Brazil Macro | June 2021

FISCAL POLICY

ÍTALO FRANCA
italo.franca@santander.com.br
+55 11 3553-5235

Brief Overview

01

Summary - Better Short-Term Figures on the Heels of Higher Inflation

- We improved our fiscal numbers due to a more persistent inflation shock. In the May scenario revision the primary deficit was revised to 3.0% of GDP in 2021 (from -3.2% of GDP) owing to an inflation "help" on the revenue side - with risks on the upside. Now, our current tracking is close to -1.9% of GDP, considering our new GDP and inflation numbers.

- Gross debt was revised down for this year, reflecting a higher GDP deflator. Yet we project an upward trajectory for the medium term, with long-term debt stabilization looking increasingly risky.

- We see a more persistent and intense inflationary shock, with the pass-through of higher costs and a recovery in profit margins resulting in higher federal tax collection (mainly on the corporate side). An important consequence from the inflationary shock in 2020-2021 is that the constitutional spending cap has some of its anchoring power. Additionally, with the inflation convergence to mid-target only expected for 2023 in our scenario, compliance with the spending cap up to 2026 is now easier than before

- That said, we believe the main market focus will be on the sustainability of government debt. In our view, despite better fiscal numbers for the short run, the long-term debt trajectory is in a challenging situation, since any additional shock that raises the neutral interest rate or reduces potential GDP growth could derail the expected debt convergence. Additionally, approving tougher fiscal measures seems increasingly hard.

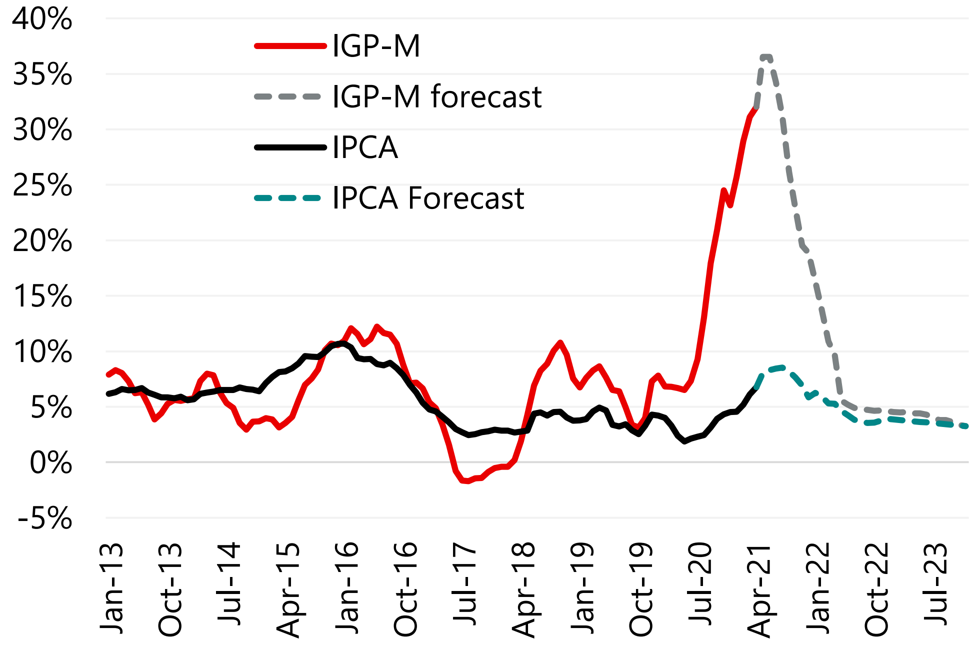
Better Short-Term Figures on the Heels of Higher Inflation and Activity Recovery

02

Background – Inflation Shock and Activity Recovery in 1Q21

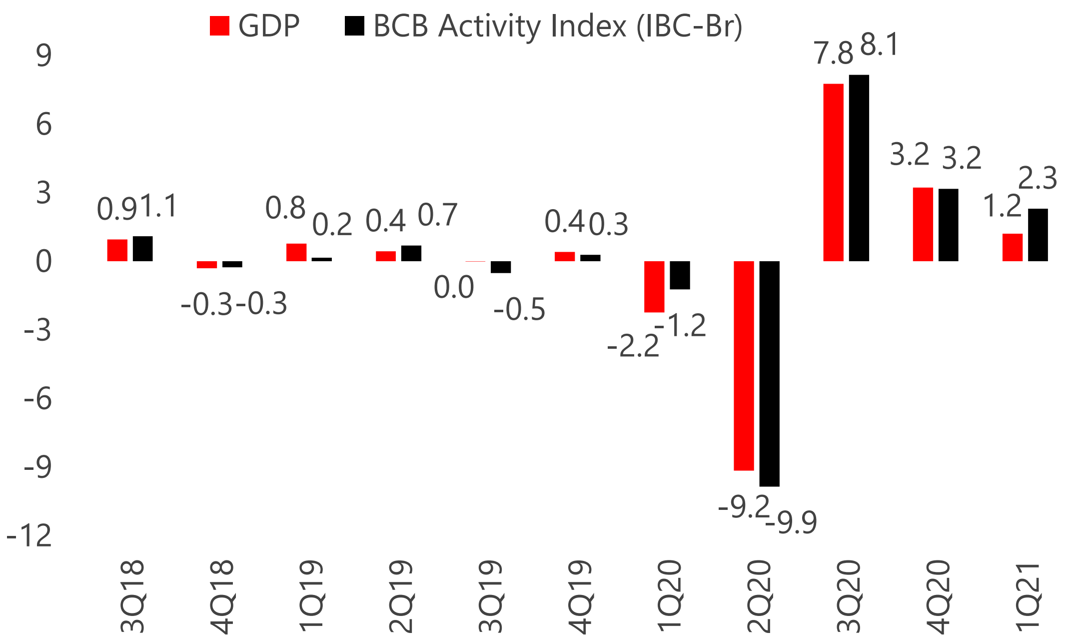
- Following the fourth quarter's solid growth, the releases of economic activity indicators surprised positively in 1Q21, even with March's retreat. Among the sectors, we can see heterogeneity, with the services sector being the main driver of the recovery, while the goods sector (industry and retail) posted weaker figures (in opposition to the pattern of recovery seen in 2H20).
- Inflationary shocks from the global recovery became more permanent and raised our forecasts.

Inflation – IGP and IPCA



Sources: FGV, IBGE, Santander.

GDP vs IBC-Br (sa, % QoQ)

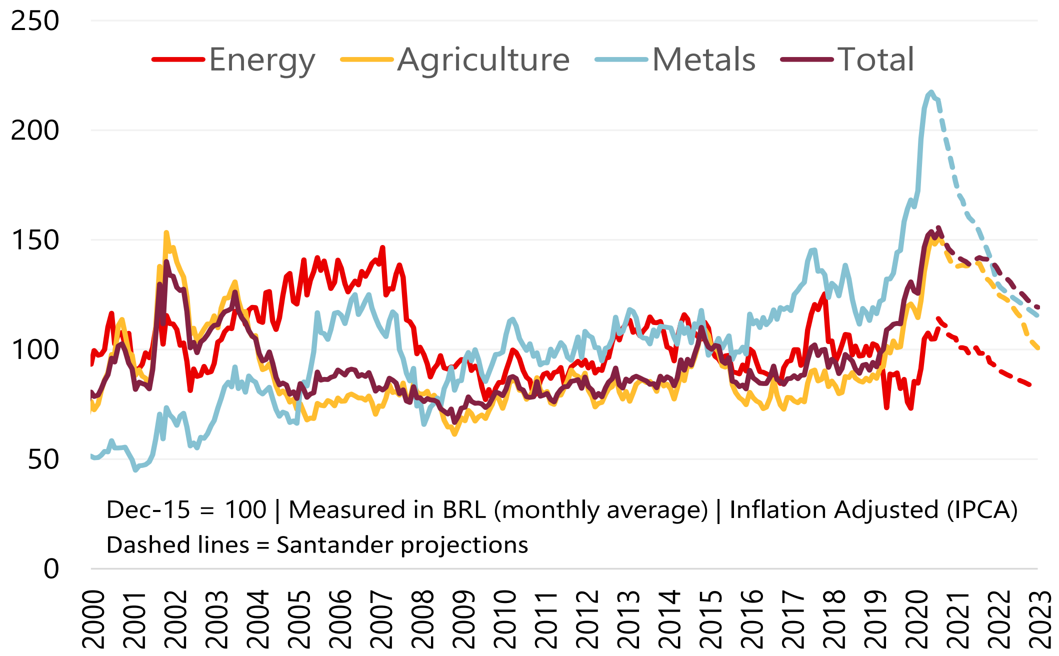


Sources: BCB, IBGE, Santander.

Background – Commodity Boom And Rise In Terms-of-trade

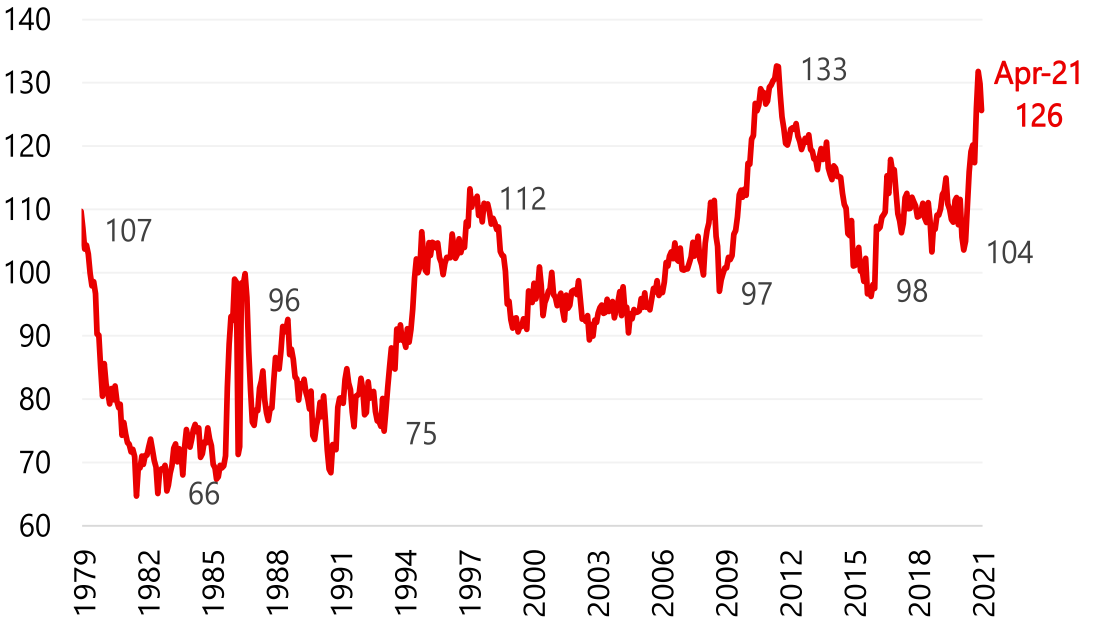
- The fact that the greater gain in terms of trade accompanies higher commodity prices helps to increase revenue for the largest companies related to the sector. It is important to emphasize that Brazilian GDP has a strong positive correlation with the commodity cycle, so the duration of this commodity cycle will be a key factor to observe. In our view, it will tend to cool down until 2023, which gives the government time to promote structural changes on the fiscal front.

CRB Commodity Index



Sources: Bloomberg, Santander.

Terms-of-Trade Index

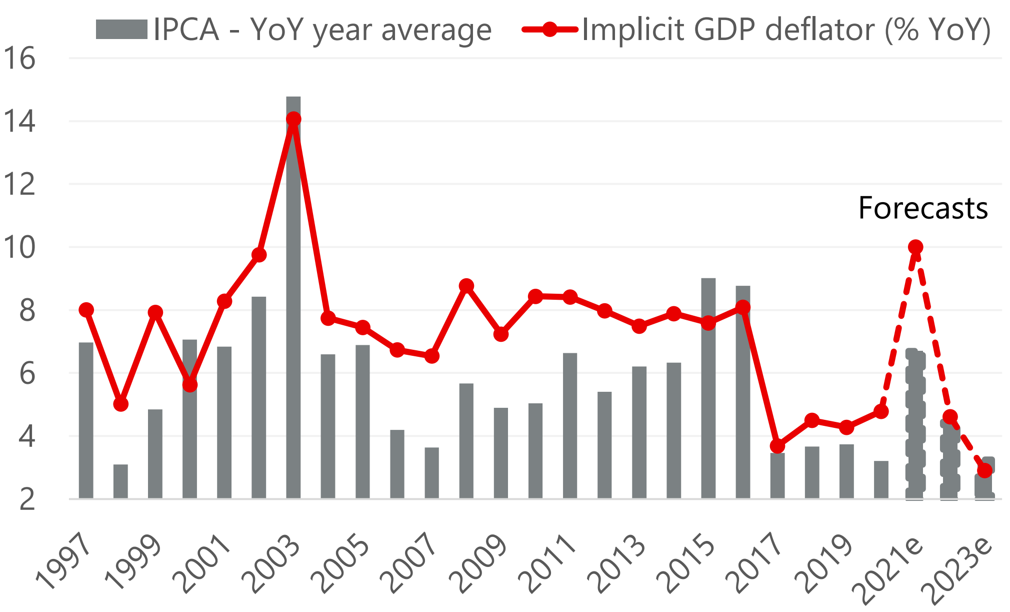


Sources: FUNCEX, Santander.

GDP Deflator Impact – Terms-of-trade And Inflation Shock Effect

- One of the main effects of both higher inflation and activity recovery is higher nominal GDP, which consequently affects the debt-to-GDP ratio. At the beginning of the year, we estimated that nominal GDP would increase by 7% in 2021; our latest tracking points to a ~15% increase. The main effect was on the GDP deflator, which went from 4.0% to 10.0%, closely related to the commodity shock and an increase in the IPCA projection from 3.6% (February) to 5.9% (May).

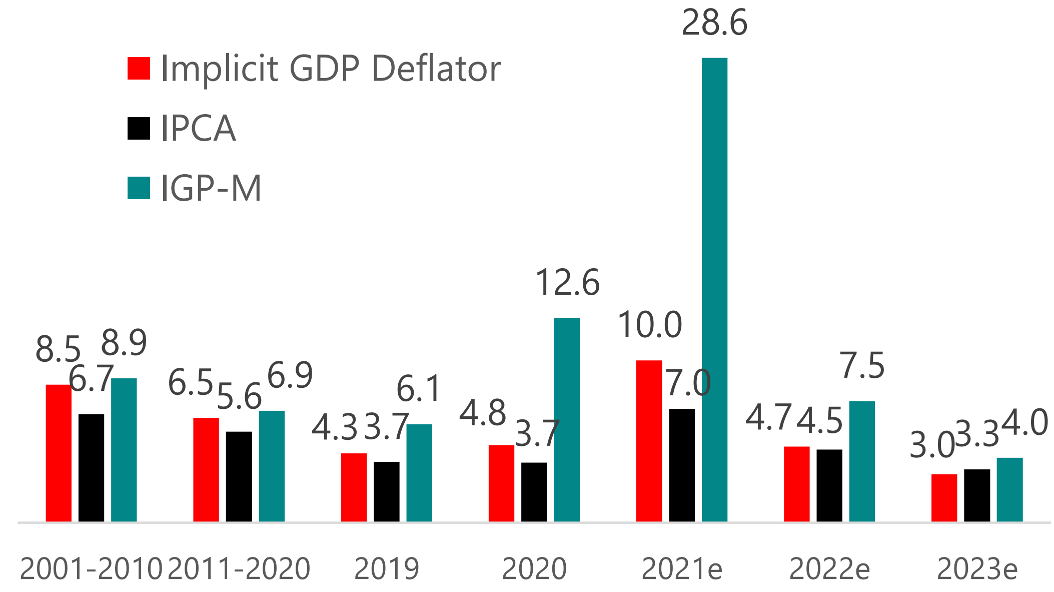
IPCA and GDP Deflator



Sources: IBGE, Santander.

IPCA, IGP-DI and GDP Deflator

YoY % | Annual average

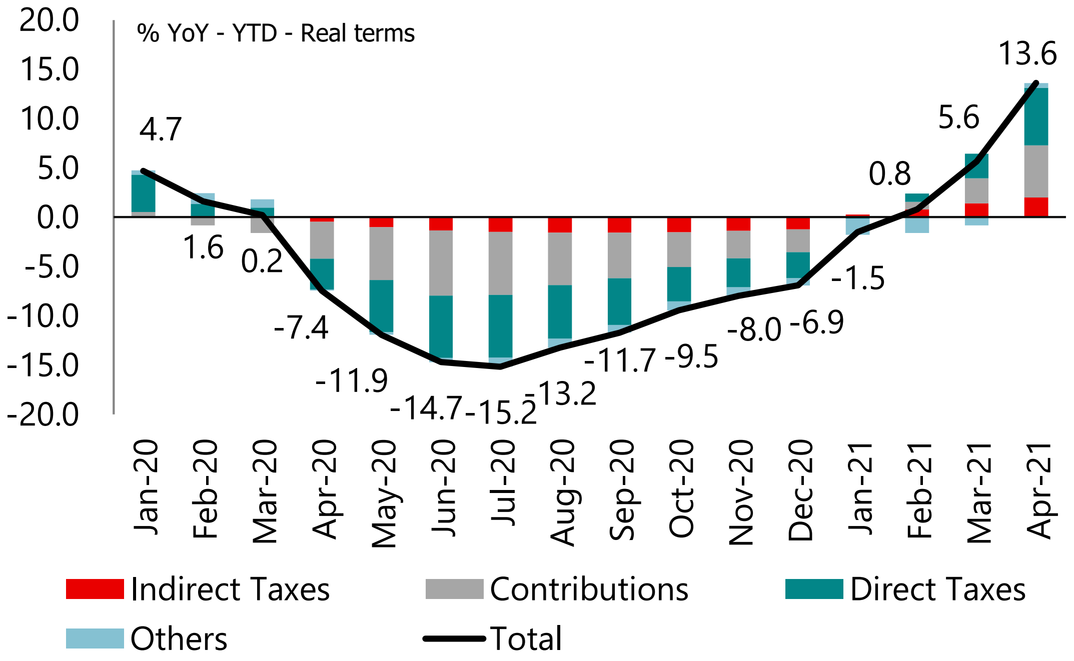


Sources: IBGE, FGV, Santander.

Revenues Impact – Inflation is boosting tax collection in federal and regional terms

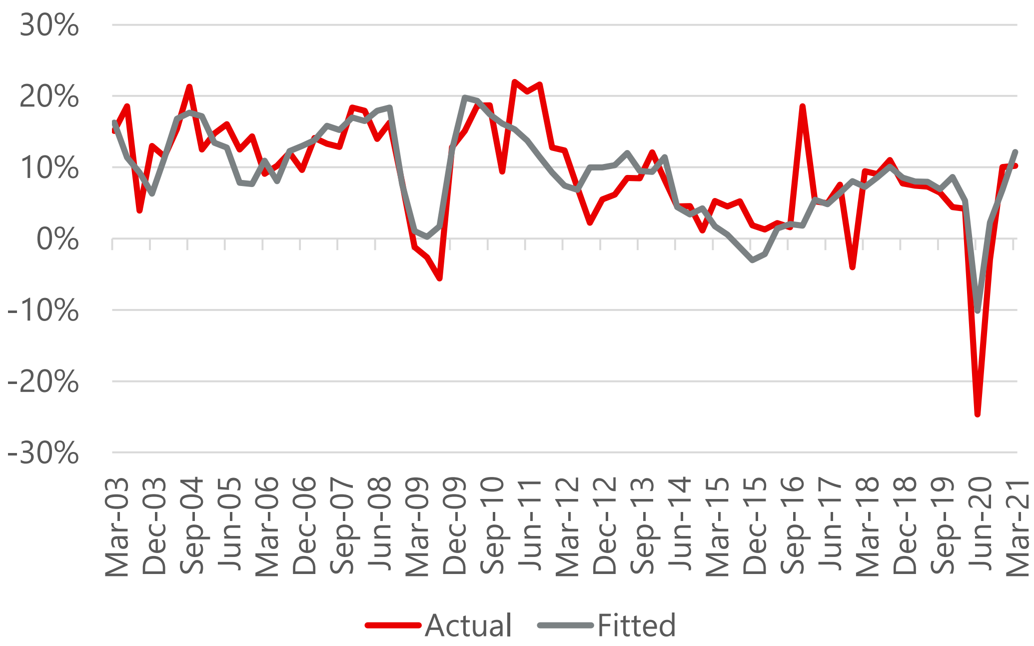
- Figure below shows a strong recovery in federal tax collection in recent months, mainly direct taxes linked to the business sector, which have posted good results recently. We ran a revenue model showing the relationship between the recovery of activity and the effect of inflation; the projection based on this model is consistent with our tracking.

Federal Tax Revenue: Year-to-date (%YoY)



Sources: Brazilian IRS, Santander.

Model – Tax Revenue – GDP and Inflation

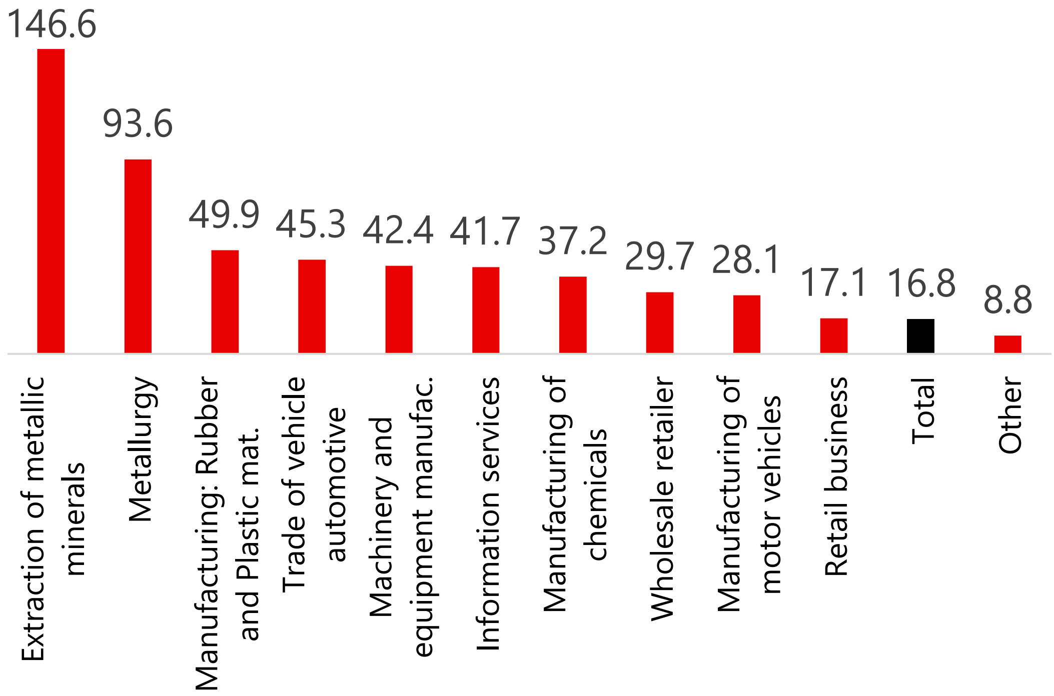


Sources: FGV, IBGE, Santander.

Revenues Impact – Inflation is boosting tax collection

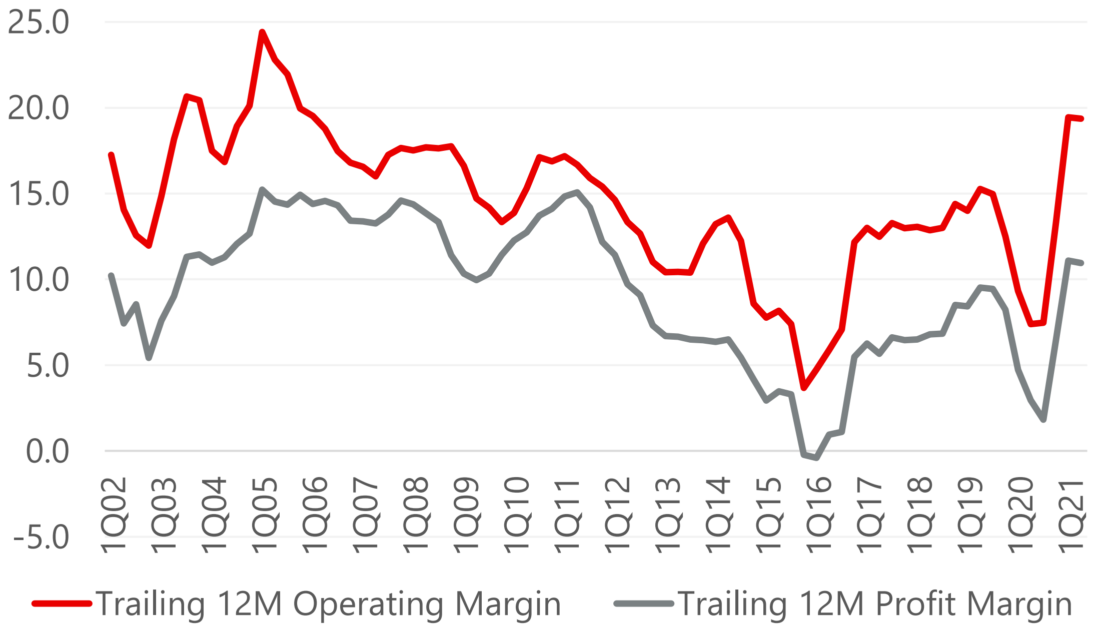
- Due to a more persistent and intense inflationary shock, with the pass through of higher costs and a recovery in profit margins resulting in higher federal tax collection (mainly on the corporate side). Moreover, the strong performance of commodity exporters (amid a combination of weaker FX rate and higher material prices) also helped boosting revenue. This took place in a context of a positive surprise in the domestic activity in 1Q21. Inflation has helped the collection of Brazilian states.

Federal Tax Revenue by sectors YTD (%YoY)



Sources: Brazilian IRS, Santander.

Margin recovery – Brazilian Companies IBX

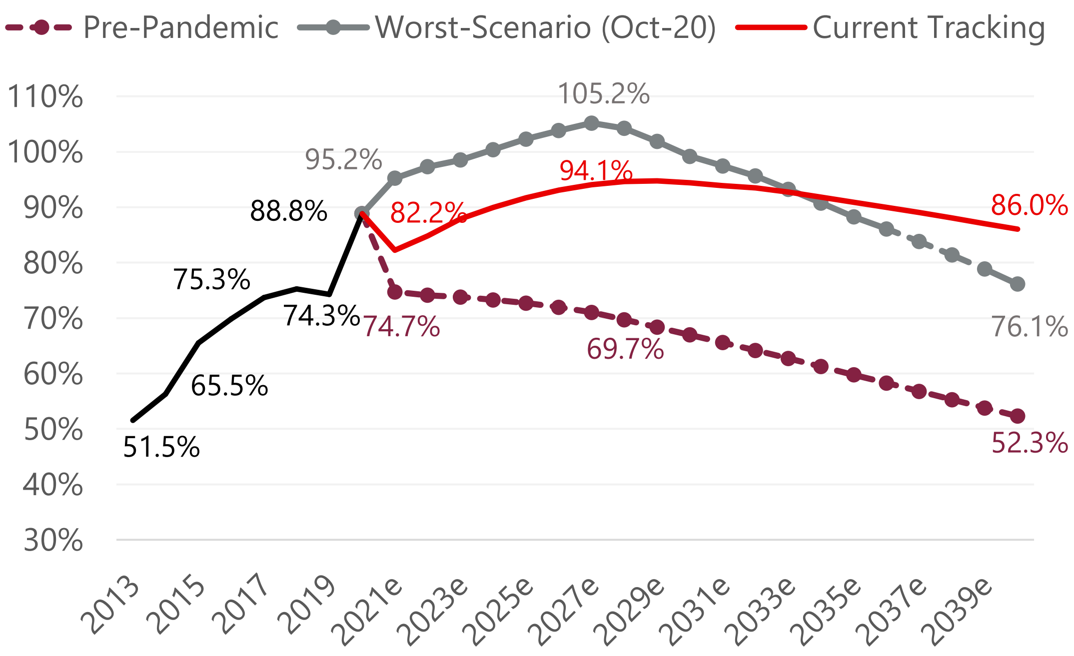


Sources: Brazilian IRS, Santander.

Fiscal Scenario – Our Debt Forecasts Dropped Due To Effect Of Inflation And Terms-Of-Trade

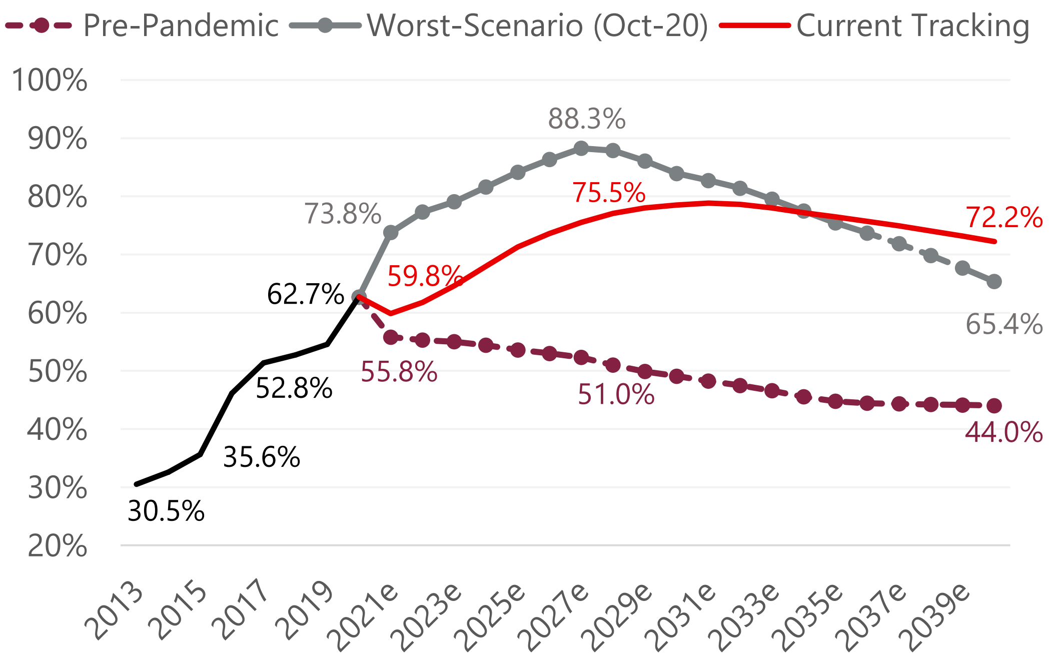
- In our most recent scenario, the impact of the inflationary shock is assumed to be more persistent and lasting than we initially expected. With that, tax collection grew and, especially, the projection of the GDP deflator rose significantly. The scenario became more positive, but there was still no structural change that would justify a reversal in the expectation of a deteriorating trend, unless the positive terms-of-trade shock is more lasting than we expect.

Gross Debt (% GDP)



Sources: BCB, Santander.

Net Debt: Gross Debt – FX Reserves (% GDP)



Sources: BCB, Santander.

Fiscal Baseline Scenario – Primary Result and Spending Cap

03

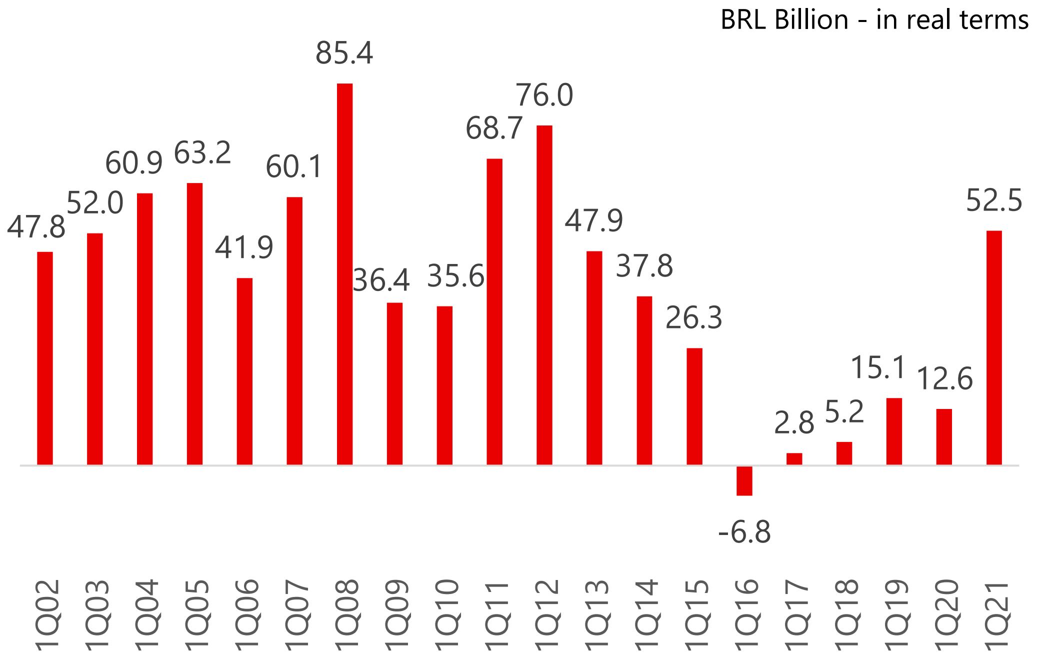
Fiscal Outlook – Qualitative Changes - Still Very Challenging

Revenues	↑	• Better Activity numbers in 1Q21 • Inflation and FX impact + M&A activity, IPOs, and corporate restructuring
Expenses	■	• No major changes (so far) • Risks of higher “extra-cap” expenditures
Public Sector Primary Balance	↑	• Better revenues • Risks of higher “extra-cap” expenditures • Better Regional Gov. Result
Risk of Shutdown	↑	• Approval of the Budget and a gradual return to a “normal life” in 2H21 • Government lost part of its budget maneuvering capacity (increase in parliamentary amendments)
New expenditures risk	↑	• Pressure to extend emergency aid beyond July • Pressure between ministries for resources
Transparency of fiscal accounts	↓	• BRL115 billion extra-cap, BRL70 billion extra-primary target • PLN4 and higher number of parliamentary amendments

Fiscal – Good result in 1Q21, yet the 12-month reading is still high

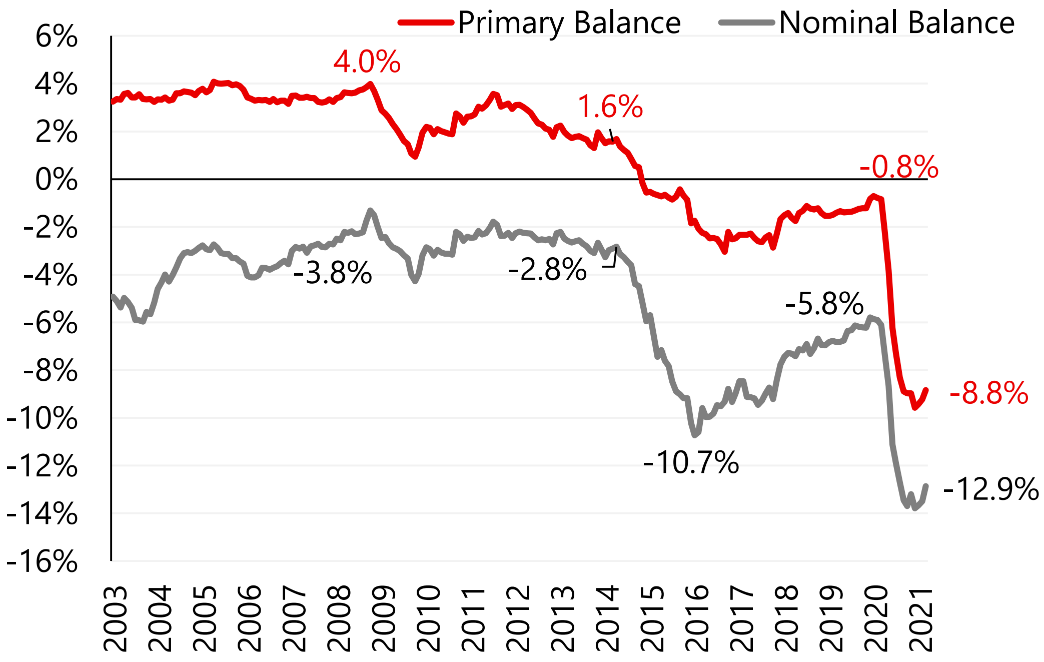
- Inflation helped tax collection in 1Q21, making it possible to achieve the best result since 2012. However, spending tends to rise ahead with the approval of the 2021 budget.

Public Sector – Primary Result 1Q



Sources: BCB, Santander.

Public Sector – 12m % GDP

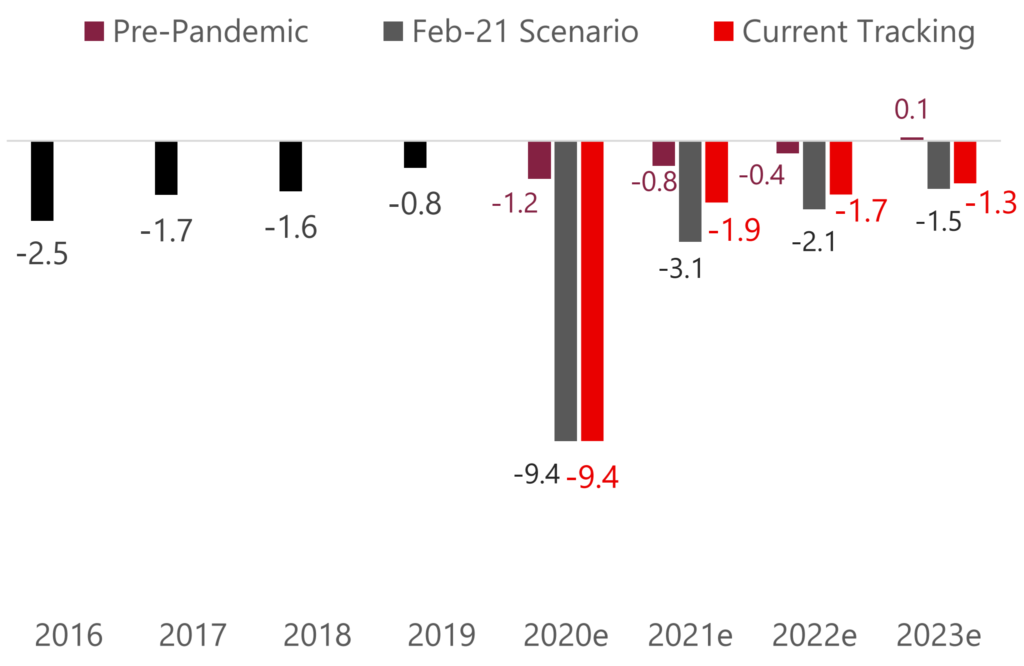


Sources: BCB, Santander.

Fiscal – Prices Shock Improved The Primary Result

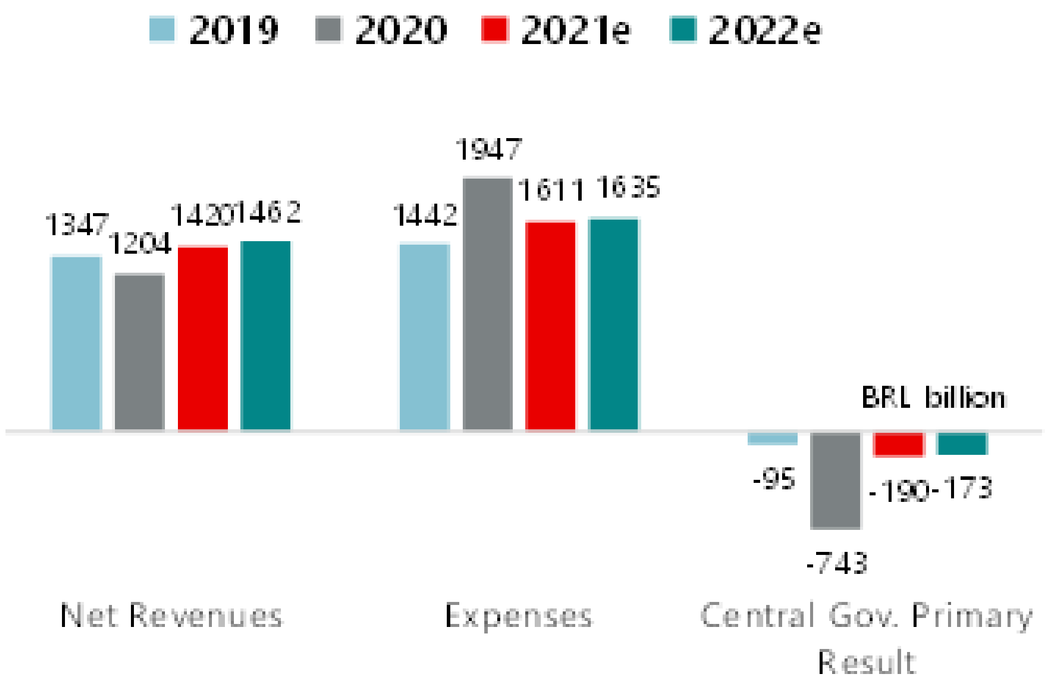
- Considering the terms-of-trade and inflation impact on the revenues we improved our forecasts for the primary result. Yet, a more persistent improvement will depend on the commodity boom.

Primary Result (% GDP)



Sources: BCB, Santander.

Primary Result Current Tracking



Sources: BCB, Santander.

Central Government – Revenues and Expenditures

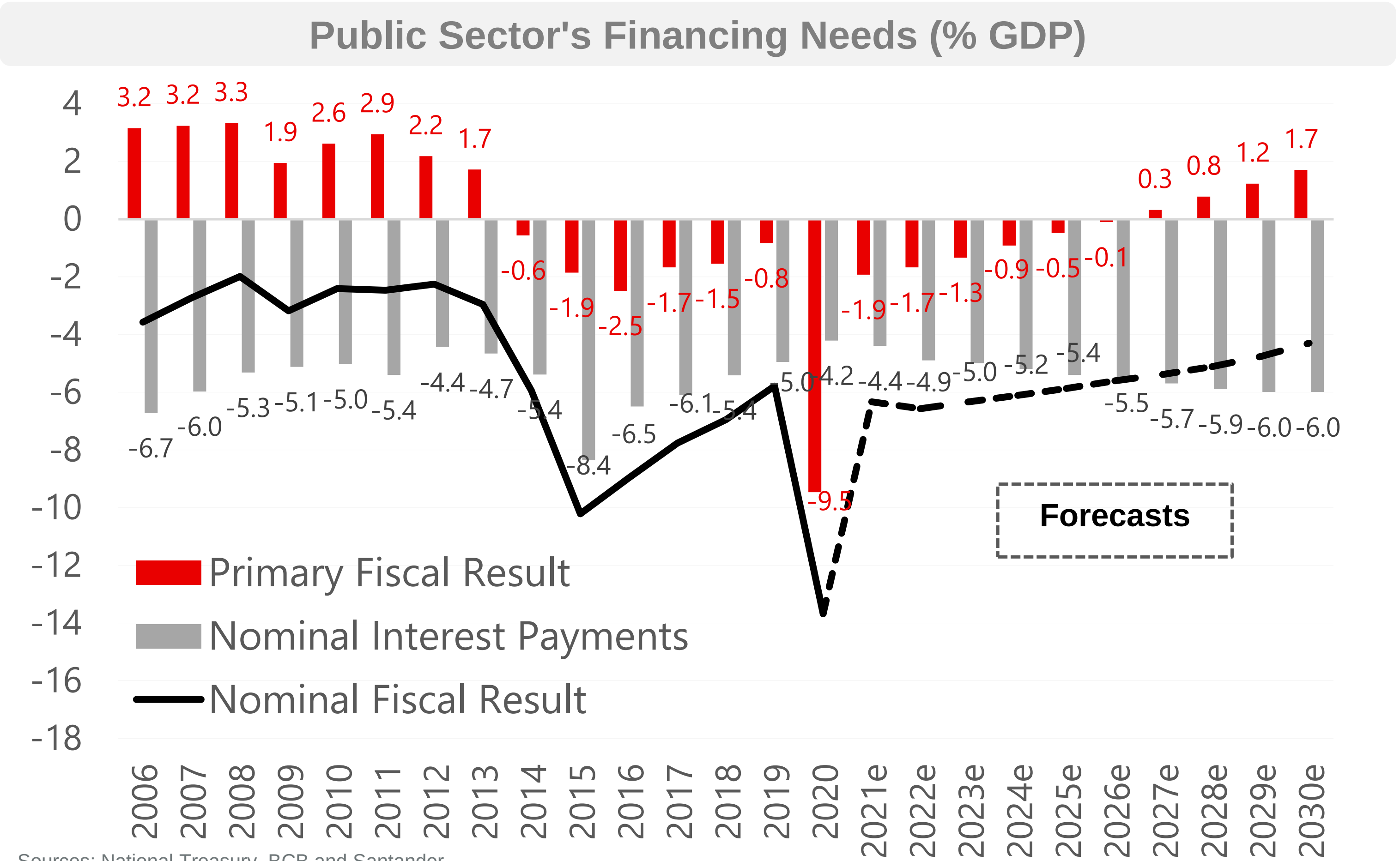
Central Government's Primary Balance													
Fiscal Items (% of GDP)	2018	2019	2020	2021e	2022e	2023e	2024e	2025e	2026e	2027e	2028e	2029e	2030e
Total Revenue	21.2	22.1	19.7	20.3	19.9	20.2	20.4	20.6	20.8	20.9	21.2	21.4	21.6
Revenues Collected by the Federal Revenue Office	12.9	12.8	12.1	12.9	12.7	12.8	12.9	13.0	13.0	13.1	13.2	13.3	13.3
Net Social Security Revenues	5.6	5.6	5.4	5.1	5.0	5.1	5.2	5.2	5.3	5.4	5.5	5.6	5.7
Revenues Not Collected by the Federal Revenue Office	2.7	3.7	2.2	2.3	2.2	2.3	2.4	2.4	2.4	2.5	2.5	2.6	2.6
Transfers by Revenue Sharing	3.7	3.9	3.5	3.7	3.6	3.7	3.6	3.6	3.6	3.6	3.5	3.5	3.5
Net Revenue	17.5	18.2	16.2	16.6	16.2	16.6	16.8	17.0	17.2	17.4	17.6	17.9	18.1
Total Expenditure	19.3	19.5	26.1	18.8	18.0	17.9	17.7	17.5	17.2	16.9	16.7	16.4	16.1
Social Security Benefits	8.4	8.5	8.9	8.3	8.3	8.4	8.4	8.4	8.3	8.3	8.2	8.2	8.1
Payroll	4.3	4.2	4.3	3.9	3.9	3.9	3.8	3.8	3.7	3.6	3.5	3.4	3.2
Other Mandatory Expenses	2.9	2.6	9.7	3.6	2.6	2.5	2.5	2.4	2.3	2.2	2.2	2.1	2.0
Mandatory Expenses with Cash Control	3.8	4.1	3.2	3.1	3.2	3.1	3.0	3.0	2.9	2.8	2.8	2.7	2.7
Discretionary Expenses	1.8	2.2	1.5	1.2	1.5	1.4	1.4	1.4	1.4	1.4	1.3	1.3	1.3
Central Government's Primary Balance	-1.8	-1.3	-10.0	-2.2	-1.7	-1.3	-0.9	-0.5	-0.1	0.4	1.0	1.5	2.0
Nominal GDP (BRL billion)	7,004	7,407	7,448	8,561	9,108	9,550	10,091	10,656	11,253	11,883	12,548	13,251	13,993

Sources: National Treasury, Brazilian Central Bank, Santander.

➔ **Main assumptions for the current baseline scenario:** our macro scenario for 2021 and 2022. **After 2023: (i)** Potential GDP growth = ~1.5%; **(ii)** Neutral real interest rate = 4.0%; **(iii)** Long-term inflation = 3.25%, GDP deflator = 4.0%; **(iv)** Compliance to the spending cap rule adjusted by inflation until 2030 **(v)** Structural reforms in 2023 to maintain the discretionary expenses close to 1.4% of GDP; **(vi)** Government will need to hire a lower number of public servants due to the digitalization of some public services**; (vii)** Pension reform will maintain the expenses almost stable in relation to GDP growth.

Fiscal Balance – An Increase In Interest Payments After 2022

- We revised our nominal Selic rate to 7.0% in 2022 (from 6.0% in the last scenario) (the neutral interest rate is now at 4.0% per year)
- This will contribute to increase the nominal deficit, specially after 2023.



Sources: National Treasury, BCB and Santander.

Fiscal Risks – Size Of The Fiscal Stimulus And Leftovers

- The total size of the War budget expenses totaled BRL524 bn. This year is currently at BRL95 billion and could reach ~BRL130 bn
- For 2021, the leftovers (not subjected to the spending cap rule) from 2020 War Budget reached BRL30.9 bn. A total of BRL7 billion of leftovers related to the BEm program was cancelled.

Expected 2021 – Extra-cap expenditure

Covid related expenditures - 2021	BRL billion
Emeregency Aid (*PEC Emergencial*)	45
Extension of the Aid until October (3 months)	20
Vaccine Acquisition (2020 Leftovers)	22
Health Expenditures	20
2020 War Budget Leftovers	13
Pronampe 2021 (credit support for SMEs)	5
BEm 2021 (formal job suport program)	10
TOTAL	**135**
Estimate of final execution in 2021 (85%)	**115**

Sources: National Treasury, Santander.

Tracking 2021 – Extra-cap fiscal expenditure

BRL Billion - Accumulated	Mar-21	Apr-21	May-21	Total Budgeted	Executed
Emergency Aid (MP 1.037/2021)	0.7	9.7	18.6	44.9	**21.7%**
Health expeditures	3.7	5.1	7.8	20.7	**24.9%**
BEm - Employment Program (MP 935/220 and MP 1.044/2021)	0.4	0.6	1.2	11.7	**5.4%**
Turism Infraestructure (MP 963/2020)	0.4	0.4	0.4	1.9	19.8%
Vaccine Acquisition (MP 1,015/2020)	3.5	4.6	5.2	22.3	20.7%
Accumulated Total	8.6	20.5	33.2	101.4	20.2%

Updated in 05/26/2021

Sources: National Treasury, Santander

Includes Leftovers of War Budget (*Restos a pagar*)

Possible Fiscal Measures that could be implemented and its impacts

Rolling Impact of some fiscal measures (% GDP)	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
Revenues										
Tax Reform (PEC 45) - Preliminary	**0**	**0.3**	**0.5**	**1.1**	**1.5**	**2.5**	**3.8**	**5.1**	**6.5**	**8.1**
Limit on tax deductions (private health)	0	0.1	0.2	0.3	0.4	0.5	0.6	0.6	0.7	0.7
10% linear drop in tax exemptions / waivers	0	0.3	0.6	0.9	1.1	1.3	1.5	1.7	1.8	2.0
Changes in Personal Income Tax (Aliquot of 35% on earnings > BRL25k per month)	0	0.1	0.1	0.2	0.2	0.3	0.3	0.4	0.4	0.4
Profits & Dividends (Aliquot of 15%)	0	0.3	0.6	0.9	1.1	1.4	1.6	1.8	2.0	2.1
End of JCP payment deduction ("Interest on Equity Capital")	0	0.1	0.2	0.3	0.4	0.5	0.5	0.6	0.7	0.7
Eletrobras Capitalization (one-off)	0	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Exclusive Funds (one-off)	0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Personal income tax exemption (BRL1,903 to BRL 2,500 per month)	0	-0.2	-0.4	-0.6	-0.8	-1.0	-1.2	-1.5	-1.7	-1.9
Expenditures										
Administrative Reform (Santander)	**0**	**0.0**	**0.1**	**0.1**	**0.2**	**0.3**	**0.4**	**0.5**	**0.6**	**0.7**
Min. Wage De-indexation (social benefits)	0	0.3	0.5	0.8	1.0	1.2	1.4	1.6	1.7	1.9
Freezing of social security benefits (above 3 Min. Wag)	0	0.0	0.1	0.1	0.2	0.2	0.2	0.2	0.3	0.3
End of Wage Bonus 'Abono' (for formal workers)	0	0.2	0.4	0.6	0.7	0.9	1.0	1.2	1.3	1.4
End of Wage Bonus 'Abono' (above 1 Min. Wage)	0	0.1	0.2	0.3	0.3	0.4	0.5	0.5	0.6	0.7
Payroll tax exemption	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Public sector wage ceiling	0	0.0	0.1	0.1	0.2	0.2	0.2	0.2	0.3	0.3
Extending grace period: unemployment insurance benefit	0	0.1	0.3	0.4	0.5	0.6	0.7	0.8	0.9	1.0
Reduction of public servants' working hours (up to 25%)	0	0.1	0.3	0.4	0.5	0.6	0.7	0.8	0.9	1.0

Source: Santander.

Tax reform estimate considers Borges (2020) impact on Potential GDP

Another possibility is the sale of public companies dependent on the National Treasury, which could generate extra BRL10 billion (one-off) in revenues, in addition to reducing expenses to maintain them.

The measures developments that would shape the outlook

- Beyond the question of vaccination, we believe certain measures and reforms are necessary to support the reduction of idiosyncratic risks. The fiscal agenda contains significant risks in its execution, in our view, so uncertainty will remain.

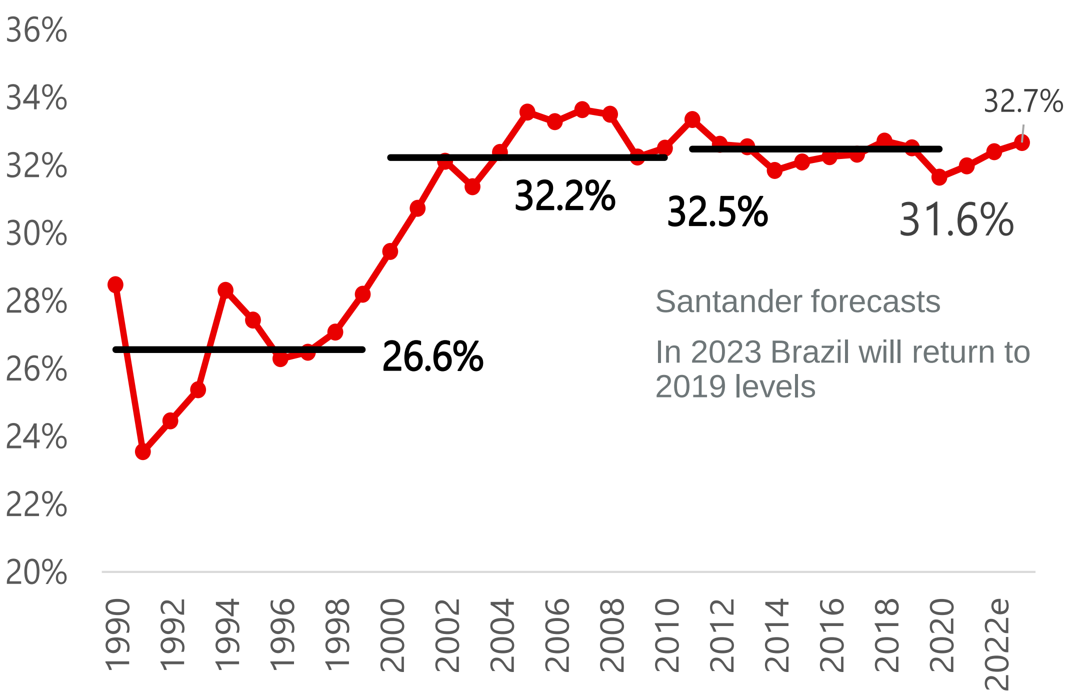
Positive Measures That Could Be Implemented	Potential Setbacks
2021 Budget law execution maintaining the current fiscal framework (spending cap)	Possible creation of new mandatory expenses or removing from the spending cap limit
Broad Tax reform, or CBS Law (Contribution on Goods and Services) with a single tax (original law sent by the government)	Permanent increases in the tax burden or increasing personal income tax exemption without compensation
Administrative reform (approving the career and salary regulations)	Approval of a new digital tax (CPMF)
Advances in the relevant privatizations and closing and selling Treasury dependent companies	Approval of federal measures that imply leniency or moral hazard with subnational fiscal adjustments
The continuity of the modernization of regulatory frameworks for infrastructure	Allocation of revenue not linked to public funds for other primary expenditures
A competitive auction for 5G for attracting investors	Paralysis of the reform agenda impacted by political disputes
Better pandemic management (more vaccines)	Salary increases for public servants
Reduction on Tax exemption (4% of GDP)	Reduction in net revenue or greater transfers to states and municipalities

Source: Santander.

Difficulty in fiscal adjustment - expenses or revenues?

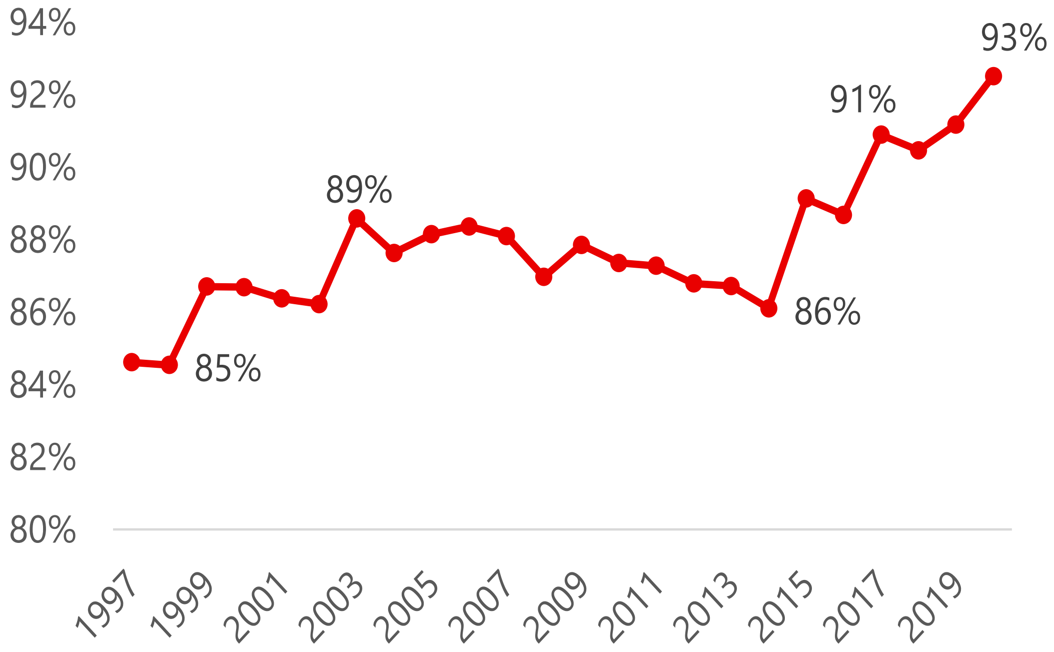
- There is a limit to increase taxes and to reduce the discretionary expenses.

Tax Burden (% GDP) – Is it possible to raise taxes?



Sources: IBRE, National Treasury, BCB and Santander.

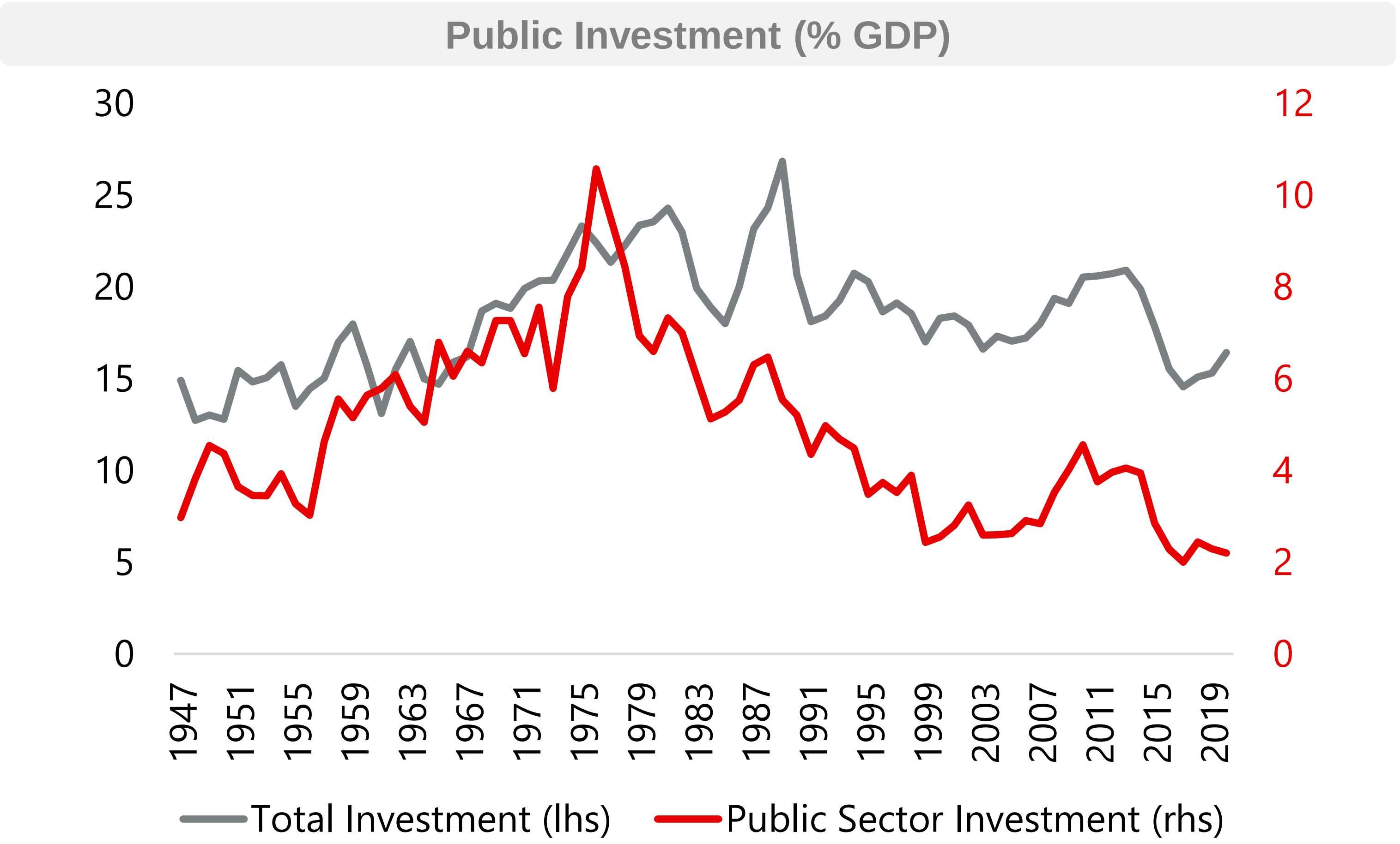
Mandatory Outlays / Total Expenses



Before 2008 there is no classification of discretionary expenses, we maintained the historical pattern among the expenses with flow control

Public Investment at low levels

- Part of the recent fiscal adjustment was made by a reduction on discretionary expenditures, mainly public investments.



Sources: IBRE, National Treasury, BCB and Santander.

Public Debt scenario and simulations

04

Fiscal Accounts: Trajectories for the Brazilian Government Debt

- Public sector's primary balance (% GDP) required for the stabilization of the gross public debt-to-GDP ratio at **95%**
- The increase in the neutral interest rate hypothesis to 4.0% (from 3.0%) will increase the primary surplus required to stabilize the debt.
- . Discounting the effects of the cyclical recovery, the long-term outlook will require a remaining 3.5% of GDP primary fiscal adjustment, just to stabilize the ratio debt-to-GDP around the higher post-pandemic level of 95%.

Current cycle:

. Real interest rate (ex-ante): +0.5%,
. GDP is expected to grow 4.8% in 2021.

. Expected primary deficit (-1.9% of GDP) + BNDES payback should maintain the Gross/Debt virtually stable.

Steady-state:

According to our hypothesis:
. Real interest rate at +4.0%
. Potential GDP at +1.5%,

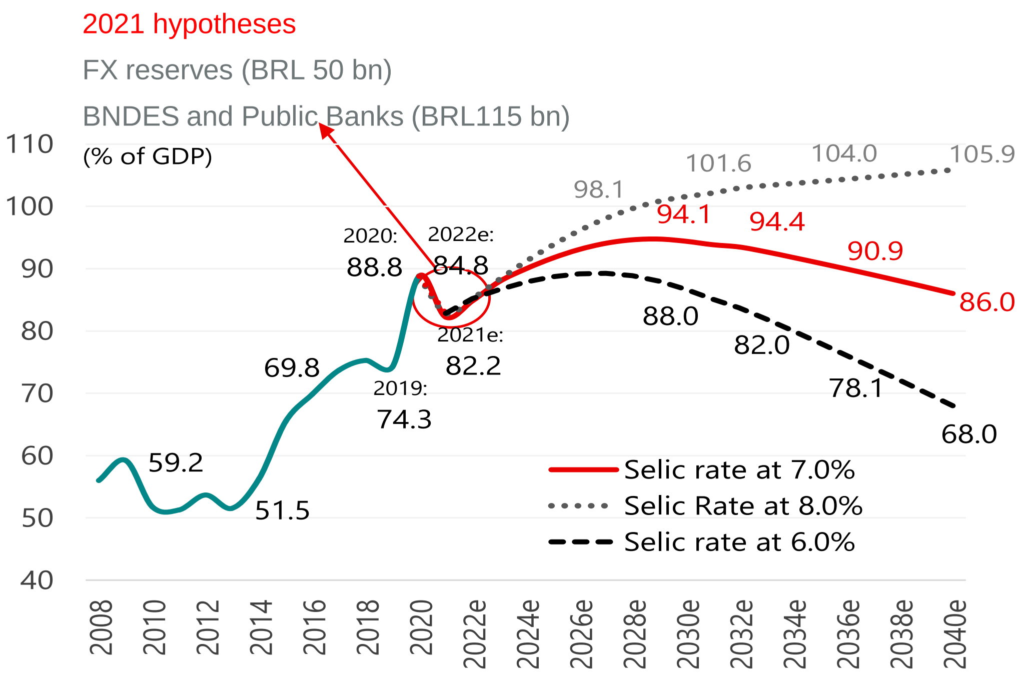
. The primary surplus must reach ~2.0% of GDP to maintain the gross debt stable.

		Real Interest Rate							
		-1.0%	0.0%	1.0%	2.0%	2.5%	3.0%	4.0%	5.0%
GDP Growth	1.0%	-1.8	-0.9	0.0	0.9	1.3	1.8	2.7	3.6
	1.5%	-2.2	-1.3	-0.4	0.4	0.9	1.3	**2.2**	3.1
	2.0%	-2.6	-1.8	-0.9	0.0	0.4	0.9	**1.8**	2.6
	2.5%	-3.1	-2.2	-1.3	-0.4	0.0	0.4	1.3	2.2
	3.0%	-3.5	-2.6	-1.7	-0.9	-0.4	0.0	0.9	1.7
	3.5%	-3.9	-3.0	-2.2	-1.3	-0.9	-0.4	0.4	1.3

Sources: BCB, Santander.

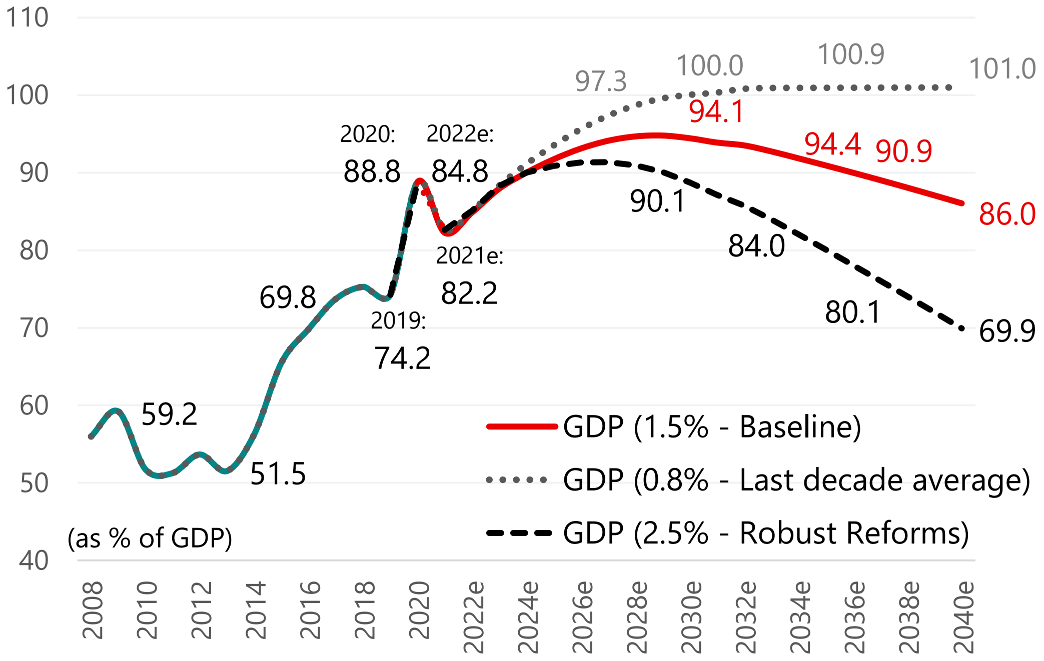
Debt Scenarios: sensitivity to small changes in the long run macro-outlook

Government Debt – Simulations for Selic Rate Hypotheses



Sources: BCB, Santander

Government Debt– Simulating for Trend GDP Hypotheses



Sources: BCB, Santander.

Notes: Debt issuances: we added a spread of + 1.0 pp in addition to the Selic rate in the models.

PEC Emergencial: Funds (+BRL150 billion for liquidity cushion in 2021)

2021 GDP Deflator: 10% – Inflation shock

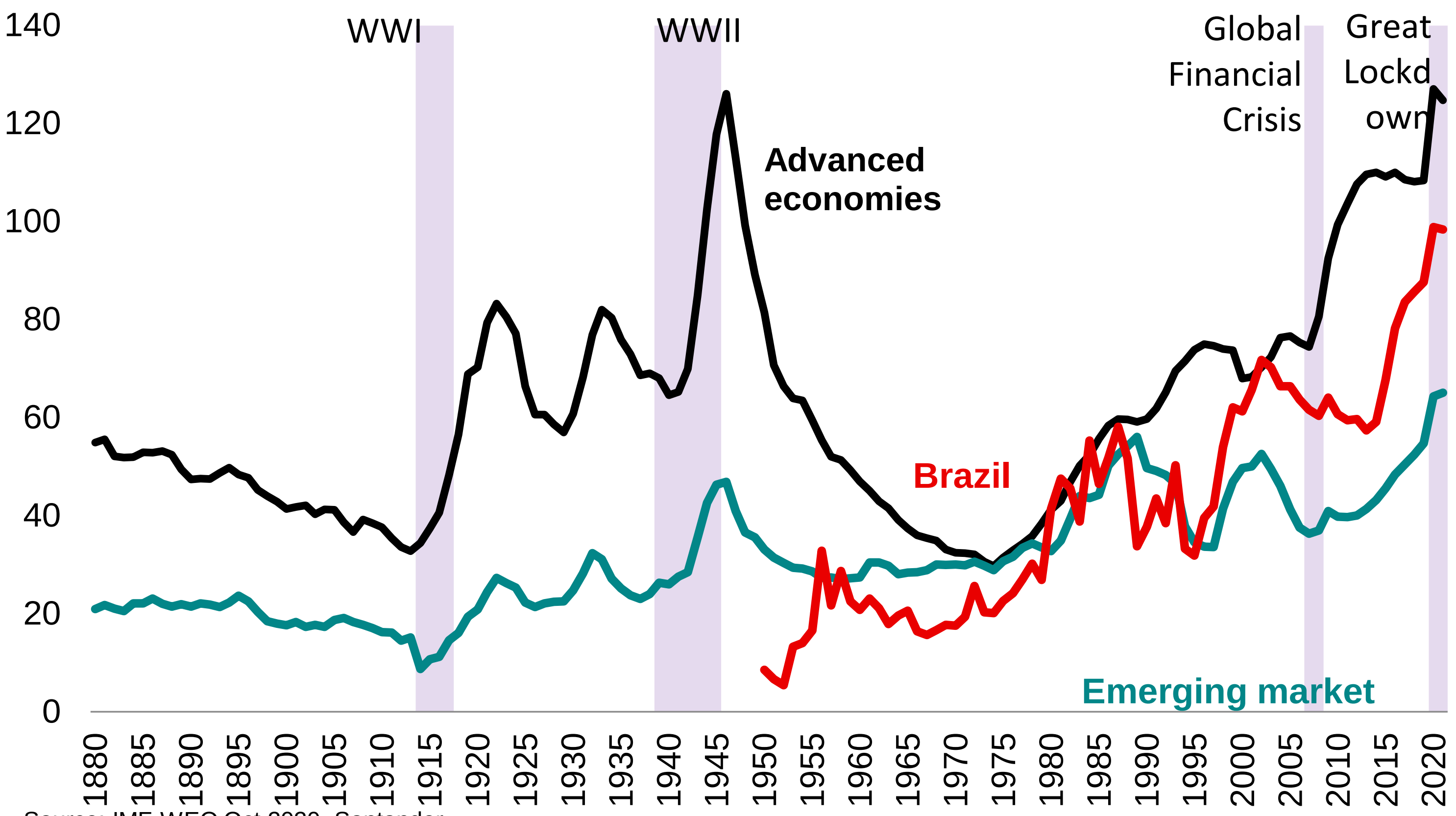
2022 hypotheses: FX reserves (BRL50 bn) + BNDES and Public Banks (BRL70 bn)

2023-40: we changed the average GDP deflator to 4.0% (from 3.3%), which is Inflation target + 0.8% (average difference of the last decade between IPCA and GDP deflator)

Brazilian gross debt approaches the level of advanced countries – International Comparison

- Brazilian government finances registered an unprecedented deterioration in 2020, affected by the government's measures to mitigate the economic and health effects of the pandemic.

Historical Patterns of General Government Debt (% GDP)

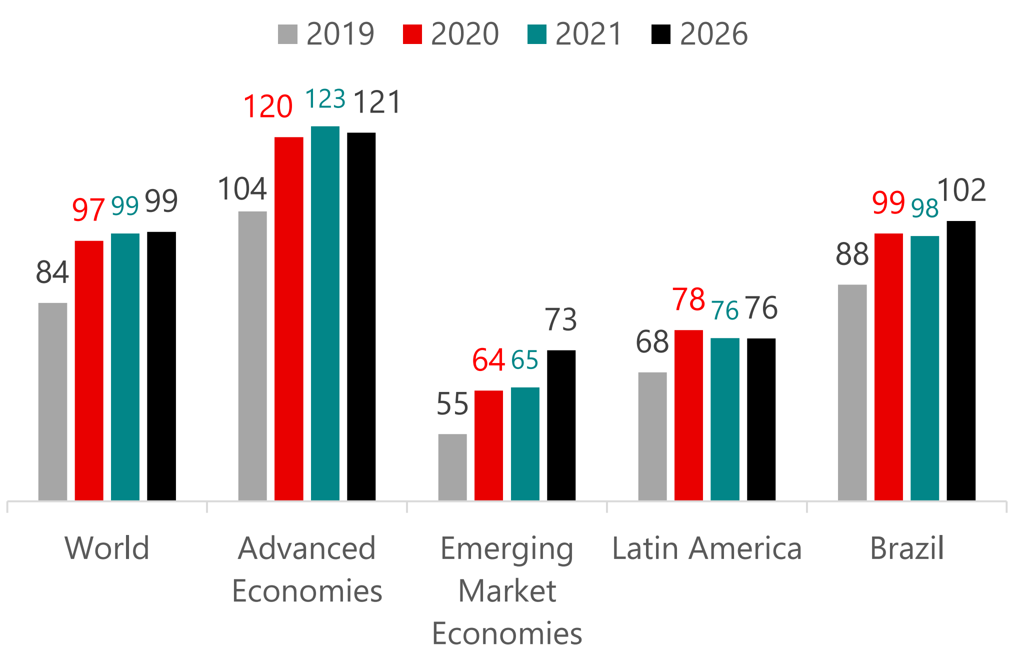


Source: IMF WEO Oct 2020, Santander
*Brazil we used th e IMF metodology

Fiscal Monitor – IMF Scenario

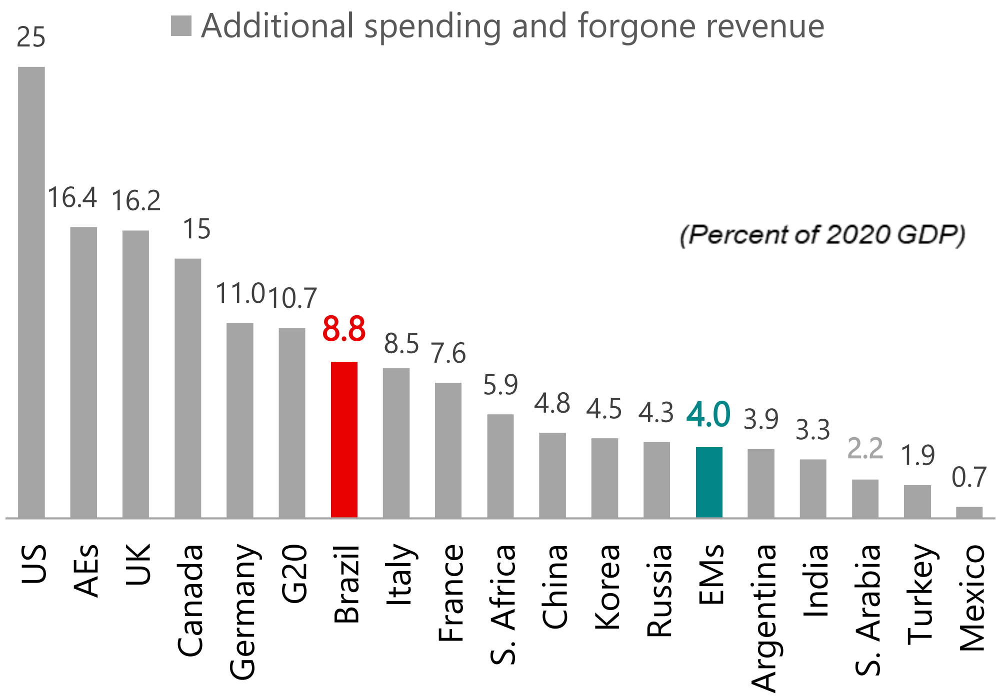
- According to data from both 2020 and 2021, Brazil's fiscal stimulus reached 8.8% of GDP, higher than the 4.0% of GDP for the average of emerging economies (EM).
- In short, the fiscal outlook presented by the IMF is close to our fiscal scenario and reinforces the importance of both measures and reforms to guarantee the credibility of the fiscal consolidation.

IMF Gross Debt Forecasts (% GDP)



Sources: IMF, Santander.

Fiscal Stimulus in 2020-21



Sources: IMF, Santander.

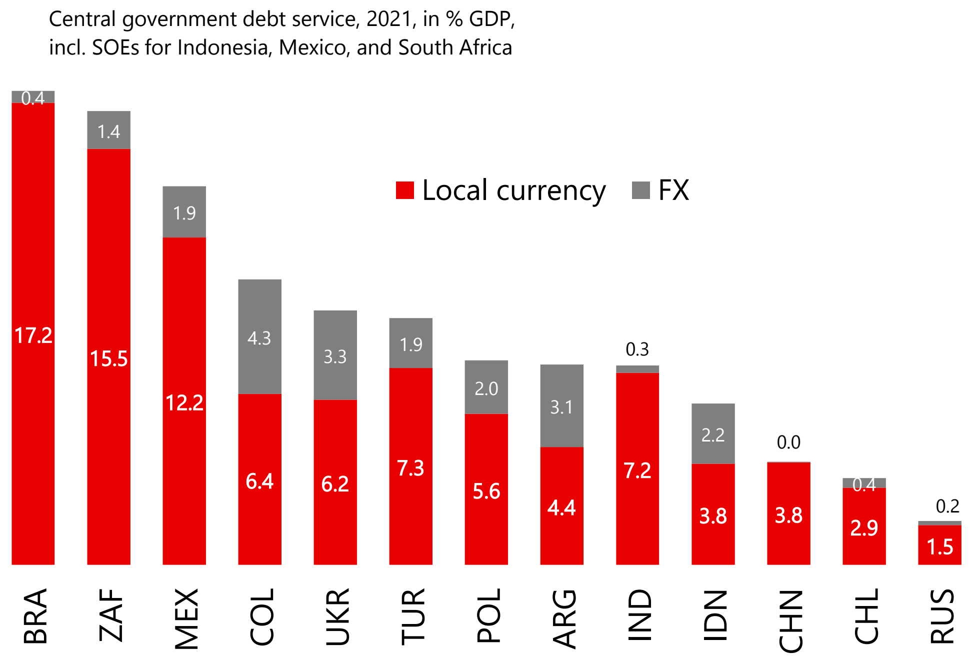
Debt Management

05

Fiscal Risks – elevated financial needs

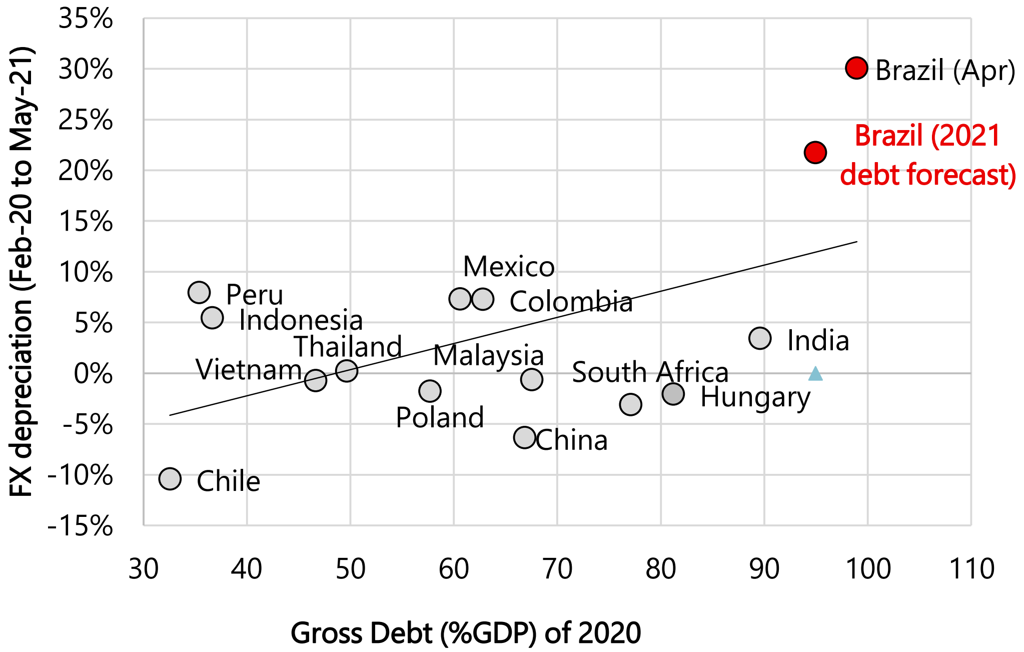
- Brazil has one of the largest gross debts among emerging countries and has significant financing needs.

Financing needs in 2021 – (% GDP)



Sources: IIF, Santander.

Higher Debt and the effect on FX rates



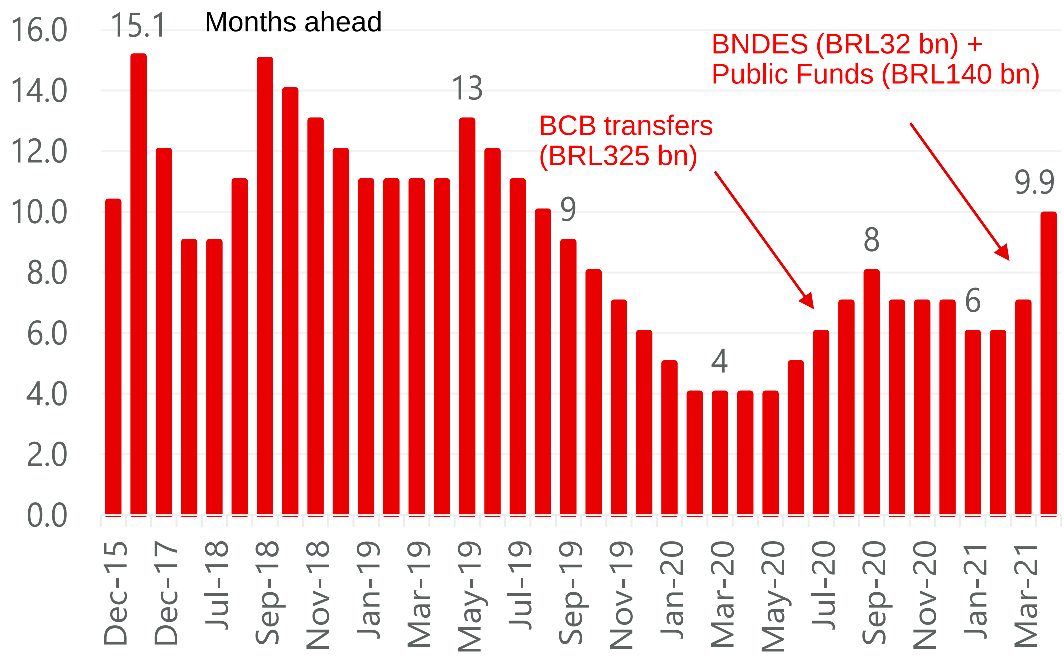
Sources: Bloomberg, Santander

Jonathan and Sergi (2021)
IIF: Economic Views – EM Public Financing Needs (Feb 02, 2021)

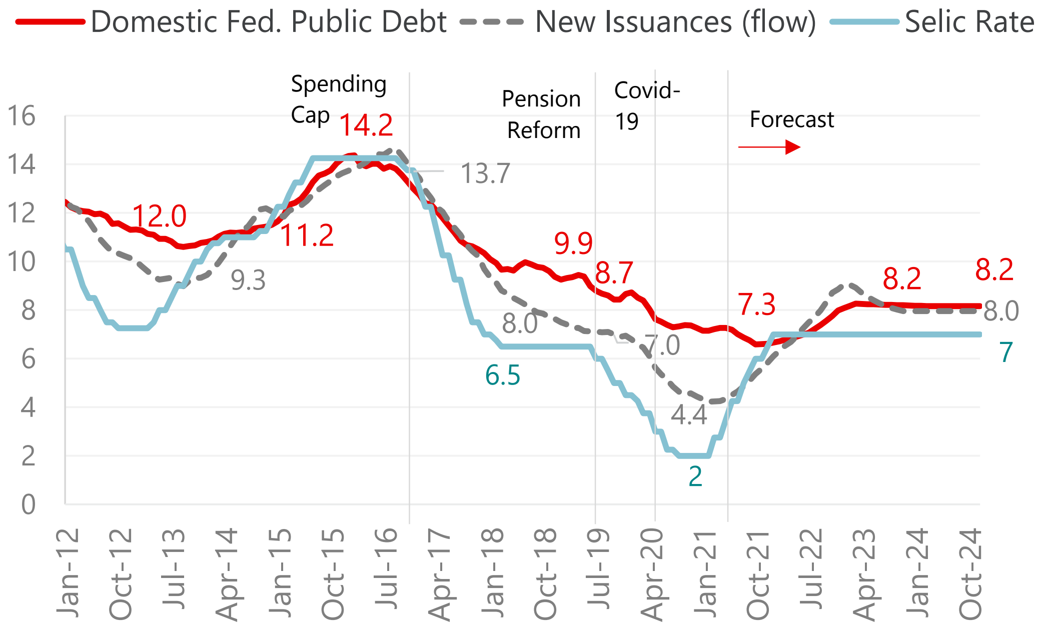
Treasury's cash position improved in the last few months with larger auctions

- With debt shortening it is important to keep the level of the liquidity cushion at comfortable levels..

Liquidity cushion coverage of domestic debt



Average cost of Federal Debt - 12 months – (%)



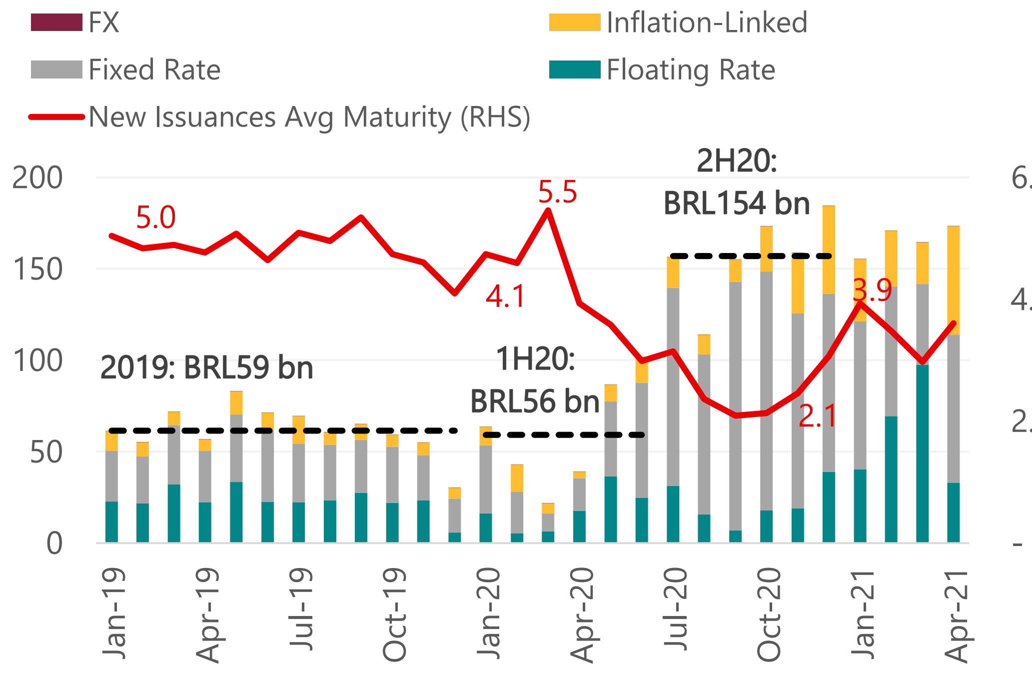
Sources: National Treasury, Santander.

Sources: National Treasury, Santander.

Fiscal – the increase in Selic rate will pressure the debt issuances

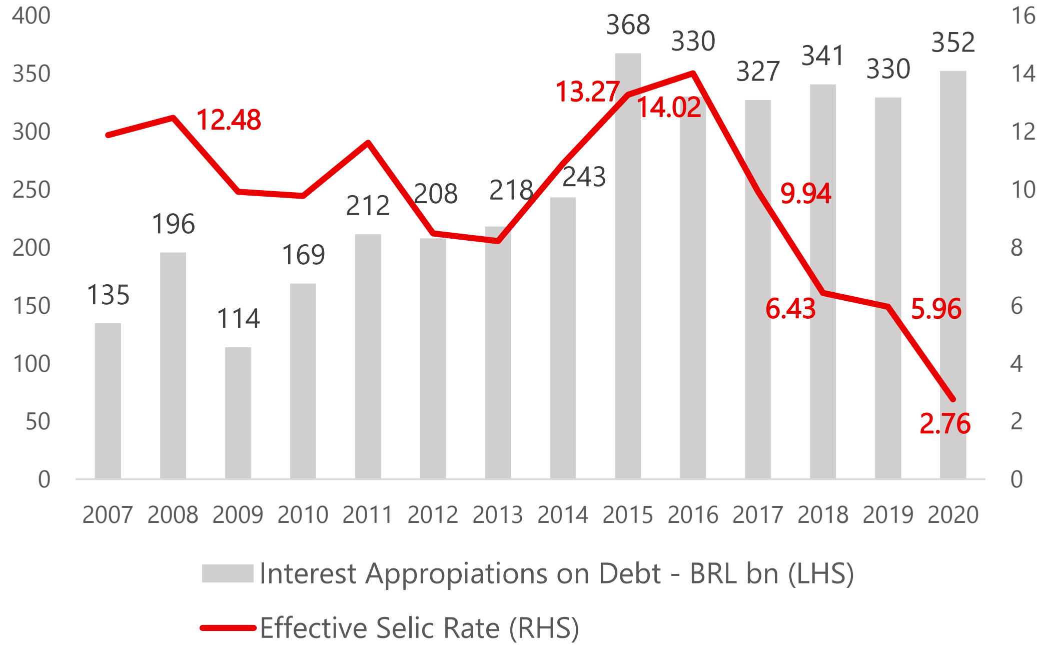
- Market conditions will be important for new debt issuances. The necessity of issuances in 2021 is ~BRL30 billion per week.

Treasury Issuances



Sources: National Treasury, Santander

Selic Rate and Debt

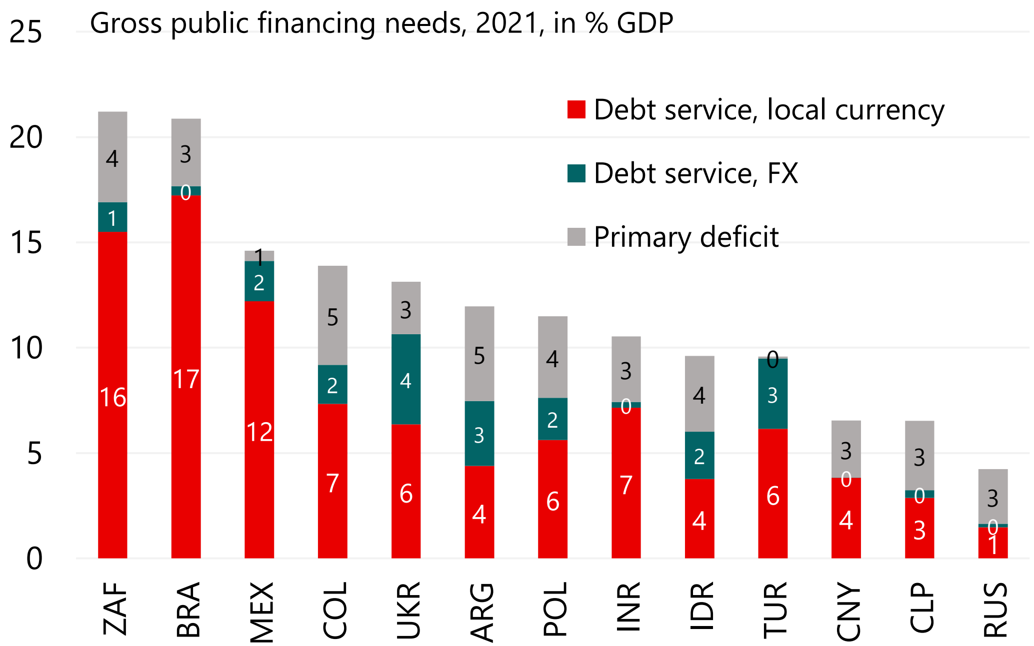


Sources: BCB, National Treasury, Santander.

Financing needs have risen and probably the EM countries will increase rates

- Fiscal deficits in emerging markets swelled last year.
- Brazil and South Africa are the most vulnerable on all fronts, and need large cuts by the standards of past fiscal adjustments.

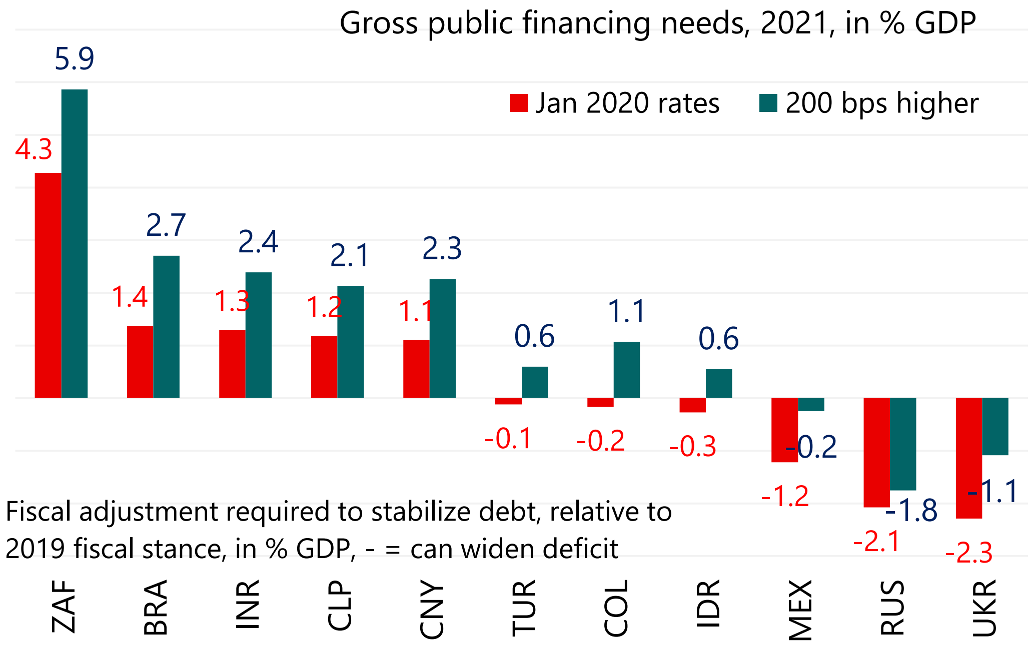
Gross financing needs have risen



Sources: IIF, Santander.

Jonathan and Sergi (2021)
IIF: Economic Views – EM Fiscal Vulnerability (Mar 09, 2021)

Higher rates would wipe out fiscal space



Sources: IIF, Santander

Jonathan and Sergi (2021)
IIF: Economic Views – EM Fiscal Vulnerability (Mar 09, 2021)

Supreme Court decision on tax methodology: a middle ground

06

Supreme Court decision on tax methodology: a middle ground

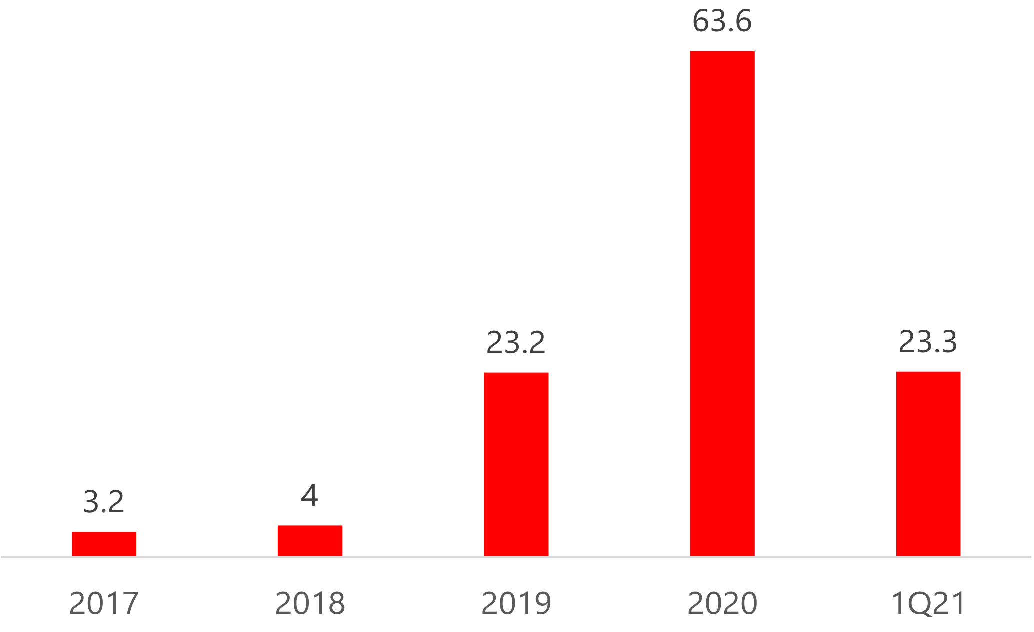
1. We published a report (on May 20) that explores the possible fiscal impact of the change in methodology for calculating tax collection following a decision by the Supreme Court (STF).
2. On May 13, the STF concluded its deliberations on the exclusion of ICMS state tax from the calculation basis for the PIS/Cofins federal taxes.
3. **The Court's decision does not lead us to modify our fiscal outlook and revenue forecasts.** The government also will maintain its fiscal numbers, as its latest estimates already consider this decision's subsequent effect on the revenue stream.
4. Our preliminary estimate for the net fiscal impact from the tax methodology change for the federal government is close to BRL180 billion. As we already considerer BRL120 billion over the next years, the STF's decision could potentially lead to a further government revenue reduction of BRL60 billion in our scenario (yet it would be diluted over the years).
5. We further anticipate that this change in tax calculation methodology will reduce revenue flow by ~0.5% of GDP per year. If in the future the decision is expanded to include municipal taxes on services (ISS), tax compensation since 2017 could reach a maximum value of BRL30 billion, with a loss in the revenue flow of 0.1% of GDP per year.

To access the full report: **Santander Brazil – Fiscal Policy: *"Supreme Court Decision on Tax Methodology: A Middle Ground"*** – May 20, 2021- Available on: http://bit.ly/Std-special-icms

Supreme Court decision on tax methodology: a middle ground

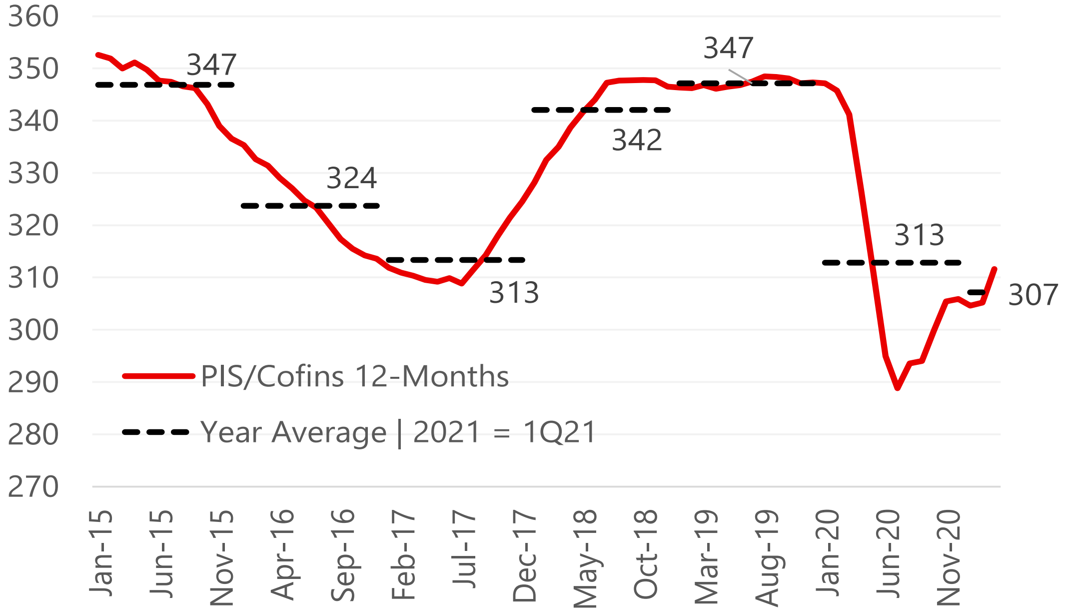
- The STF decision in 2017, it has already generated a greater use of tax credits based on the initial decision. However, its use intensified after 2020, many companies managed to use these claims for lawsuits. This can be seen in the Figure below, and according to the PGFN, more than 92% of these decisions refer to the case of ICMS in the PIS/Cofins calculation base. It is worth mentioning that for any estimate of the fiscal impact, these tax credits already used must be disregarded.

Tax Credit by Judicial Claims – BRL billion



Sources: Receita Federal, MCM , Santander.

Federal Tax Collection PIS/Cofins – 12-months in real terms – BRL billion

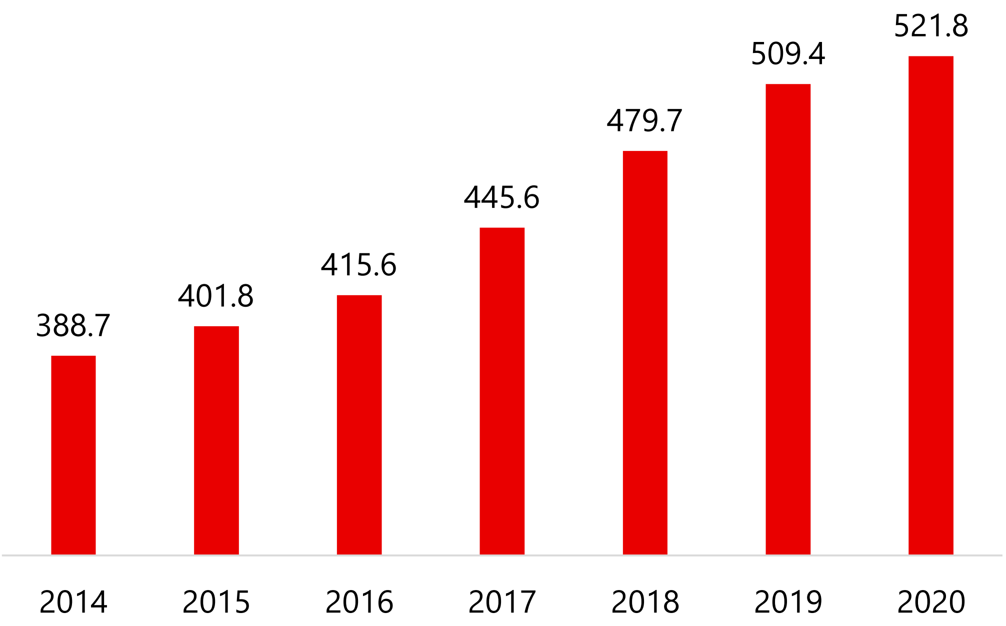


Sources: Receita Federal, MCM , Santander.

Supreme Court decision on tax methodology: a middle ground

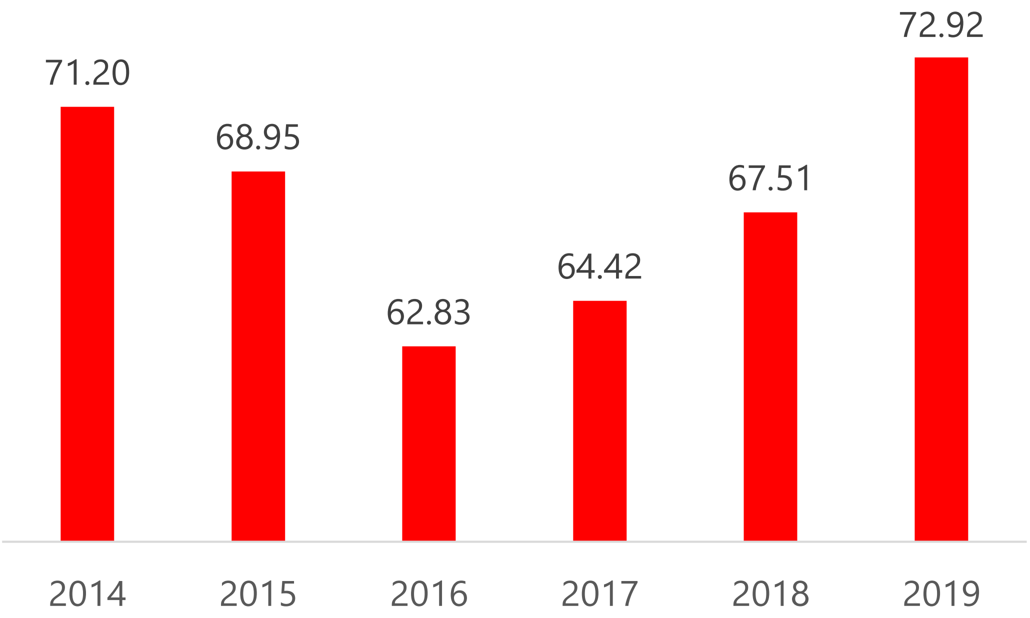
- We can see that the collection amounted to values above half a trillion BRL per year, possibly a good part is included in the PIS/Cofins calculation base.
- if in the future, it is possible to extended the decision over the tax methodology to municipal taxes on services (ISS) based on the same thesis over the ICMS decision.

Total ICMS states tax collection - BRL billion



Sources: Receita Federal, MCM , Santander.

Total Municipal Taxes on Services (ISS) – BRL billion

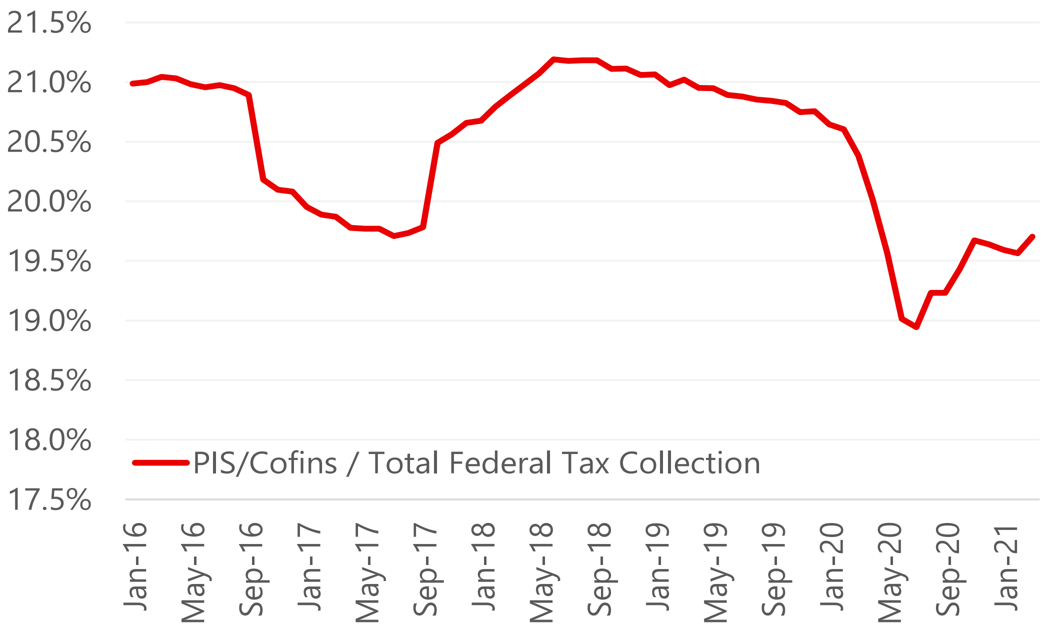


Sources: Receita Federal, MCM , Santander.

Supreme Court decision on tax methodology: a middle ground

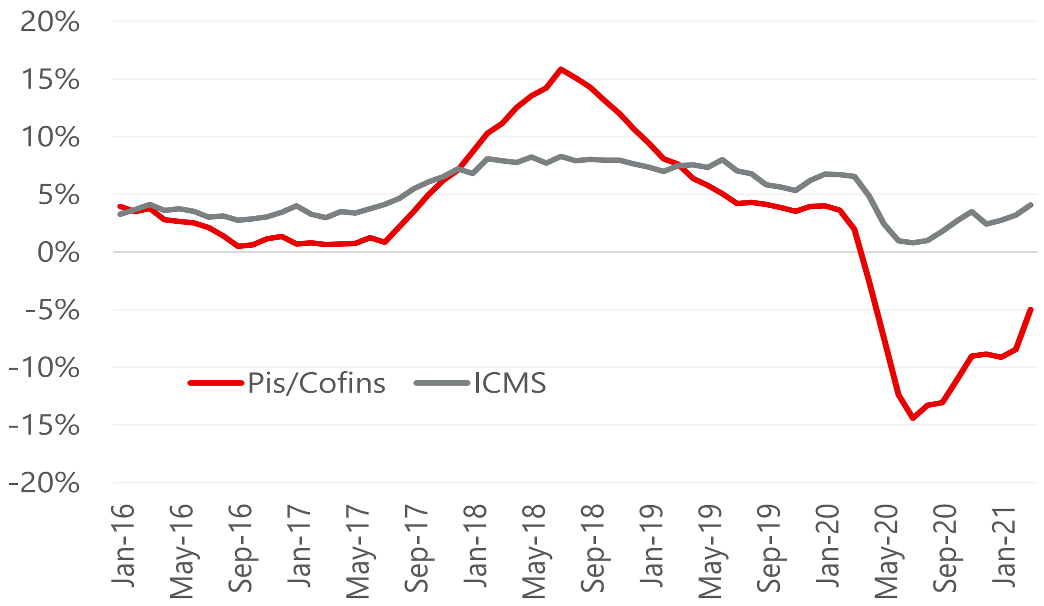
- We can see that the collection amounted to values above half a trillion BRL per year, possibly a good part is included in the PIS/Cofins calculation base.
- 2017

% of PIS/Cofins in Federal Tax Collection



Sources: Receita Federal, MCM , Santander.

Federal Tax Collection PIS/Cofins – 12-months in real terms – BRL billion



Sources: Receita Federal, MCM , Santander.

Taxes Added Along the Productive Chain

	Industry	Wholesaler	Retailer
Operation Value	BRL100	BRL160	BRL210
ICMS state rate	10%	10%	10%
ICMS highlighted in the invoice	BRL10.0	BRL16.0	BRL21.0
ICMS to be offset	-	BRL10.0	BRL16.0
ICMS to be collected / paid	BRL10.0	BRL6.0	BRL5.0
PIS / Cofins calculation basis *(ICMS highlighted in the invoice)*	BRL90	BRL144	BRL189
PIS / Cofins calculation basis *(ICMS to be collected / paid)*	BRL90	BRL154	BRL205

Sources: PGFN and Santander

ICMS highlighted in the invoice
BRL47.0

ICMS to be collected / paid
BRL21.0

The decision to limit the effects of the exclusion of ICMS from the calculation of PIS/Cofins as of 2017 was positive from a fiscal point of view (even more due to the monetary correction with the higher Selic before 2017), yet this change for full ICMS was detrimental and increases the potential fiscal impact.

For collection purposes, the "collected" tax is considered simpler to measure than the one on the invoice, given the complexity of the system. This final decision favored companies that received higher tax credits to receive

Thank you.

Our purpose is to help people and businesses prosper.

Our culture is based on believing that everything we do should be:

Simple Personal Fair

Santander

Brazil Macroeconomic Research Team

Ana Paula Vescovi
Chief Economist
anavescovi@santander.com.br
+55 (11) 3553-8567

Mauricio Oreng
Head of Research & Strategy
mauricio.oreng@santander.com.br
+55 (11) 3553-5404

Jankiel Santos
Economist – External Sector
jankiel.santos@santander.com.br
+55 (11) 3012-5726

Ítalo Franca
Economist – Fiscal Policy
italo.franca@santander.com.br
+55 (11) 3553-5235

Tomas Urani
Economist – Global Economics
tomas.urani@santander.com.br
+55 (11) 3553-9520

Daniel Karp Vasquez
Economist - Inflation
daniel.karp@santander.com.br
+55 (11) 3553-9828

Lucas Maynard
Economist – Economic Activity
lucas.maynard.da.silva@santander.com.br
+55 (11) 3553-7495

Felipe Kotinda
Economist – Credit and Commmodities
felipe.kotinda@santander.com.br
+55 (11) 3553-8071

Gilmar Lima
Economist – Modeling
gilmar.lima@santander.com.br
+55 (11) 3553-6327

Gabriel Couto
Economist – Special Projects
gabriel.couto@santander.com.br
+55 (11) 3553-8487

Raissa Freitas
Business Manager
raifreitas@santander.com.br
+55 (11) 3553-7424

IMPORTANT DISCLOSURES

This report has been prepared by Santander Investment Securities Inc. ("SIS"; SIS is a subsidiary of Santander Holdings USA, Inc. which is wholly owned by Banco Santander, S.A. "Santander"), on behalf of itself and its affiliates (collectively, Grupo Santander) and is provided for information purposes only. This document must not be considered as an offer to sell or a solicitation of an offer to buy any relevant securities (i.e., securities mentioned herein or of the same issuer and/or options, warrants, or rights with respect to or interests in any such securities). Any decision by the recipient to buy or to sell should be based on publicly available information on the related security and, where appropriate, should take into account the content of the related prospectus filed with and available from the entity governing the related market and the company issuing the security. This report is issued in Spain by Santander Investment Bolsa, Sociedad de Valores, S.A. (“Santander Investment Bolsa”), and in the United Kingdom by Banco Santander, S.A., London Branch. Santander London is authorized by the Bank of Spain. This report is not being issued to private customers. SIS, Santander London and Santander Investment Bolsa are members of Grupo Santander.

ANALYST CERTIFICATION: The following analysts hereby certify that their views about the companies and their securities discussed in this report are accurately expressed, that their recommendations reflect solely and exclusively their personal opinions, and that such opinions were prepared in an independent and autonomous manner, including as regards the institution to which they are linked, and that they have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report, since their compensation and the compensation system applying to Grupo Santander and any of its affiliates is not pegged to the pricing of any of the securities issued by the companies evaluated in the report, or to the income arising from the businesses and financial transactions carried out by Grupo Santander and any of its affiliates: **Ítalo Franca*.**

*Employed by a non-US affiliate of Santander Investment Securities Inc. and not registered/qualified as a research analyst under FINRA rules, and is not an associated person of the member firm, and, therefore, may not be subject to the FINRA Rule 2242 and Incorporated NYSE Rule 472 restrictions on communications with a subject company, public appearances, and trading securities held by a research analyst account.

The information contained herein has been compiled from sources believed to be reliable, but, although all reasonable care has been taken to ensure that the information contained herein is not untrue or misleading, we make no representation that it is accurate or complete and it should not be relied upon as such. All opinions and estimates included herein constitute our judgment as at the date of this report and are subject to change without notice.

Any U.S. recipient of this report (other than a registered broker-dealer or a bank acting in a broker-dealer capacity) that would like to effect any transaction in any security discussed herein should contact and place orders in the United States with SIS, which, without in any way limiting the foregoing, accepts responsibility (solely for purposes of and within the meaning of Rule 15a-6 under the U.S. Securities Exchange Act of 1934) for this report and its dissemination in the United States.