%	338,806	7.6%	364,673	7.6%
Social Security benefits	495,909	13.7%	554,941	11.9%	612,172	10.3%	658,911	7.6%	709,219	7.6%
Workers support fund (FAT)	54,197	13.0%	60,071	10.8%	64,967	8.2%	70,626	8.7%	76,019	7.6%
Economic subsidies	85,592	45.2%	75,002	-12.4%	55,002	-26.7%	35,002	-36.4%	15,002	-57.1%
Assistance Benefits (LOAS e RMV)	48,429	13.8%	52,645	8.7%	56,936	8.2%	61,283	7.6%	65,962	7.6%
Non-Mandatory Spendings	**266,004**	**-17.3%**	**273,539**	**2.8%**	**288,125**	**5.3%**	**298,496**	**3.6%**	**305,405**	**2.3%**
health	90,475	8.0%	99,316	9.8%	109,022	9.8%	119,086	9.2%	129,460	8.7%
education	29,492	8.0%	32,374	9.8%	35,538	9.8%	38,818	9.2%	42,200	8.7%
capital expenditures	59,581	5.1%	62,560	5.0%	66,313	6.0%	69,629	5.0%	73,110	5.0%
other expenditures	86,457	-43.8%	79,290	-8.3%	77,253	-2.6%	70,963	-8.1%	60,635	-14.6%
Others	7,976	7.0%	8,534	7.0%	9,132	7.0%	9,680	6.0%	10,164	5.0%
Aid for Regional government + Committed investments expenses net from Foreign asset	19,900		13,760	-30.9%	1,564	-88.6%				
Fiscal Balance of central gov't (primary balance)	**(158,044)**		**(158,966)**		**(109,841)**		**(39,279)**		**41,723**	
Fiscal Balanceof central gov't (primary balance) % GDP	**-2.52**		**-2.38**		**-1.52**		**-0.51**		**0.50**	
Fiscal Balance of regional government (primary balance) % GDP	**0.02**		**0.08**		**0.12**		**0.11**		**0.10**	
Fiscal Balance of total public sector (primary balance) % GDP	**-2.50**		**-2.30**		**-1.40**		**-0.40**		**0.60**	

Source: Santander estimate.

Fiscal effort (tax increase)

As the government indicated, we expect some tax increase in 2017. However, taking into account (a) the hike of CIDE, (b) the change of individuals' marginal income tax bracket, and (c) a marginal hike of IOF, IPI and PIS/Cofins, we estimate an increase in tax collections of around BRL 22 billion.

Tax increase (impact on tax collection in 2017)

	R$ bn	% GDP
CIDE (tax on gasoline)	11.8	0.2%
IRPF (tax income for individuals)	3.5	0.1%
IOF (tax on finacial operations)	3.7	0.1%
IPI (tax on manufacturing goods)	2.0	0.0%
PIS/Cofins	1.0	0.0%

Source: Santander estimate.

Concessions and Dividends

The government's strategy in restarting the concession/privatization program in 2017 is clear. The government expects most of the BRL55.4 billion in fiscal effort to come from concession/privatization, according to the Finance Minister Henrique Meirelles. We believe that the next step of economic policy is the development of the infrastructure sectors. We see a lot of low-hanging fruit among these sectors, however we now believe that there is not sufficient time to reap those benefits during 2017, which is slightly more cautious than our thoughts previously, and the government's assumptions. Previously, we expected the privatization/concession agenda of almost 1% of GDP happening in 2017. Now, we expect the successful completion of the concession and privatization agenda to occur in 2018.

Foreseeable Privatization/ Concession Agenda

	Impact on tax income (IR)	Impact on Dividends	% of GDP
Companies subsidiaries which are state-owned			
Caixa Seguridade (caixa Economica Federa	2,142	1,428	0.06%
BR Distribuidora (Petrobras)	4,284	2,856	0.12%
Eletrobras subsidiaries (DisCos)	918	612	0.02%
	Concession revenue		
Concessions			
Railroad	1,360		0.02%
Airport	680		0.01%
Highway	10,880		0.18%
Total Concession/Privatization (% GDP)	**25,160**		0.41%

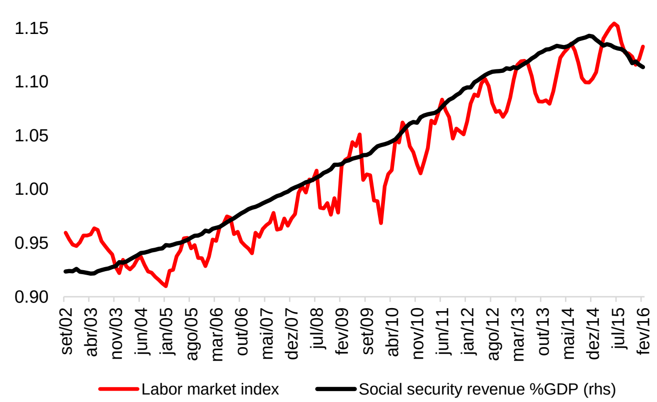
Source: Santander estimate.

We estimate that the foreseeable privatization/concession agenda might result in revenues of around BRL25 billion, and optimistically, we are assuming that the government might raise this amount to BRL50 billion due to the selling asset, and conferment payments of other concessions that are not yet in the pipeline.

Tax collection and Social security revenue

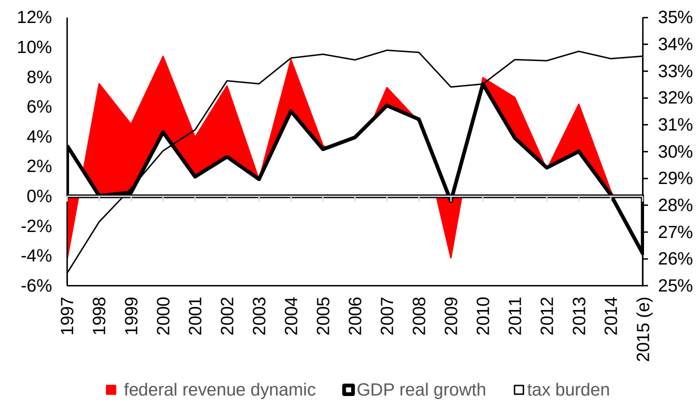
We expect the economic recovery from 2017 onwards to have a positive impact on tax collection, and also on social security revenues. Tax collection and GDP growth are positively correlated. According to our model, revenue-elasticity-to-GDP growth is 1.44, which is in-line with macroeconomic theory, and means that each percentage point increase in the output gap would generate a percentage change in revenues larger than 1 (for further details, see our report, *Match point*, dated June 14, 2016). Also, labor market conditions – which should improve as a result of economic recovery – and social security revenues are positively correlated. The charts below show the influence of economic cycles on tax collection, and of the labor market on social security. We constructed an index combining formal jobs and the unemployment rate, and we find that the influence over social security revenue is clear. Because of these positive correlations, we estimate tax collection and social security revenues growing above 10% from 2018 onwards.

Social security revenue ratio to GDP and labor market



Sources: Ministry of Finance, IBGE and Santander estimate.

Revenue dynamic and real GDP growth



Sources: Ministry of Finance, IBGE and Santander estimates.

Mandatory spending

For 2017-2018 period, we assume payroll growth at approximately the rate of inflation plus 2.0% per year, and social spending (social security benefits + unemployment insurance + non-contributory social assistance), reflecting the minimum wage adjustment policy (real GDP growth two years ago + consumer inflation one year ago), population growth, and labor market conditions. Therefore, we assume that mandatory spending will run at inflation plus 1.4%, on average, during this period.

Thus, we forecast 2017 and 2018 mandatory spending increasing above the rate of prior year's inflation, mainly due to the absence of the disengaging of social spending (which represents about 68% of mandatory spending) from minimum wage policy, and of social security reform. We believe that these two structural measures will be fully implemented from 2019 onwards, and then, as a result, we see mandatory spending increasing in line with the prior year's inflation (and in line with the application of the proposed spending cap[1]).

According to our exercises, the disengaging of the social spending from the minimum wage adjustment policy might save around 1.6% of GDP in 20 years (0.1% of GDP per year for each 2 p.p. difference in annual adjustment policy). And, the increase in the minimum age for retirement and the equalization between men's and women's requirement age (e.g., to 65 years old), would also save around 2.0% of GDP in 20 years (0.2% of GDP per year). For further details, see our report, *The Clash of Titans: Desirable versus Feasible*, dated May 12, 2016.

Non-mandatory spending

On the other side of the coin, we expect fiscal adjustments to continue relying on non-mandatory spending as a result of the spending cap. In other words, if mandatory spending will run at inflation plus 1.4%, on average, non-mandatory spending will have to run at inflation minus 2.0%, according to our estimate. Moreover, as the health and education spending amounts might be more influenced by the GDP growth than the spending cap policy, we expect government investments to remain constrained by fiscal adjustments. The only exception would be non-mandatory spending in 2018, due to the election calendar for president, governor of states, Lower House and Senate.

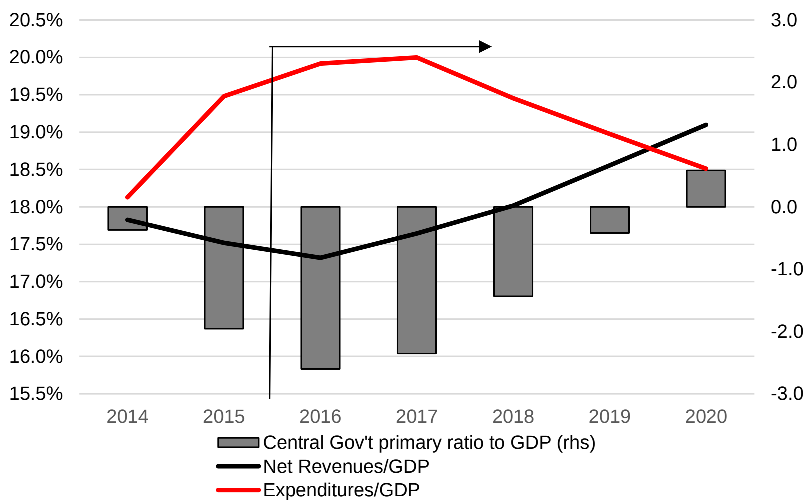
Aid for regional governments

The agreement between regional governments and the federal government regarding the debt service payments owed to the federal government brings some relief to the financial needs of regional governments between 2016 and mid-2018, according to our projections. However, it also involves the increase of federal expenditures with this aid for regional governments.

The schedule of payments proposed in the agreement, which includes a decreasing discount scale on the payment of the debt of regional governments, implies that the federal government will have to finance the regional governments until 2018, when the discount on debt service payments fades away. We estimate the aid for regional governments at BRL13.8 billion and BRL1.6 billion, respectively in 2017 and 2018.

[1] The cap of spending is a government proposal that is still pending approval in Congress. It is a PEC (Constitutional amendment), which requires a three-fifth majority of votes and has to be voted on twice in both the Lower House and Senate.

Fiscal drivers evolution



Source: Santander estimate.

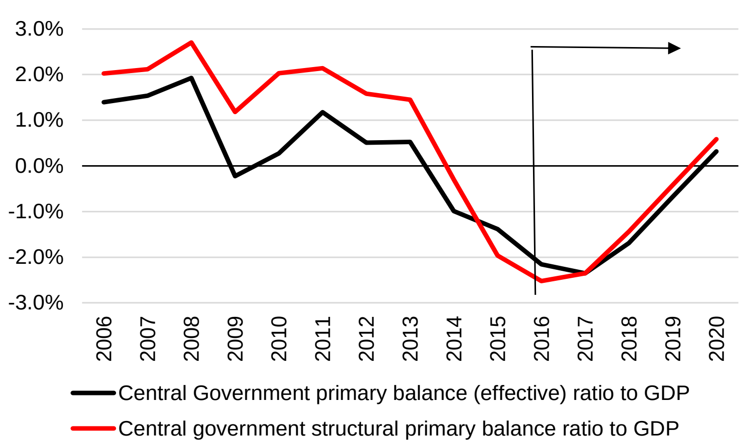
In summary, according to our estimates, if there is an economic heat-up from 2017 onwards, and some structural measures are approved by Congress and implemented, the revenue and expenditure ratios to GDP might reach a balance from 2019 onwards. We believe that the government's strategy to tackle the fiscal adjustment will result in a downward trend for expenditure ratio to GDP from 2017 onward, and the economic recovery will result in an upward trend for revenue ratio to GDP from 2017 onwards. However, we think it will take quite some time for this strategy to play out, as illustrated by the chart above.

In our opinion a faster fiscal adjustment process would require a positive surprise on the revenue side, as a result of an economic rebound, given that structural reforms will not promote relevant savings in the short term, and an increased tax burden is not yet a part of the government's strategy.

Structural primary balance

According to our forecasts for primary balance, nonrecurring revenues, payment of fiscal maneuver and GDP growth trajectories this year and 2017, the primary balance, adjusted for cycles (following the IMF methodology), will remain in negative territory, indicating that the central government will continue to run a stimulative policy in upcoming years. We foresee the structural primary balance becoming tightened at the end of 2019.

Structural and Adjusted primary balance forecasts



Sources: National Treasury and Santander estimate.

Debt dynamics

The government also announced, pending approval in Congress, some measures intended to reduce the gross-debt-to-GDP ratio, which is good news for the long term.

The main measures proposed by the government which require approval by Account Court (TCU) and Senate, are as follows:

- Prepayment of BRL100 billion in the BNDES loans to the National treasury (in installments: BRL40 billion in 2016; BRL30 billion in 2017, and BRL30 billion in 2018)
- Unwinding of the Sovereign Wealth Fund (Fundo Soberano), representing an impact of BRL2 billion revenue on the primary balance

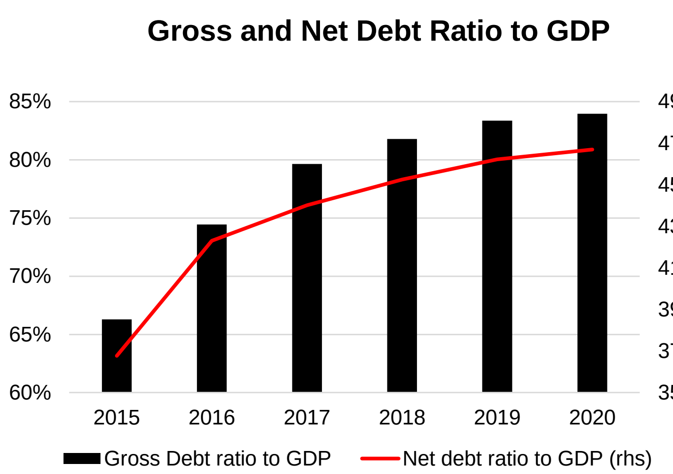
We believe that these measures can mitigate, but cannot reverse, the gross-debt-to-GDP ratio's upward trend. Therefore, we are revising our debt ratio to GDP due to a larger budget deficit in the short term, and a long-term process of reversing the primary deficit to a surplus. Previously, we foresaw the gross-debt-to-GDP ratio peaking at 75.9% of GDP in 2017. Now, we foresee gross debt in an upward trend until 2020, reaching 84% of GDP, and the net-debt-to-GDP ratio reaching almost 47% of GDP, as the primary balance remains below the 2%-3% level, which, according to our model, is required to stabilize the debt dynamic. Our assumptions are:

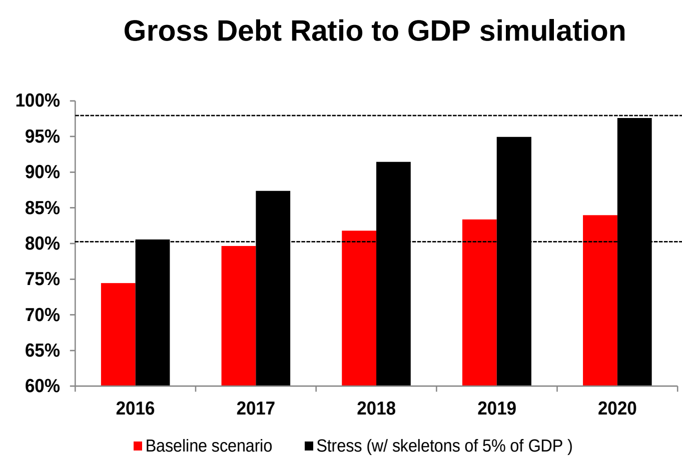
(a) real interest rates at 4% from 2017 onwards;

(b) real GDP growth at 2.5% from 2017 onwards; and

(c) reversal of the current primary deficit to a surplus of 2% of GDP from 2021 onwards.

We believe the continued upward trajectory for both gross and net debt ratio to GDP may not trigger a revision of the sovereign credit risk if, and only if, the government fulfills the promises made regarding the implementation of structural reforms. In our opinion, markets expect to see a Congressional debate regarding the structural measures starting in 4Q16, with the first voting sessions occurring throughout 2017. If this expected calendar does not happen, we believe we may see a higher country risk premium being priced in asset prices again.





Source: Santander estimate.

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