Brazil Macro | April 2023

FISCAL POLICY

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Brief Overview

01

Fiscal Consolidation: In Search for a Primary Balance

- The blueprint for the new fiscal framework was unveiled recently. For now, it does not significantly change our scenario, as we see challenges for its full implementation. A permanent rise in tax burden would add a positive bias to our estimates. For this year, we lowered our consolidated primary deficit estimate to 1.2% of GDP (previously: 1.4%), with higher revenue related to labor market performance and still-high commodity prices.

- In the short term, we continue to see the effects of favorable winds (especially due to still-high commodity prices and the labor market recovery) on the revenue side, although with some signs of losing steam at the margin. We believe that the maintenance of revenue positive performance will be crucial for buying some time for a gradual fiscal adjustment. It would be important to monitor the fading of temporary shocks that contributed positively to the last years, such as strong oil proceeds and robust collection of taxes on corporate profits.

- We have increased the total disbursement estimate for the welfare program (Bolsa Família) by BRL15 billion, to BRL165 billion. On the fiscal rule, we expect stability in expenditures as percentage of GDP at 19-20%, with a fiscal adjustment on the revenue side to gradually reduce the primary deficit. Moreover, we continue to foresee a deterioration in the nominal budget results, also due to heavier debt costs. We have cut our 2023 gross debt/GDP forecast to 77.4% (from 78.2%). For the longer term, however, we continue to see a risky path toward debt stabilization, in a context of elevated pressure on social spending and the natural difficulties in raising taxes. Though high commodity prices could temporally offset the increase in outlays, the high level of mandatory expenses remains a problem that needs to be urgently addressed, in our view.

Fiscal Consolidation: In Search for a Primary Balance

Short Term: Higher Revenues with + Inertia

- **2023 Primary Balance**: marginal improvement
  -BRL120 bn (-1.2% GDP) | Feb (e): - BRL140 bn (-1.4% of GDP)
  Central Gov.: -BRL125 bn (-1.2% GDP) | -BRL20 bn from Feb
  Regional Gov.: +BRL5 bn (0.1% GDP) | No change
- **Revenues:** more uncertainty after positive results in 2021-22. Some softening in growth is expected. Highly correlated to the commodity prices
- **Gross Debt/GDP:** ended in 72.9% in 22 | **77.4%** in **23**
  We reduced the GDP Deflator estimate from 3.9% to 3.5%, considering lower IGP-M average in the year (1.1%).
  Lower level of liquidity cushion (~7-8 months)
- **Fiscal rules: key issue in the short-term**
  Guidelines not biding to our scenario. Need to observe the parameters. Could maintain the expenditures around 19% of GDP
- **Welfare Program increase to BRL165 bn**
  We rose our estimate in BRL15 bn with the new benefits to teenagers and higher number of beneficiaries

Medium Term: Bumpy Road Ahead

- **Risks: Additional Fiscal + Quasi-Fiscal Stimulus**
  In a scenario with a positive output gap. Gradual and limited quasi-stimulus.
- **Unpaid Debt – Judicial Claims**
  We see R$55 bn unpaid by 2023 (not in Fiscal statistics)
- **Higher Nominal Deficit (Selic)**
  Nominal Deficit : close 8.0% of GDP
- **Fiscal adjustment: ~3.0% of GDP**
  In a context of elevated pressure for social spending and natural difficulties to raise taxes
- **Debt-path: on the edge for convergence**
  ~94% of GDP in 2040. Sensitivity with macro structural variables (such as Potential GDP, Neutral Rates, Deflator)
- **Risks for debt convergence**
  Long-term: Neutral interest rate above 5.0%, Potential GDP below 1.5%. Total Expenditures above 19% of GDP.

Fiscal : Higher revenues in the short-term, cyclical effects ahead will be on the spotlight

Central Gov. Primary Result

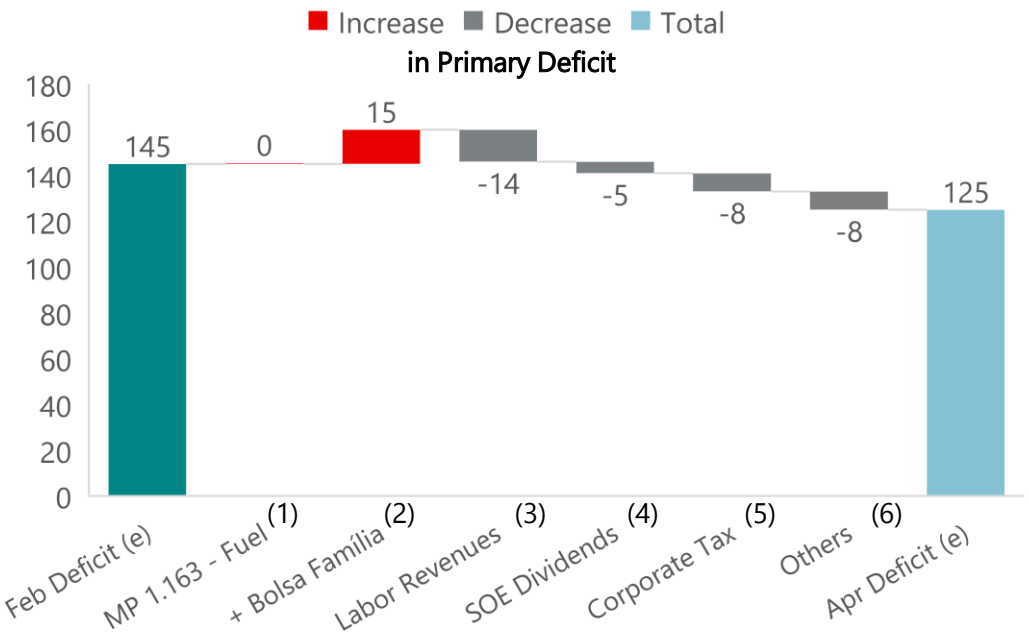
2023 - BRL billion	1st Budget Review (a)	% GDP	Santander (b)	% GDP	Δ (b) - (a)
Total Revenue	**2,376**	**22.2%**	**2,365**	**22.9%**	-10.7
Collected by the Brazilian IRS	1,474	13.8%	1,451	14.0%	-23.1
Net Social Security Revenues	598	5.6%	590	5.7%	-7.1
Not Collected by the IRS	304	2.8%	323	3.1%	19.5
Transfers by Revenue Sharing	460	4.3%	472	4.6%	11.9
Net Revenue	**1,916**	**17.9%**	**1,893**	**18.3%**	-22.6
Total Expenditure	**2,023**	**18.9%**	**2,018**	**19.5%**	-5.5
Social Security Benefits	859	8.0%	870	8.4%	11.5
Payroll - Public Servants	365	3.4%	363	3.5%	-2.1
Other Mandatory Expenses	283	2.6%	290	2.8%	7.7
Mandatory with Cash Control	323	3.0%	324	3.1%	1.2
Discretionary Expenses	194	1.8%	170	1.6%	-23.9
Central Gov. Budget Gap	-107.6	-1.0%	-124.6	-1.2%	-17.0
Nominal GDP	10,712		10,344		

Sources: Finance Ministry, Santander.

The 2023 budget (LOA) estimate was BRL231 billion (2.2% of GDP) deficit for 2023.
GDP Estimate: Budget Review 1.6%, Santander: 0.8%
A rise in public servant`s wage of 9%. Bolsa Família outlays should be BRL165 bn. We see the budget leftovers in BRL25 billion.
We see as more likely the deficit between 1.4%-1.0% of GDP and a permanent increase in tax burden can reduce this value.

Santander

Public Sector – Primary Deficit Estimate

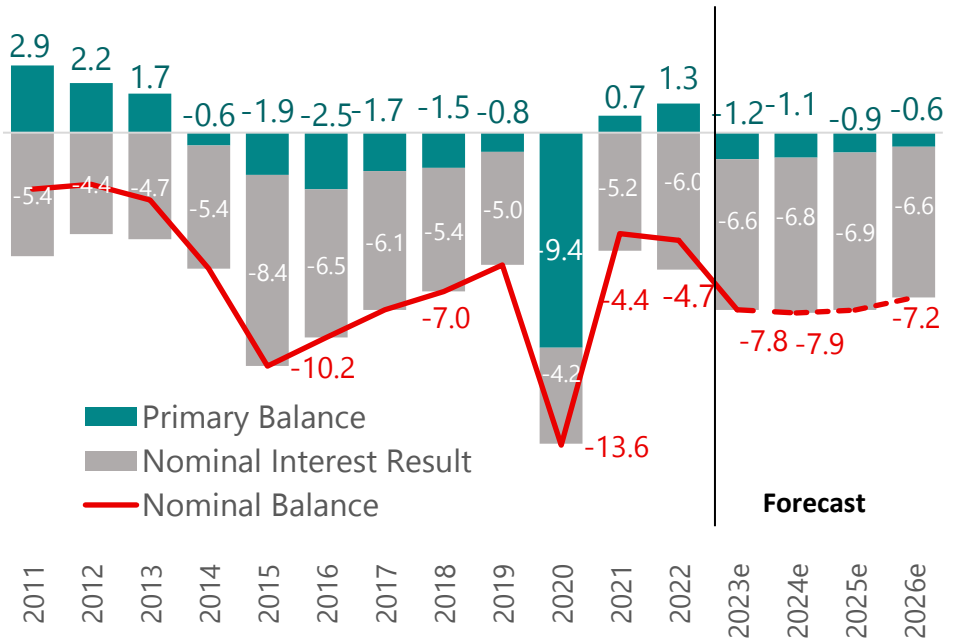


(1) Fuel tax return + Export Tax = BRL27 bn (already in our Scenario)
(2) Welfare Program: BRL165 bn (+BRL15 bn, more families and extra-benefit)
(3) Real Wage Bill increase + more inertia (BRL10 bn)
(4) Surprise in 1Q23 oil dividends (+BRL5 bn). Total of BRL37 bn
(5) Additional surprise in YTD result
(6) Reestimate of revenues considering the YTD results (+ inertia)
Extra: We included the personal income tax break - IRPF (limited to 2 min wage) =BRL6 bn, fully compensated by an increase in tax (probably on online bets)

Fiscal Policy: A higher interest burden to weigh on the debt dynamics

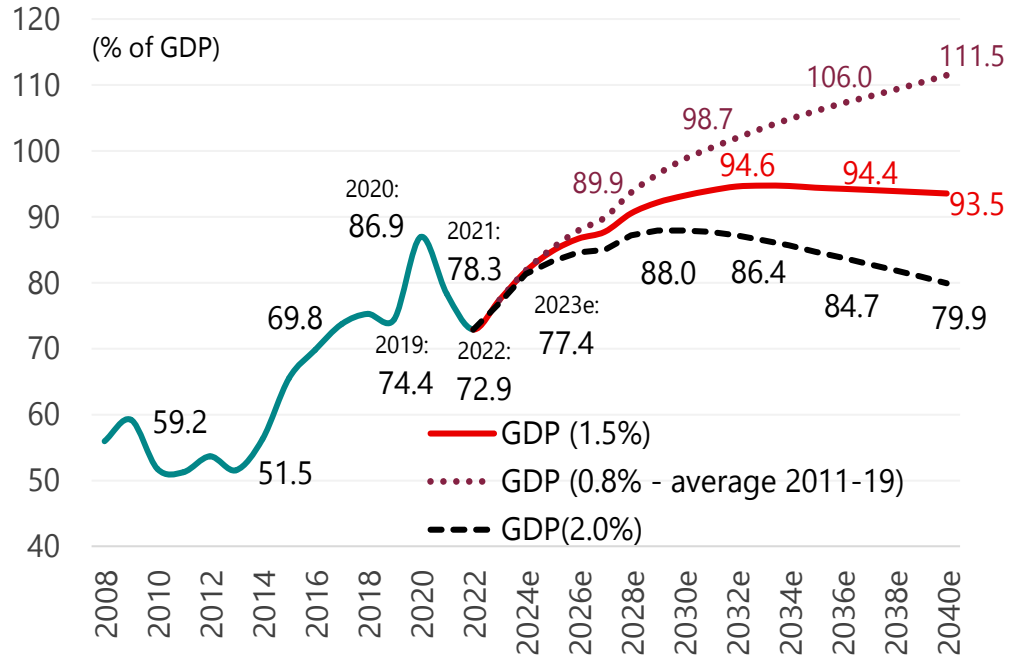
- Interest payments should continue to rise (Selic increase) with the nominal result showing strong deterioration, remaining close to 8.0% of GDP in the coming years. We reduced a tad the interest payment due to the lower issuance of National Treasury, using part of the liquidity reserves.
- We simulated scenarios for the debt trajectory: the main debate will be on the structural macroeconomic variables (GDP, Neutral Interest Rate and GDP Deflator).

Public Sector's Financing Needs (% GDP)



Sources: BCB, Santander.

Scenarios - Gross Debt Scenario (% GDP)



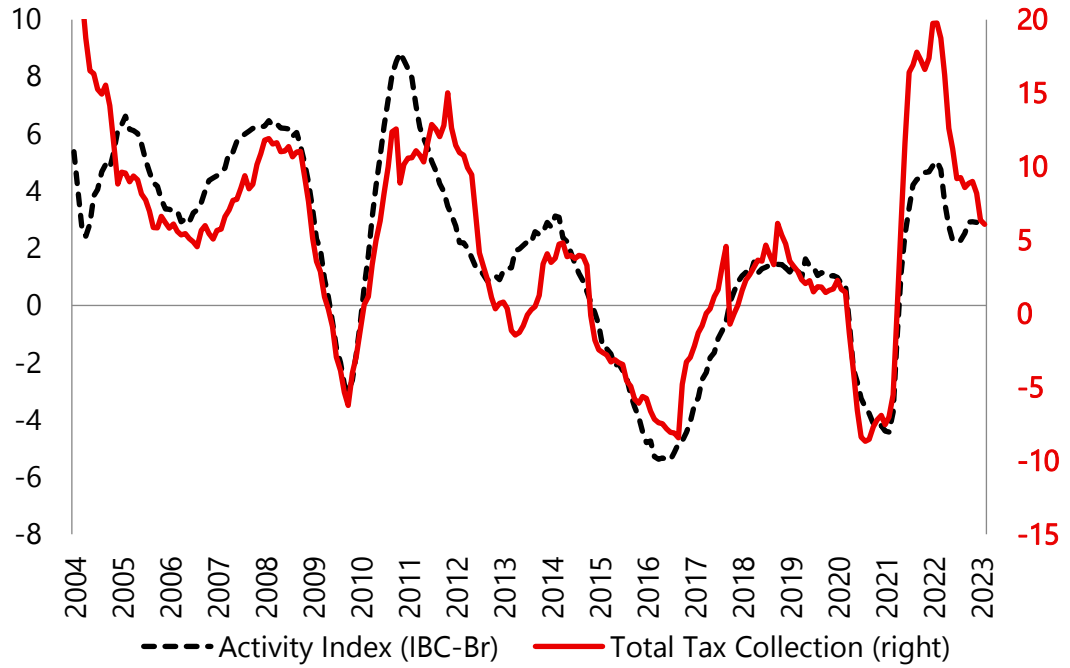
Sources: BCB, Santander

Simulation: Uses our macro estimates until 2026.
Long term Selic: 9.0%, and GDP deflator of 5.0%

Revenues: Cyclical Reduction vs. Increased Inertia + Labor Market recovery

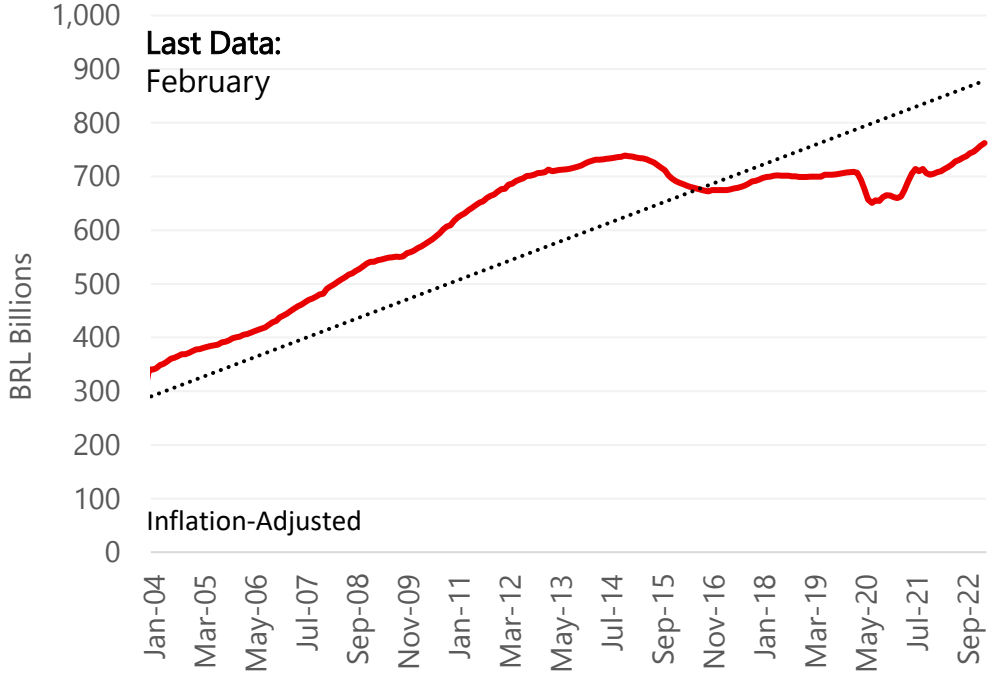
- The increase in Real Broad Wage Bill to 2.9% (+0.3pp) and Pension Contribution are showing a more persistent recovery
- We expect some softening in the federal tax collection growth ahead with the reduction in domestic activity and lower wholesale prices, the revenue result will be a key-element to the fiscal consolidation ahead, in context of expanding the outlays.

Activity and Tax Collection (12m - % YoY)



Sources: Brazilian IRS, BCB, Santander.

Tax Collection – Linked to Labor Market



Sources: Brazilian IRS, Santander

Fiscal – Mitigating the deficit in the short-term, challenges ahead

Central Gov. Primary Balance																
Fiscal Items (% of GDP)	2017	2018	2019	2020	2021	2022e	2023e	2024e	2025e	2026e	2027e	2028e	2029e	2030e	Δ 26-17	Δ 30-17
Total Revenue	21.0	21.3	22.1	19.3	21.7	23.3	22.9	22.8	22.9	23.1	23.1	23.0	22.9	22.8	2.1	1.8
Revenues Collected by the IRS (1)	12.7	12.9	12.8	11.8	13.4	14.0	13.9	13.6	13.7	13.9	13.8	13.7	13.6	13.5	1.2	0.8
Net Social Security Revenues (2)	5.7	5.6	5.6	5.3	5.2	5.4	5.8	5.8	5.8	5.9	5.9	5.9	5.9	5.8	0.2	0.1
Revenues Not Collected by the IRS (3)	2.7	2.8	3.7	2.2	3.1	3.9	3.2	3.3	3.3	3.4	3.5	3.5	3.5	3.4	0.7	0.8
Transfers by Revenue Sharing	3.5	3.7	3.9	3.5	4.0	4.6	4.6	4.5	4.4	4.3	4.2	4.1	4.1	4.0	0.8	0.5
Net Revenue	17.5	17.6	18.2	15.8	17.7	18.7	18.3	18.3	18.5	18.8	18.9	18.9	18.9	18.8	1.3	1.3
Total Expenditure	19.4	19.3	19.5	25.6	18.1	18.2	19.5	19.4	19.4	19.5	19.1	18.8	18.5	18.2	0.0	-1.2
Social Security Benefits (4)	8.5	8.4	8.5	8.7	8.0	8.0	8.4	8.5	8.5	8.5	8.4	8.4	8.3	8.3	0.0	-0.2
Payroll (5)	4.3	4.3	4.2	4.2	3.7	3.4	3.5	3.6	3.7	3.8	3.8	3.8	3.7	3.6	-0.5	-0.7
Other Mandatory Expenses (6)	3.0	2.9	2.6	9.5	3.4	3.0	2.8	2.7	2.7	2.6	2.5	2.5	2.4	2.4	-0.3	-0.6
Expenses with Cash Control (7)	1.9	2.0	1.9	1.8	1.6	2.2	3.1	3.0	2.9	2.8	2.8	2.7	2.6	2.5	1.0	0.6
Discretionary Expenses (8)	1.8	1.8	2.2	1.4	1.4	1.5	1.6	1.6	1.6	1.7	1.6	1.6	1.5	1.5	-0.1	-0.3
Central Gov. Primary Balance	-1.9	-1.7	-1.3	-9.8	-0.4	0.5	-1.2	-1.1	-0.9	-0.6	-0.1	0.1	0.3	0.6	1.3	2.5
Public Sector Primary Balance	-1.7	-1.5	-0.8	-9.4	0.7	1.3	-1.2	-1.1	-0.9	-0.6	-0.1	0.1	0.4	0.6	1.1	2.3
Nominal GDP (BRL billion)	6,585	7,004	7,389	7,610	8,899	9,915	10,344	10,864	11,578	12,340	13,151	14,016	14,937	15,919	5,754	9,334

Notes and Hypothesis

(1) Elasticity: Revenues-GDP 2021: 1.7 | 2022: 1.3 | 2023:0.96 | Long-term: 1.05. We see a slowdown in extraordinary revenues from 2023 onwards. Potential GDP: 1.5%. Inflation: 4.0%, GDP deflator 5.0%. (2) Recovery in the formal labor market and earnings (better short-term numbers), expected some softening ahead. (3) Oil revenues will increase with greater federal share in pre-salt, the reduction in prices in medium-term will be compensated with more production. 4) A permanent fiscal waiver of BRL170 billion in 2023 onwards. We assume a fiscal rule that incorporates the waiver for 2023 as a permanent shift in the constitutional spending cap, which remains indexed to IPCA inflation up to 2026 (before the new fiscal anchor proposal). Expenditures limited to ~19% of GDP (close to the level before enactment of the spending cap law). Real minimum wage increase (IPCA + average of last 5 years of GDP growth). The government will mitigate the impact of real gains in minimum wage by a tighter rule for the welfare program. Pension Reform approved in 2019 will stabilize the expenditures as % of GDP in the long-term (even with the rapid aging of the population). In the short-run we eliminate the queue (repressed by the pandemic). (5) Gradual increase in admissions (faster than the previous scenario, 70% instead of 55%) to the federal workforce ("normalization"). In the short-term (2024-25) decomposition of 80%, We included the 9% increase in 2023 and 2024, after that is decreasing gradually to 4% in Medium-term. Long-term: digitalization effects contain the increase. (6) Includes: higher payments in Court-ordered debt budget (sub-cap) – better management with a reduction in long-term, rise in federal contribution to Fundeb (Educational Fund), BPC (pension benefit). Court-ordered debts to accumulate to 1.6% of GDP by 2026, with the government negotiating future payments. (7) The main change was the increase in the welfare program (*Auxílio Brasil*). 2022 budget: BRL90 billion (from BRL35 bn of the former Bolsa Família). For 2023 onwards a more efficient and focalized welfare program with a total of BRL165 bn (gradual reduction in outlays after 2024). (8) Discretionary Expenses maintained at ~1.5% - a level that we consider enough to avoid a partial shutdown of public services, with and increase in investment with the reforms. (9) Not consider an increase in Tax exemption from 2023 onwards.

1H23 Expected Agenda

January

24

2022
Federal **Tax Collection**
8.2% YoY real growth

26

PAF 2023 – Financial Needs BRL1.5 tn
More LFT (Floating rate)
Nomination of Prates for Petrobras

27

Central Gov. Primary result (Treasury)
BRL54 bn surplus

31

Public Sector Fiscal Indicators (BCB)
Gross Debt 73.5%
Primary Surplus BRL125 bn

February

01

End of Parliamentary and STF Recess
Election for House Speakers | Lira and Pacheco reelected
Copom 13.75%

02 to 28

Nomination for the Congressional **committees**

17

STF – "Coisa Julgada"

28

Ends the tax break of **PIS/Cofins** on Gasoline – we observed a partial return

March

02

2022 **GDP release**
4Q22: -0.2% 2022: +2.9%

10

Federal Gov. agreement to pay BRL27bn to states due to ICMS (VAT) cap

22

Copom Meeting
Maintained at 13.75%
1st Budget Review
Primary Deficit 1.0% GPD

27

End of **Bruno Serra**'s mandate on **BCB**

30

2023 Tax Burden estimate release
Public Sector: 33.8% of GDP

April

10 April
IMF WEO

13 April
Supreme Court analysis of ICMS credit (Difal)

April 15-17
PLDO – 2024 **Budget Guidelines Deadline + Fiscal Framework**

25 April
BCB president audience in Senate

1 May
Labor Day - Minimum Wage announcements

3 May
Copom Meeting
(e) 13.75%

22 May
2nd Budget Review

May

- The govt. should send the proposal to increase revenues (BRL100-150 bn)
- Could end the Parliamentary working group of the Tax reform
- STF – Lewandowski retired. Lula can indicate the substitute.
- Two Presidential nominations for BCB direction (requires Senate approval)

Provisional Measures

New format of ministries
Bolsa Família
Housing Program (MCMV)
*Desenrola Brasil (*indebtness)

June

01

2023 **GDP release**
1Q23: +0.5% QoQ s.a

ICMS (VAT) rise on gasoline to rise to BRL1.22 per liter

21

Copom Meeting
(e) 13.75%

30

End the Provisional Measure that partially returned the **PIS/Cofins** on Gasoline and Ethanol – End the tax on oil exports

Sources: BCB, STF, Congress, National Treasury, Arko, BCB, Santander

New Fiscal Framework Guidelines

02

Fiscal Policy: New Fiscal Framework Proposal

New Fiscal Framework Guidelines

1. **Primary result target** - % GDP (bands of +/- 0.25pp): 2023: -0.5% | 2024: 0% | 2025: +0.5% | 2026: 1.0%;

2. **Commitment** to the target up to 2026 (including the bands)

3. **Outlays in the spending ceiling real limit between 0.6% and 2.5%** p.a. (countercyclical mechanism), with FUNDEB and the nursing salary floor excluded from the limits (already existing constitutional rules).

4. Annual growth within the **expenditure growth range limited to 70% of the primary revenue** change in the last 12m.

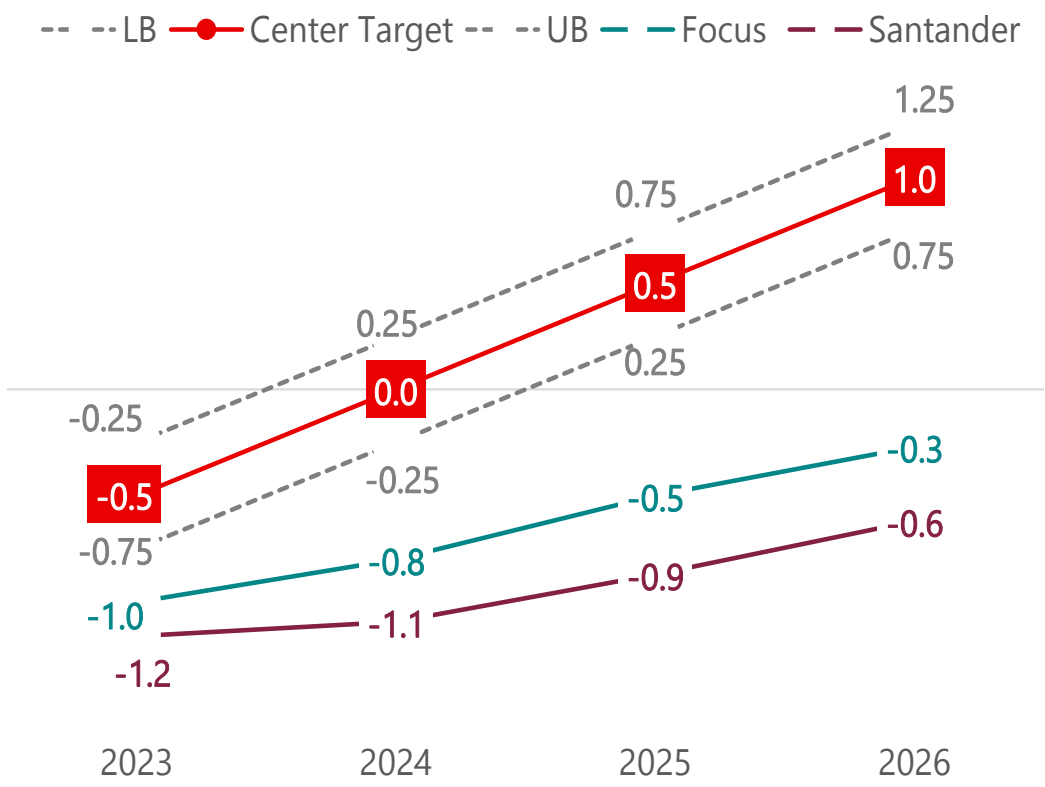
5. **Primary result above the ceiling of the band allows the use of surplus for investments.**

6. Not compliance to the target: a reduction in expenditure growth to 50% of revenue growth in the following year.

7. **Investments floor**. 2023 value updated to IPCA.

Sources: Finance Ministry, Santander.

Primary Result - Target and Scenarios % GDP



Sources: Finance Ministry, Santander

New Fiscal Framework - Efficacy Will Depend Largely on Revenue Performance

Main Aspects of the New Framework

Federal tax collection will be a key factor

- Dependency of Macro Parameters
- Cyclical Payback (?) and Commodities Prices

Necessity of increase in Net Revenues

In total revenue this amount could double if we observe a rise in taxes of which part is shared by subnational entities/

Dependency of Macro Parameters:

Gov. Parameters: (permanent) increase in federal net revenue of 1.2% of GDP in 2024

Our scenario: it would be necessary for net revenue to increase by 2.3% of GDP in 2024

No increase: deficits of
-1.2% in 2023, -1.8% of GDP in 2024, -1.6% in 2025, -1.3% in 2026

Details and Global Overview

Uncertainty about the details:

- Need to observe the first draft
- Level of the 2024 outlays limit
- Which revenue measure and time window will be used
- Investment bonus (duration and size)
- Spending limit: only Fundeb and Nursing Wage Floor?
- Transition – new lower bound Education and Health
- The primary target will be set only in LDO (biding for 1 year)

Some aspects (not totally defined):

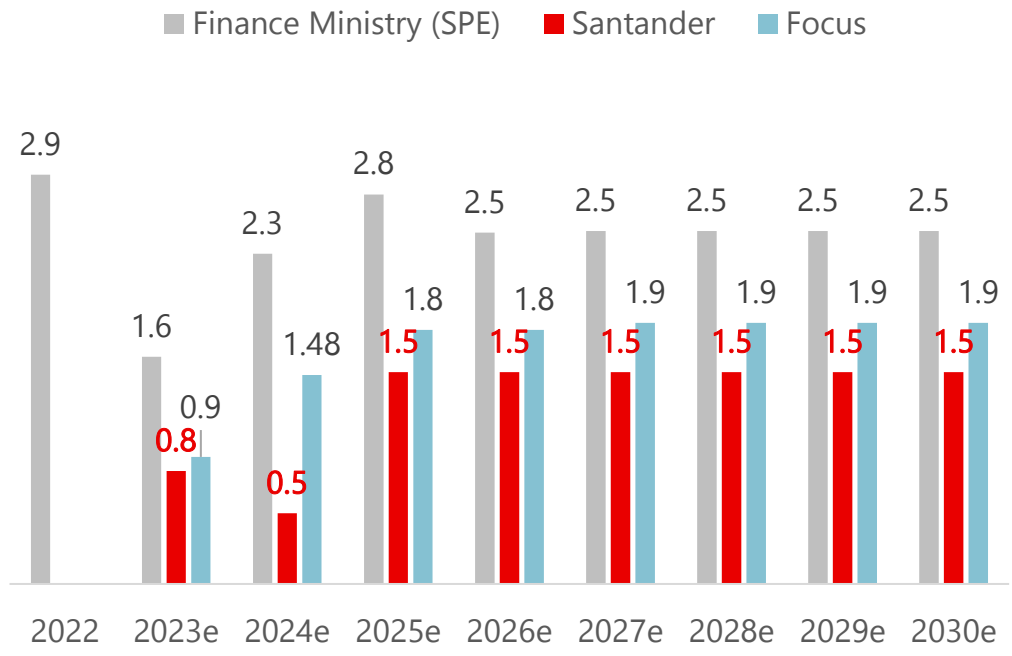
- Pursuit of reaching a primary surplus (Very Important)
- No new exceptions to the spending limit
- Use of past revenues (not using estimates)
- Reducing the size of outlays with a drop in revenues

Challenges:

- Diminish the adjustment by tax increase (outlays are linked)
- Floor for investments (corrected by inflation)
- New lower bound for health and education
- Gradual drop in expenditures, with necessity to cut discretionary
- Congressional approval of tax burden adjustments
- Less enforcement for the approval of reforms
- Debt Convergency – depending on parameters

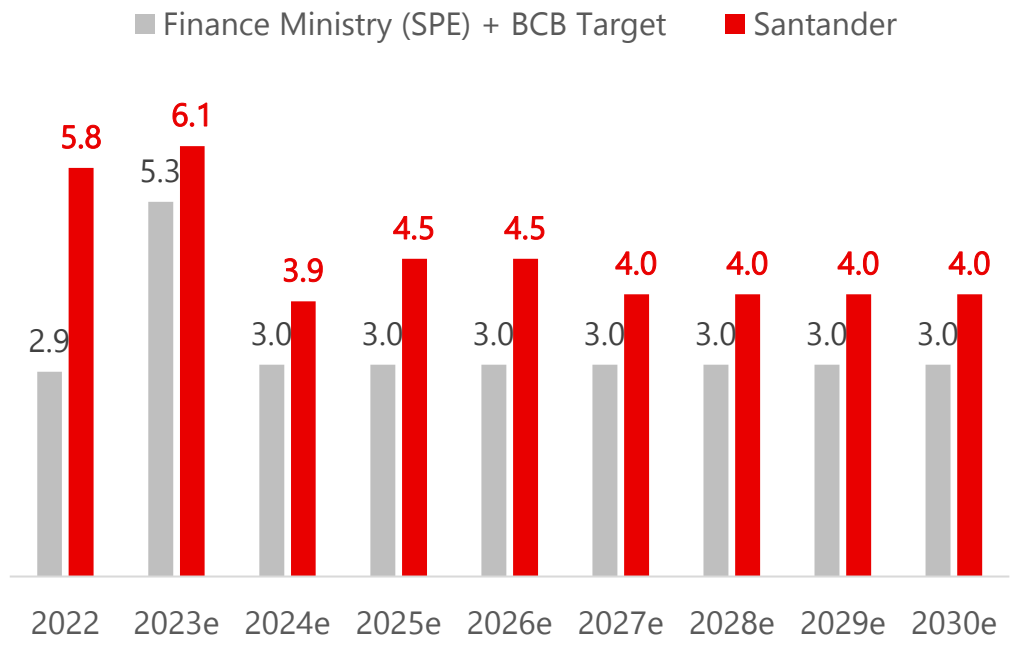
Fiscal Policy: Highly Dependency of the Macro Parameters

GDP Forecast



Sources: Finance Ministry, Santander

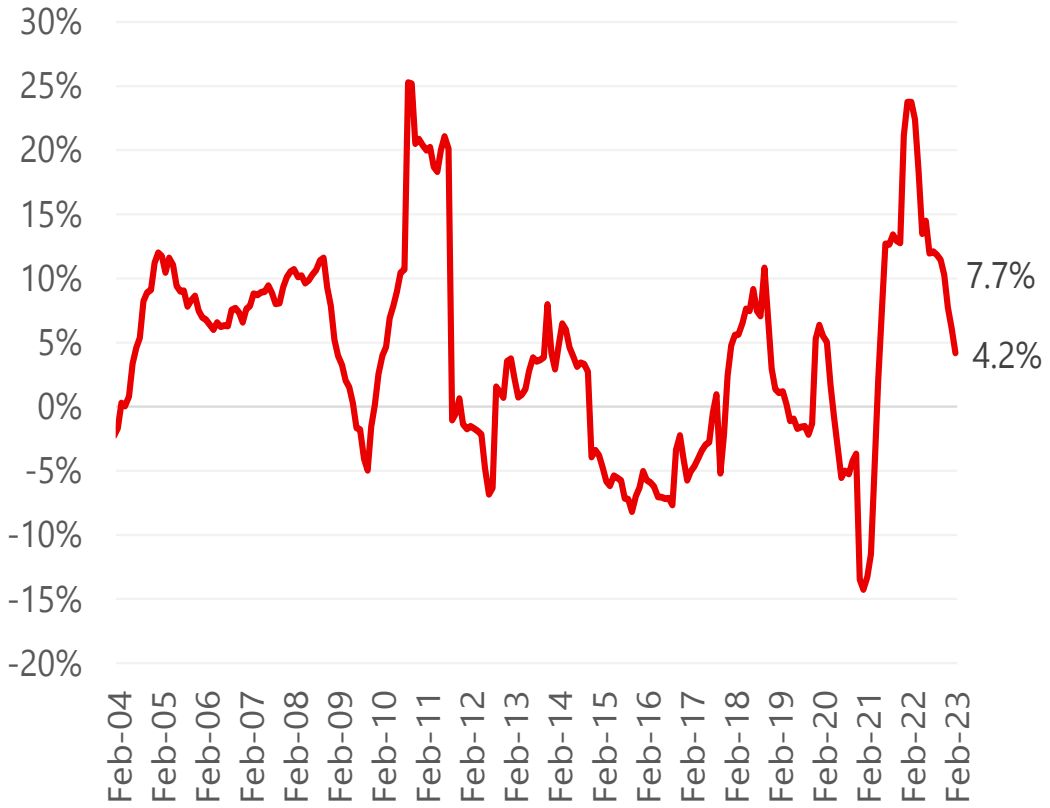
Inflation Estimates



Sources: Finance Ministry, Santander

Fiscal Policy: New Fiscal Framework Proposal

Net Revenue - % GDP



Sources: National Treasury, Santander.

Expenditures – Gradual Decline

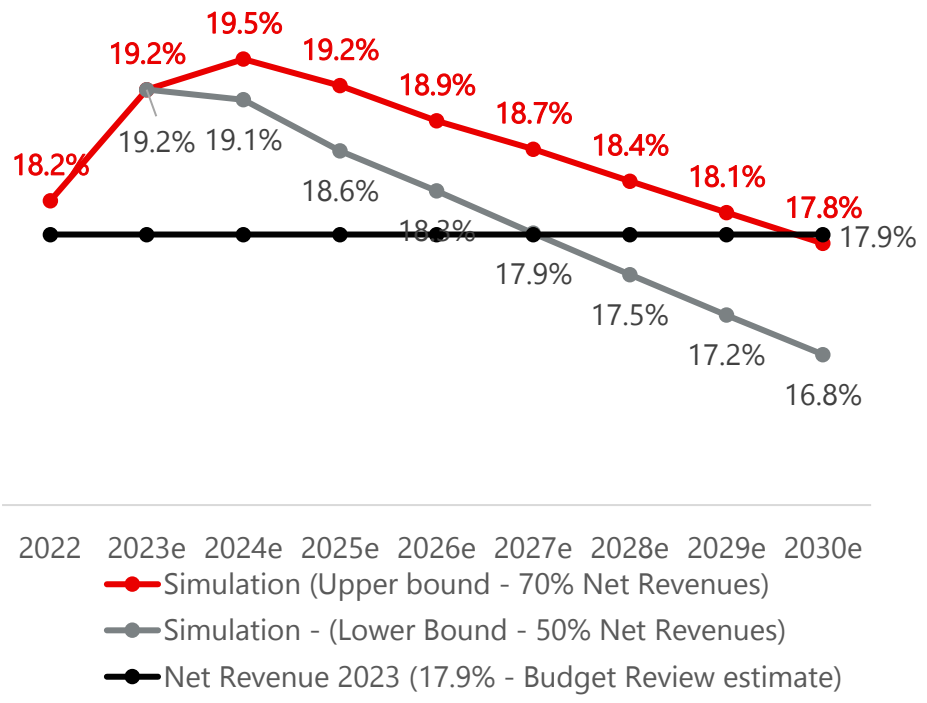
GDP	Net Revenue	Total Expenditure % YoY		Expenditures (% GDP) - 2023:18.9%	
		50%	70%	50%	70%
0.0%	0.0%	0.6%	0.6%	-0.1%	-0.1%
1.0%	1.0%	0.6%	0.7%	-0.3%	-0.2%
2.0%	2.0%	1.0%	1.4%	-0.4%	-0.3%
2.5%	2.5%	1.3%	1.8%	-0.4%	-0.3%
3.0%	3.0%	1.5%	2.1%	-0.5%	-0.4%
4.0%	4.0%	2.0%	2.5%	-0.6%	-0.5%

Nominal GDP = f(REAL GDP, IPCA + 1.0%)

Sources: Finance Ministry, Santander

Fiscal Policy: Expenditures Simulation – No increase in Tax Burden

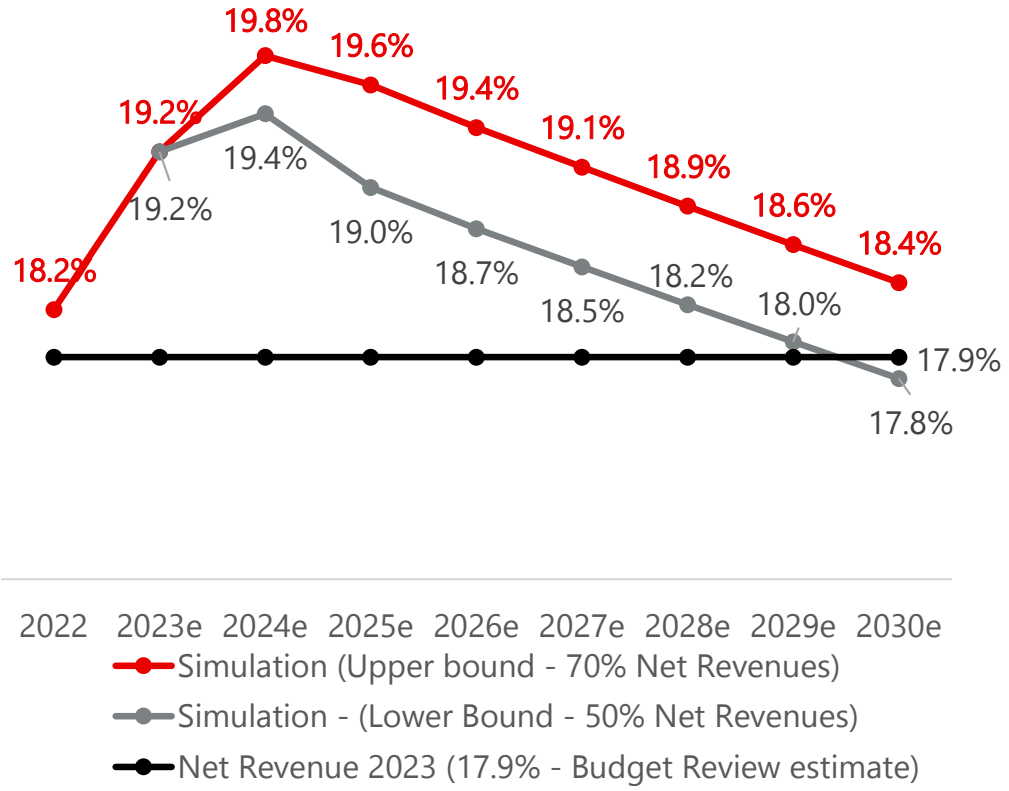
Finance Ministry Parameters



Sources: National Treasury, Santander.

2023 we added BRL30 bn increase in Heath Outlays to increase to reach the new lower bound

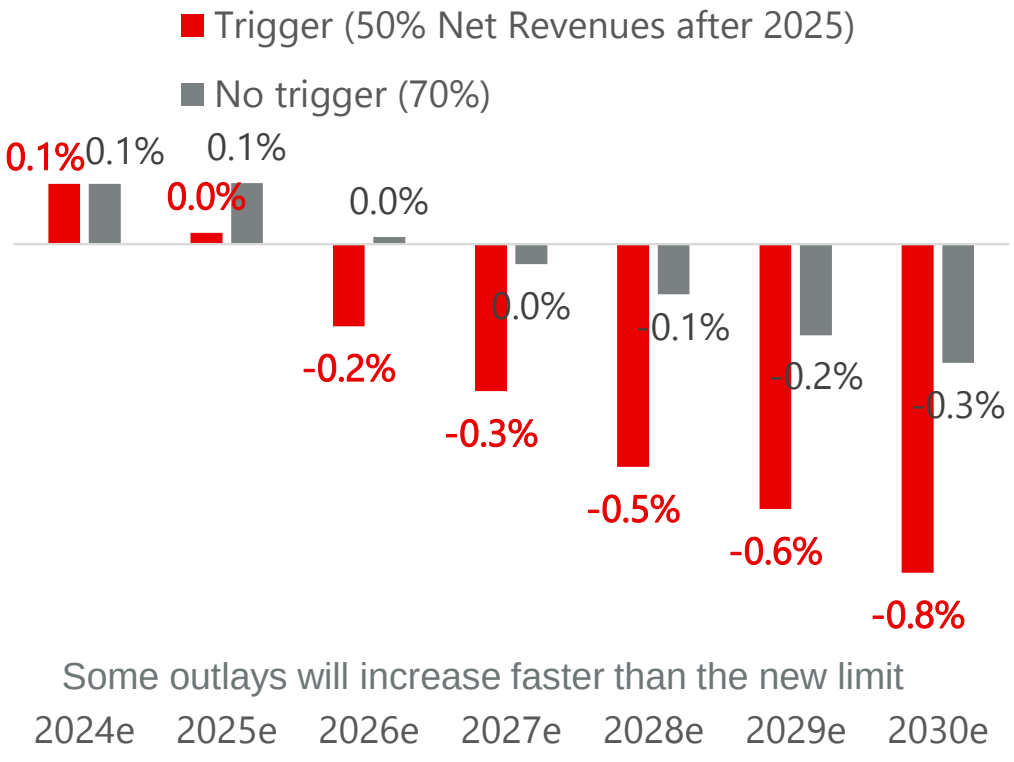
Expenditures – Gradual Decline



Sources: Finance Ministry, Santander

Fiscal Policy: A simulation of the new spending limit

Simulation - Expected cut in discretionary outlays



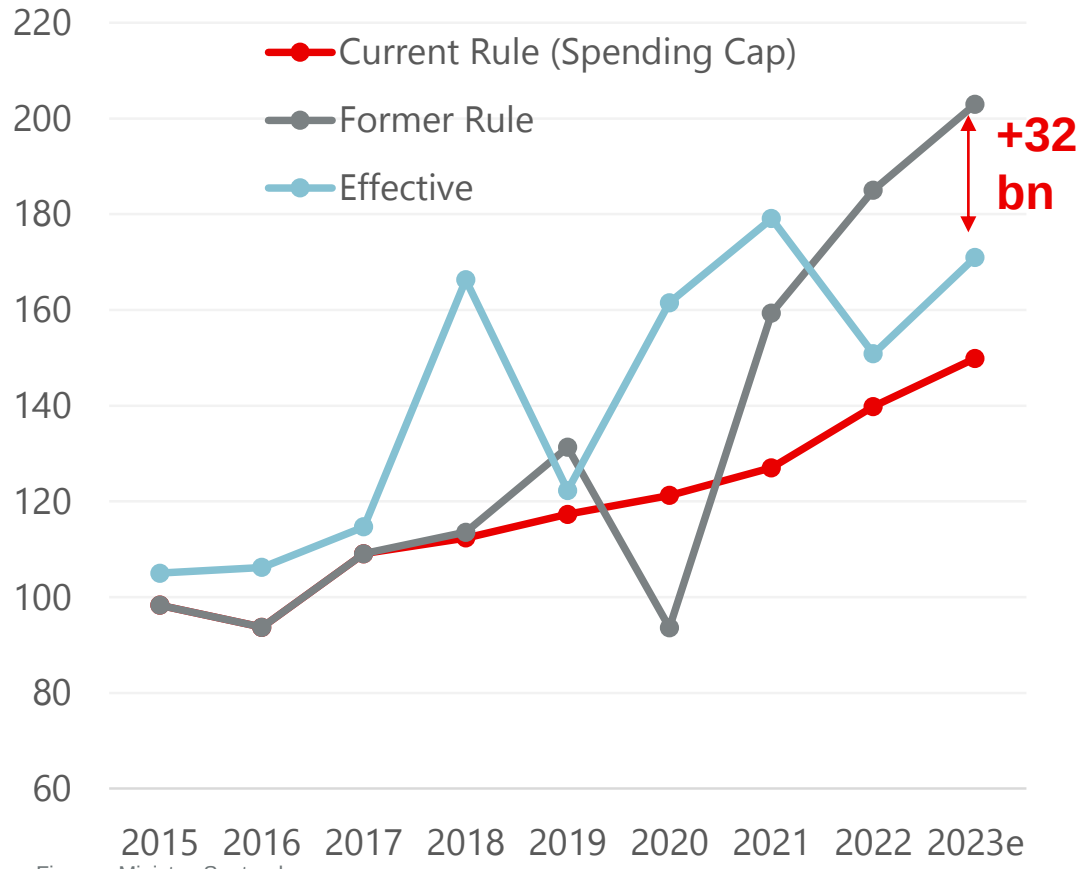
Sources: National Treasury, Santander.

Education: 18% RLI | Health 15% RCL | Minimum Wage = IPCA + 5y GDP average

Public Servants wage = 8% | Welfare Program (Bolsa Família) = IPCA/2

Supposing no changes in the primary targets and the full-effect of the fiscal rule

Health Outlays – Lower Bound – BRL bn



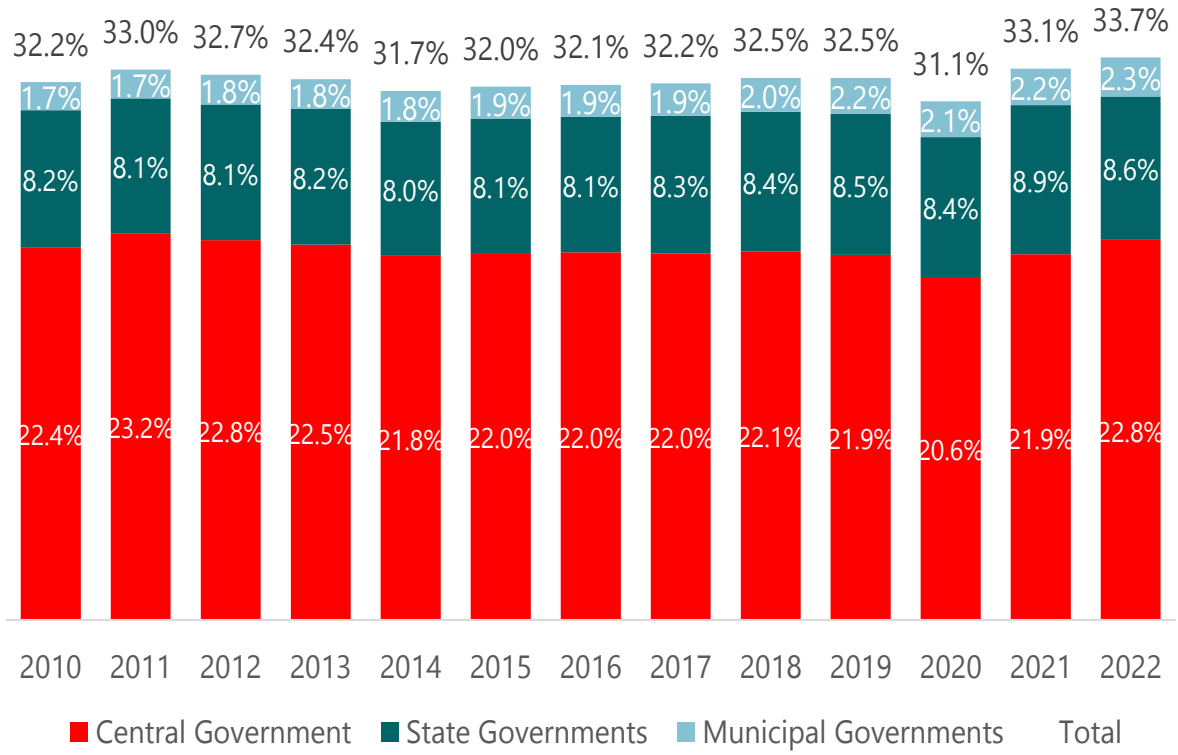
Sources: Finance Ministry, Santander

Fiscal Policy: Is it possible to raise revenues?

Considering OECD data, Brazil's tax revenue was 31.6% of GDP in 2020, the 4th highest among emerging economies.

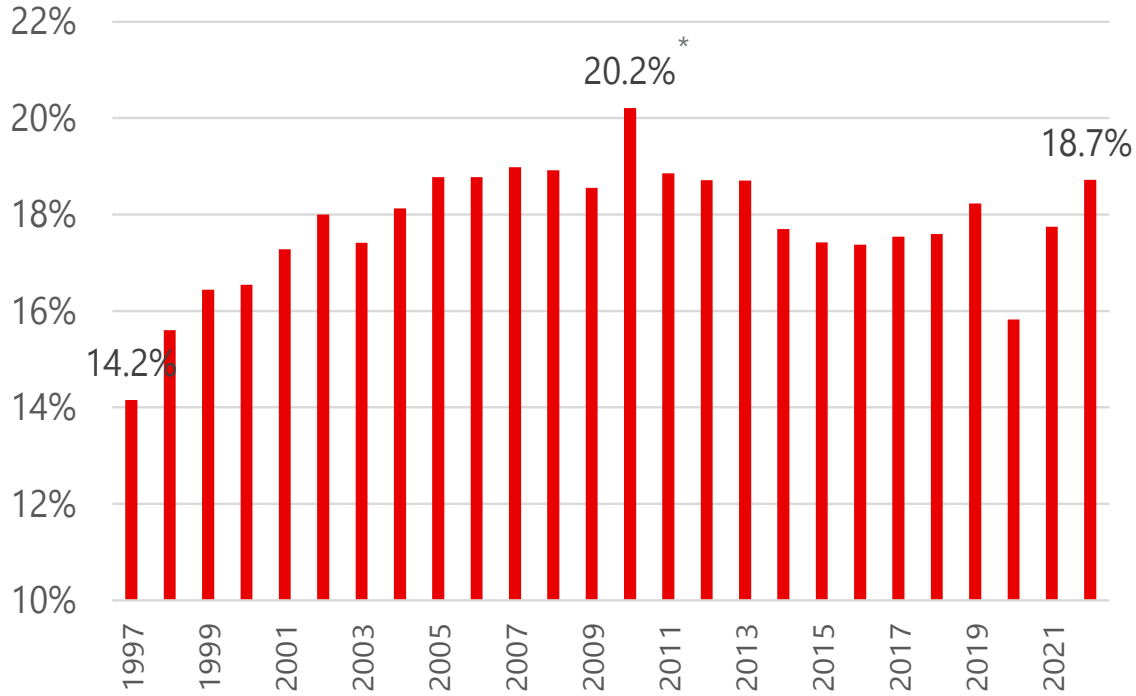
From 1990 to 2020: Brazil's tax revenue rose 3.9 pp, compared to LatAm (4.2 pp) and OCDE countries (2.7 pp).

Brazilian Tax Burden - % GDP



Sources: National Treasury, Santander.

Historical Net Revenues - % GDP



Sources: Finance Ministry, Santander

* 1.9% of GDP in extraordinary revenues

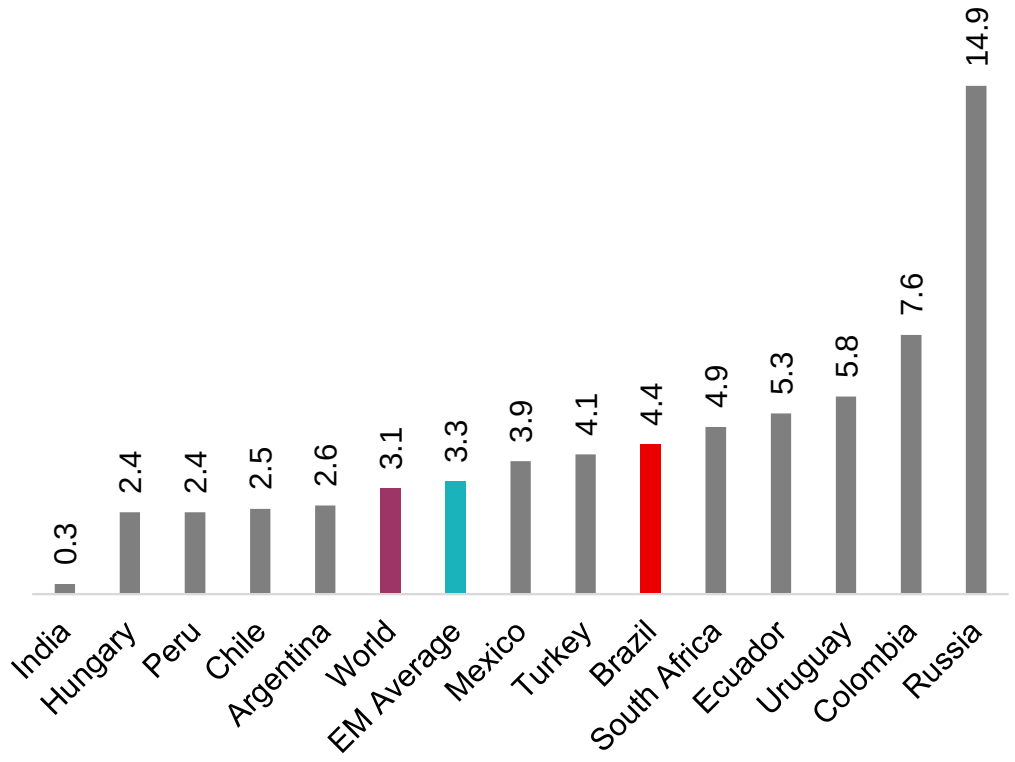
Brazil: Tax Relief Is 1.3 pp of GDP Higher Than Global Average

Fiscal Incentives - % GDP

2023 Tax Incentives	BRL Billion	%	% of GDP
Simples Nacional	89	20.2%	0.9%
IRPF - Exempt Deductions and Earning	75	17.0%	0.8%
Zona Franca Manaus (Trade Zone)	55	12.5%	0.6%
Agriculture	52	11.8%	0.5%
Non-profit Org.	35	8.0%	0.4%
Savings and Credit Bonds - LCA, LCI, etc	19	4.3%	0.2%
Medicines and Medical Equip.	18	4.1%	0.2%
Employee Benefits	16	3.6%	0.2%
Regional Development	15	3.4%	0.2%
Automotive Sector	10	2.3%	0.1%
Payroll Tax Exemption	9	2.0%	0.1%
IT sector	8.6	2.0%	0.1%
Scientific Research and Tech.	7	1.6%	0.1%
Aircraft and Ships	5	1.1%	0.1%
Individual Enterpreneur (MEI)	5	1.1%	0.1%
ProUni	3	0.7%	0.0%
Others	32	7.3%	0.3%
Total	**440**	**100.0%**	**4.4%**

Sources: National Treasury, Santander.

2020's Tax Relief by Country - % GDP



Sources: OECD, Santander

Highly dependent on increase on revenues, some proposal could be unveiled

- Federal is expected to present measures hat boost revenue, part of which will need the approval by Congress.
- A main proposal could be the use ICMS credit could only be deducted from the IRPJ and CSLL calculation base if it was earmarked for investments (tax benefits that require a contribution from the taxpayer, such as job creation or factory construction). According to the Treasury, the total break reported by the 26 States and by the Federal District in ICMS tax recently reached a total of BRL 183 billion in 2021, which we believe is closer to BRL200 billion. According to Ministry of Finance projections, the measure might generate between R$85 billion and R$90 billion. Yet, recall that almost half of the revenues on IRPJ is transferred to states and municipalities, reducing its impact. According to our calculations, depending on the parameters (such as the effective rate and % of the funding subsidy) and removing the subnational transfers, the total potential is reduced to an interval between BRL30-40 billion in a year. Among sectors, retailers would be more affected, but some may be able to mitigate the impact if they pass through this possible increase in the tax rate to consumers through higher prices.

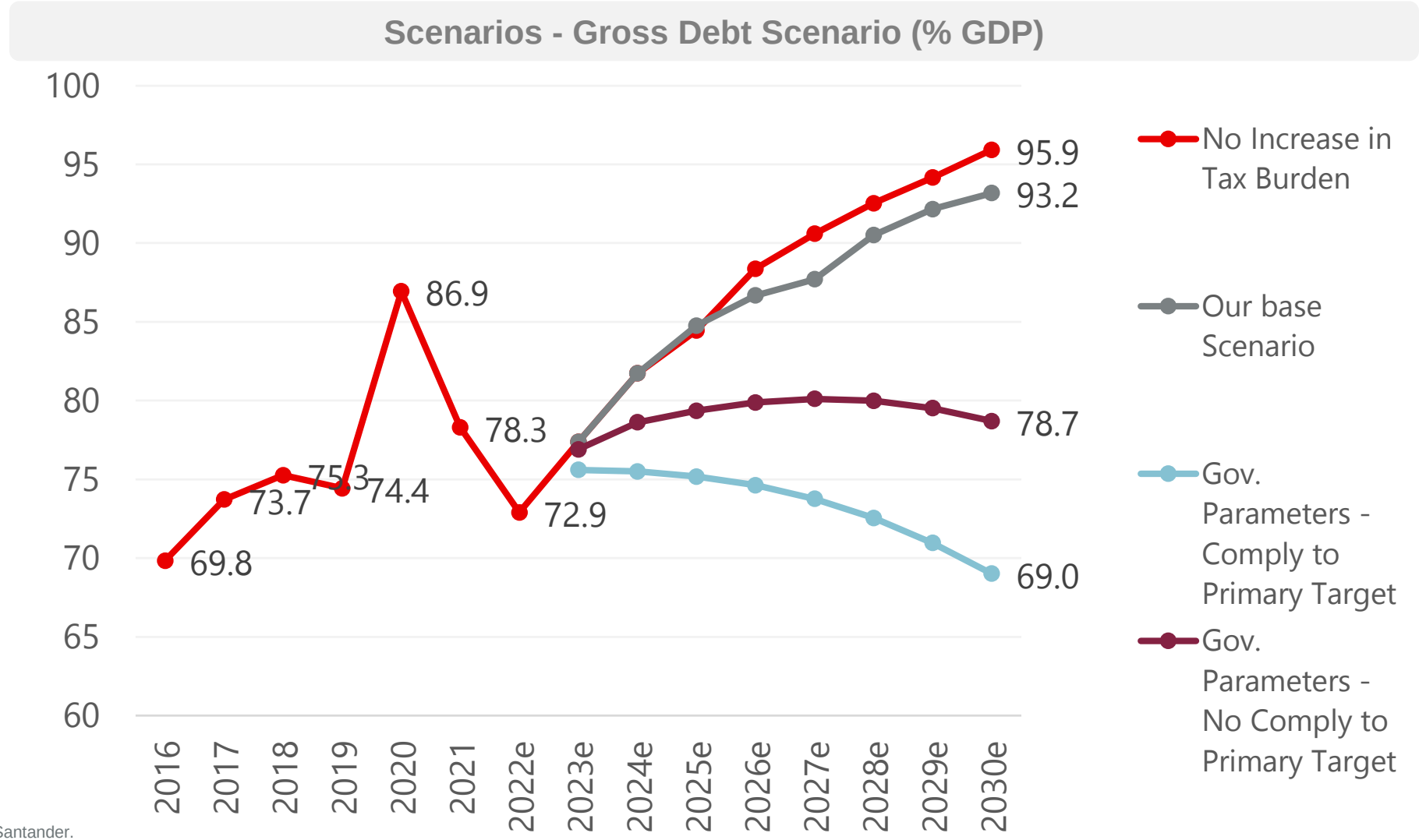
Measures mentioned in the Newsflow

Measures - BRL bn	Gov. Estimate	Our Estimate for Fed. Gov.	Likely?
Original Plan			
Sports betting tax	12-15	7	Yes
Tax of imported goods purchased by individuals online	7-8	7	Yes, yet could face popular pressure
Restricting corporates' to deduct ICMS tax benefits in income taxes	85-90	30-40	May face resistance in Congress
Others			
MP 1152 - Transfer Price[1]	20-30	12	Yes
Lottery "Raspadinha"	12	12	Yes, could be not go the Fed. Gov.
End of JCP*	-	8	Only in General Income Tax Reform
Tax on Dividends (15%)*	-	25-30	

* Not Likely now

Sources: Finance Ministry, Broadcast, Santander.

Gross Debt Trajectory – still upward, depending on the parameters

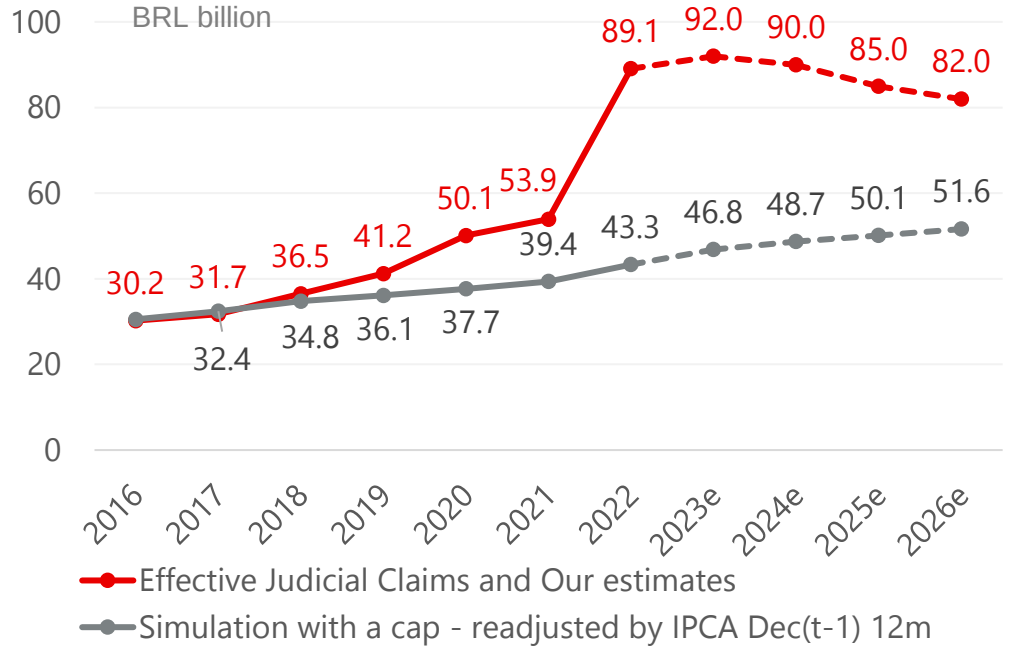


Sources: BCB, Santander.

The judicial claims remains limited and accumulating a non-paid debt (not in the statistics)

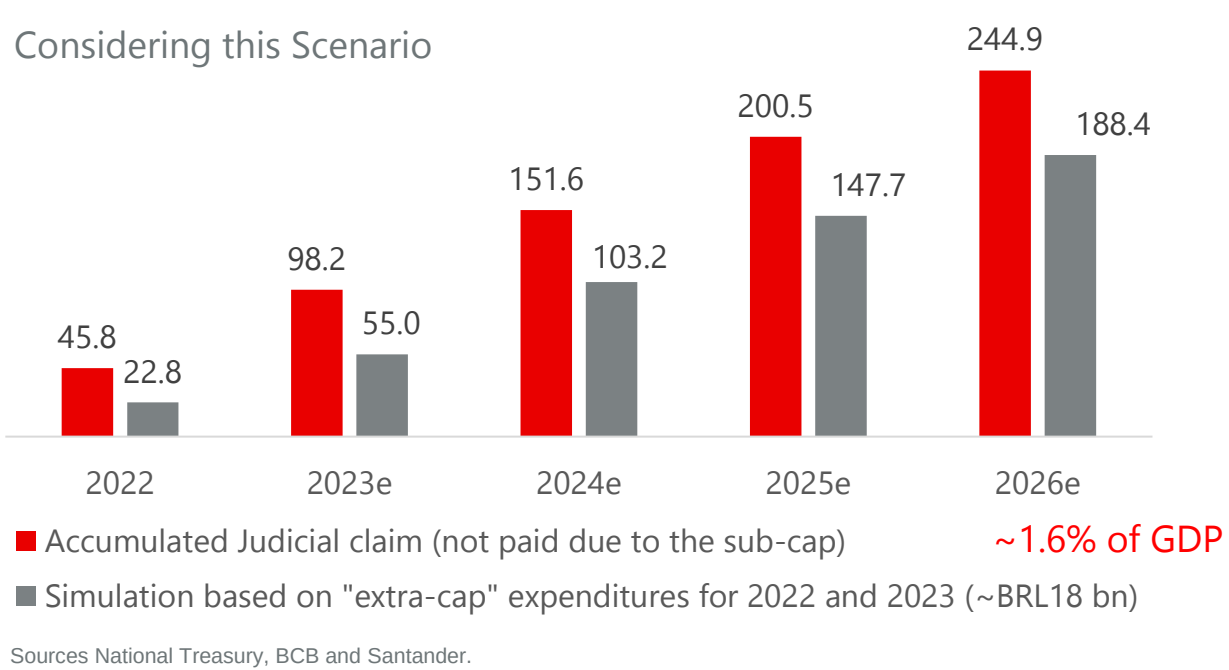
- In order to reduce the judicial claims payments, the government proposed to create a ceiling for these liabilities and postponing the remaining for the next few years (or paying outside the spending cap limit).
- Creating a cap since 2016 would reduce the judicial claim payments in 2022 to close to BRL43 billion, from the BRL89.1 billion official number. We believe that ~BRL55 billion will be accumulated for being paid in the future. If not paid the court-ordered debt could reach a total of 1.6% of GDP in 2026

Simulation - A limit for Judicial Claims payments



Sources: National Treasury, BCB and Santander.

Simulation with a cap – Accumulated judicial claims



Sources National Treasury, BCB and Santander.

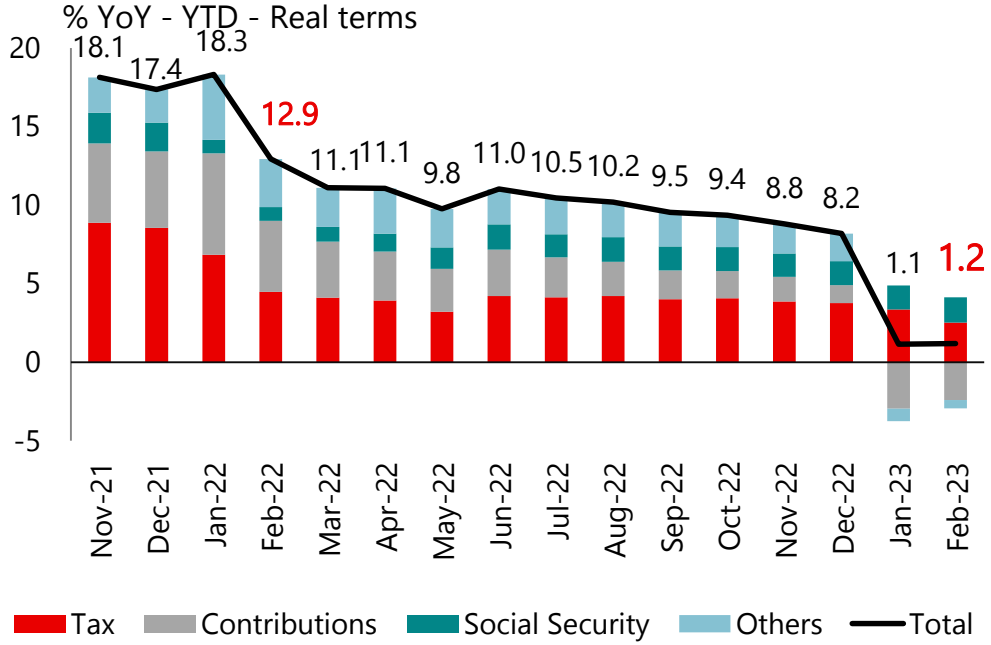
Tax Collection Performance
Two years of good results
Softening expected ahead

03

Revenues Impact – Price Effect + Activity Recovery

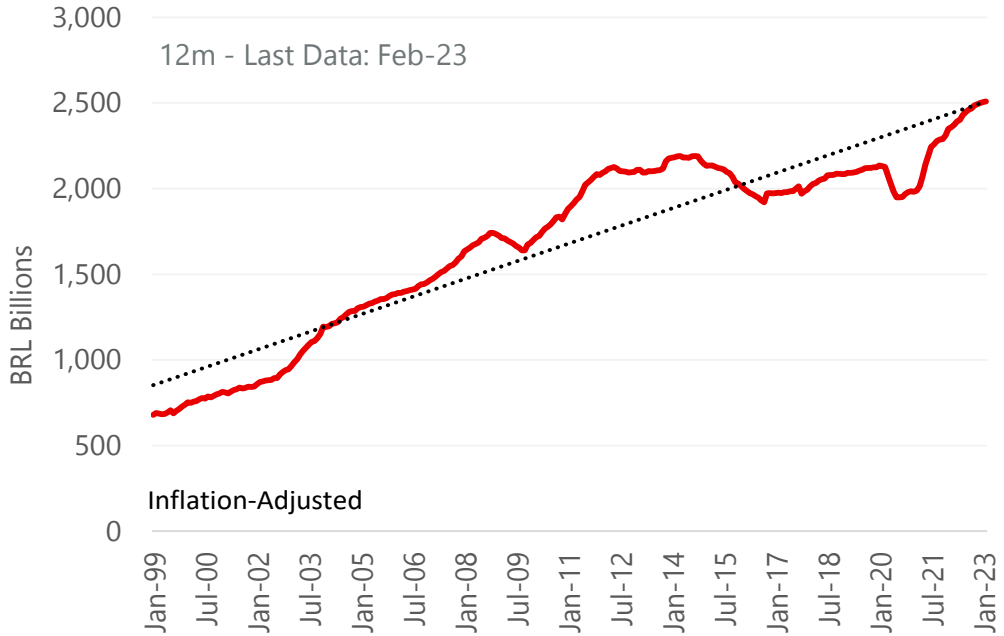
- We see a strong recovery in federal tax collection in recent months, mainly direct taxes linked to the corporate sector, which have posted good results. We can also observe that the increase in tax collection is highly correlated with sectors linked to the commodity boom, especially those related to metals & oil.
- In our view, we expect revenue growth to slow down ahead, for the following reasons: i) Greater basis for comparison; ii) commodity prices losing steam; iii) normalization of the consumption basket - with more services (lower tax collection); iv) activity at a slower pace of growth after the crisis recovery;

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



Sources: Brazilian IRS, Santander.

Total Federal Tax Collection –

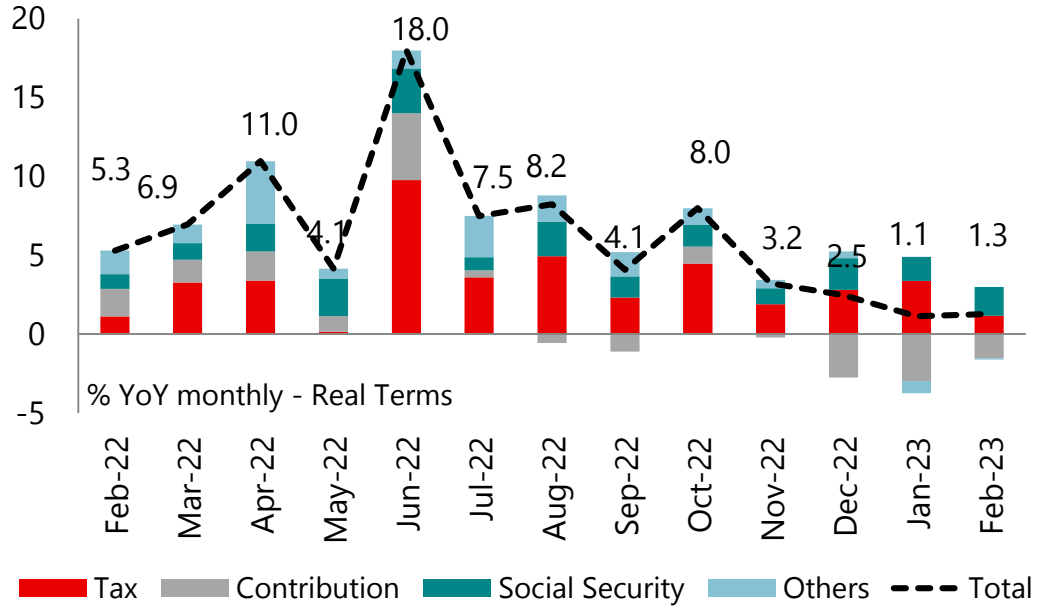


Sources: Brazilian IRS, Santander.

Now, federal tax collection is showing signs of losing steam

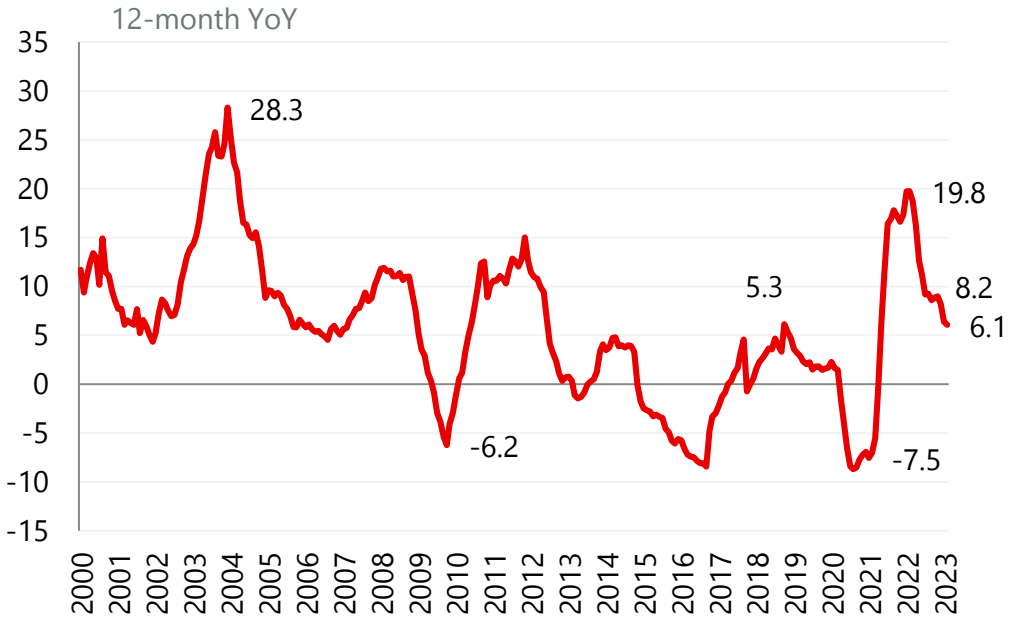
- In the February, Federal Tax Collection reached BRL159 bn, above our call (BRL154 bn) and in line with the market median (BRL158.7 bn). The main surprise to our forecast were: a better revenue related to companies' profits and revenues linked to the labor market.
- The revenues linked to corporate profits showed a 12% YoY in IRPJ/CSLL increase in February, above our forecast of 7% YoY. This revenue boosted the recent positive performance in tax collection, we expect some deceleration ahead with a reduction in commodity prices and increase in costs compared to last year,

Federal Tax Revenue: Monthly (%YoY)



Sources: Brazilian IRS, Santander.

Federal Tax Collection

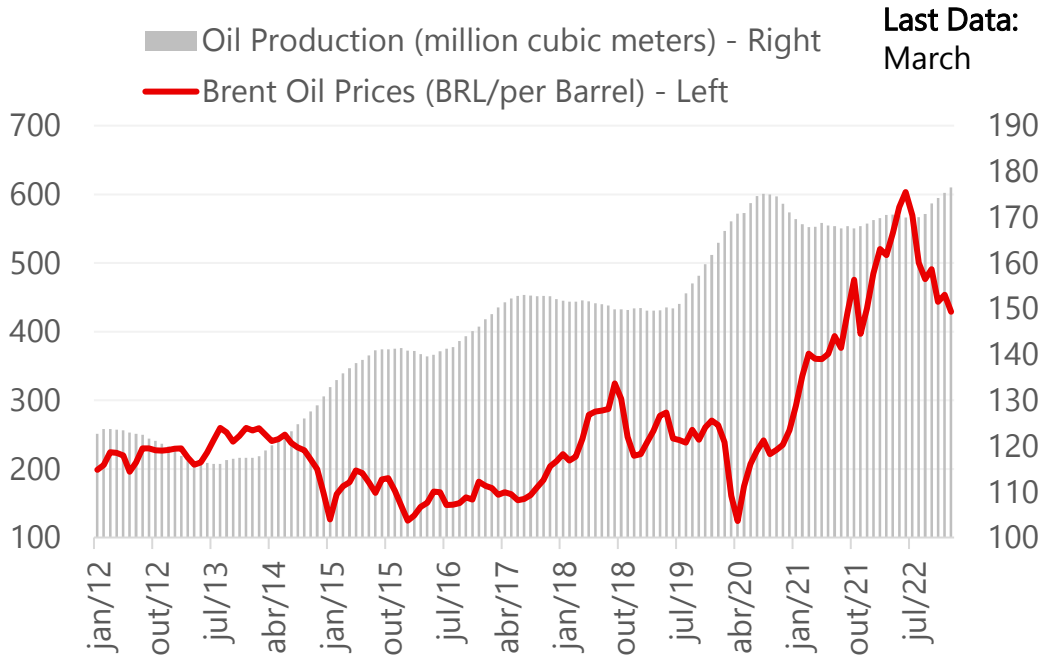


Sources: Brazilian IRS, Santander.

Oil Revenues – still helping the public sector revenues

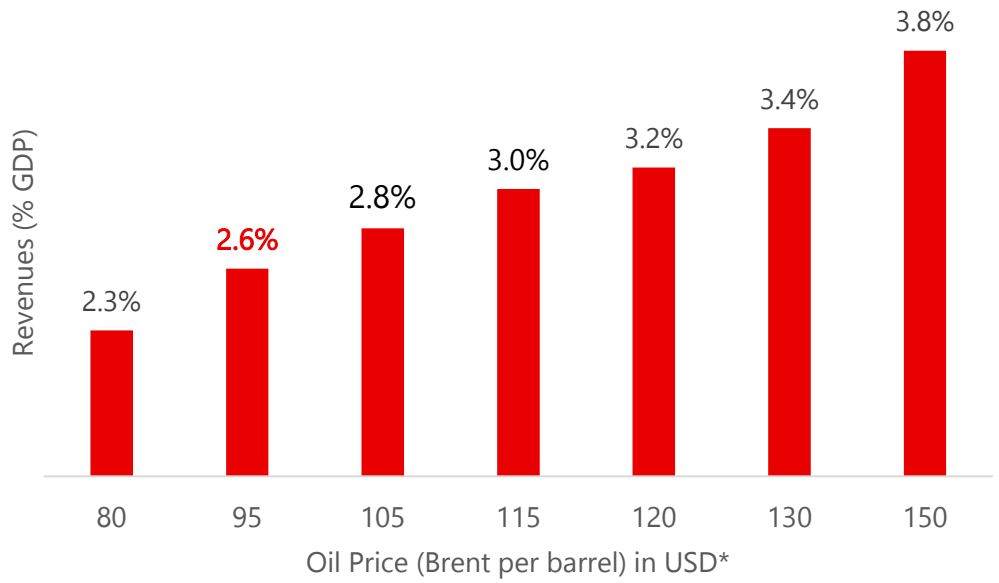
- In energy, oil prices tumbled on fears about contagion from crises involving some international banks triggered a broad risk-off sentiment in the market. With lower 2Q23 and 3Q23 prices, we now see our Brent forecast (year-average) at USD90/bbl for 2023 (from USD95/bbl previously), but we are keeping our year-end forecast unchanged at USD95/bbl for 2023.

Oil production and Prices



Sources: Bloomberg, ANP, Santander

Public Sector – Oil Revenues

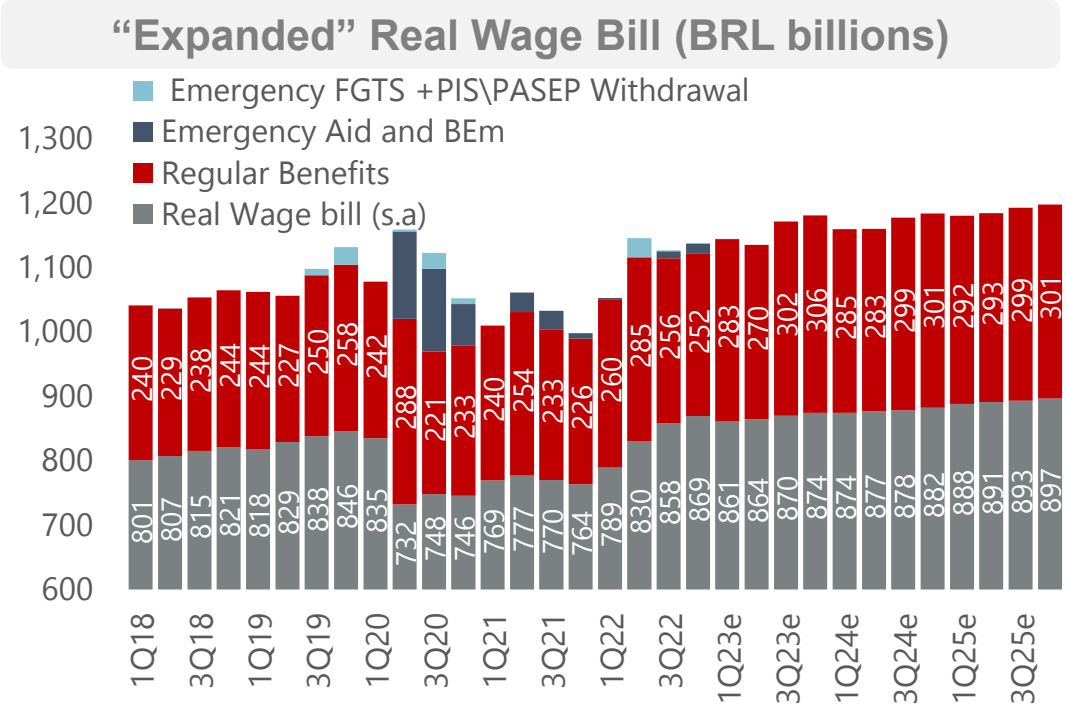


FX rate maintained at BRL5.40

Sources: National Treasury, Santander

Labor: An Upward Revision for the Real Wage Bill in 2023

- After a considerably higher than expected growth in 4Q22, we increased our projection of the expanded real wage bill for 2023 to a 2.9% growth in 2023, weighting a lower employment trajectory and the positive impact higher average real wages. For 2024, our forecast remained practically unchanged. We expect an acceleration for 2025, with growth slightly above our long-term estimate for the real wage bill.



Sources: National Treasury, IBGE, Ministry of Economy, Santander.

Old

	2021	2022(E)	2023(E)	2024(E)
Real Wage Bill	+0.6%	+7.2%	+2.8%	+0.6%
Real Wage Bill (With Government Transfers)	-8.0%	+6.4%	+2.6%	+1.2%

New

	2022	2023(E)	2024(E)	2025(E)	Long-Term
Real Wage Bill	+8.7%	+3.7%	+1.2%	+1.6%	+1.4%
Real Wage Bill (With Government Transfers)	+8.7%	+2.9%	+1.1%	+1.6%	+1.4%

Sources: National Treasury, IBGE, Ministry of Economy, Santander.

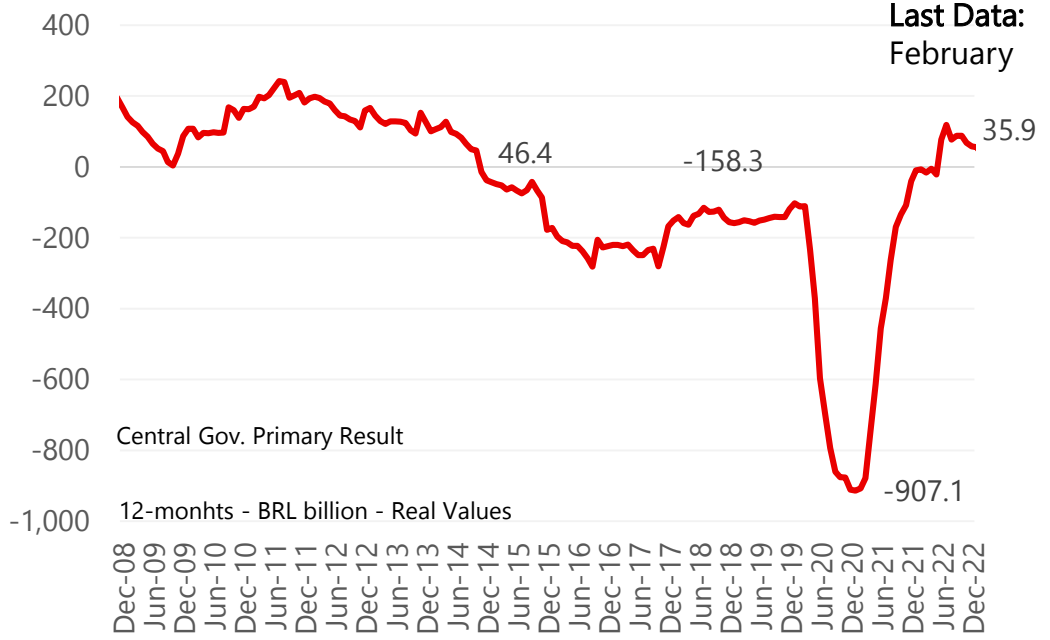
Primary Result and Debt Central Gov. and Public Sector

04

Central Gov: Fleeting Glimpse – A Surplus After Eight Years

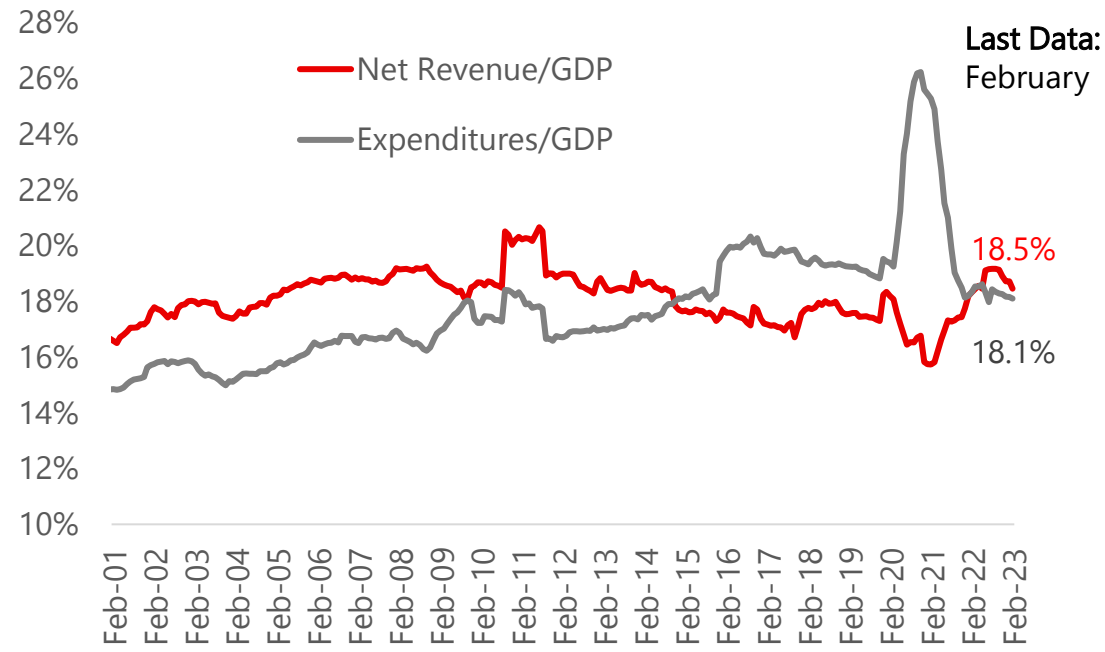
- In 2022, the Central Gov. registered a primary surplus of BRL54 bn (0.5% of GDP), compared to a deficit of BRL35 bn (-0.4% of GDP) in 2021. This was the first positive result after eight years registering primary deficits.
- In 12-month reading, the Central Gov. registered a primary surplus of BRL35.9 bn (0.3% of GDP), from BRL54.5 bn (0.5% of GDP) in January. For 2023, our forecast for the Central Gov. Result is a deficit of BRL125 bn (1.2% of GDP).

Central Gov. Primary Balance – 12m % GDP



Sources: National Treasury, Santander.

Revenue and Expenditures (%GDP)

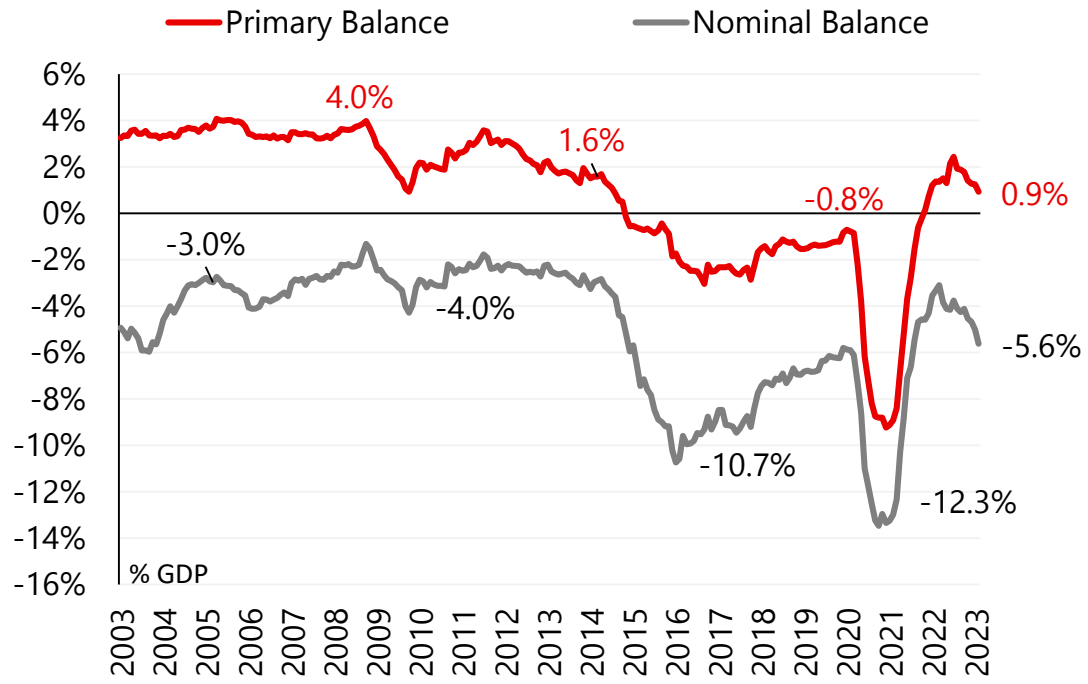


Sources: National Treasury, Santander.

Public Sector Primary Result slowing down gradually

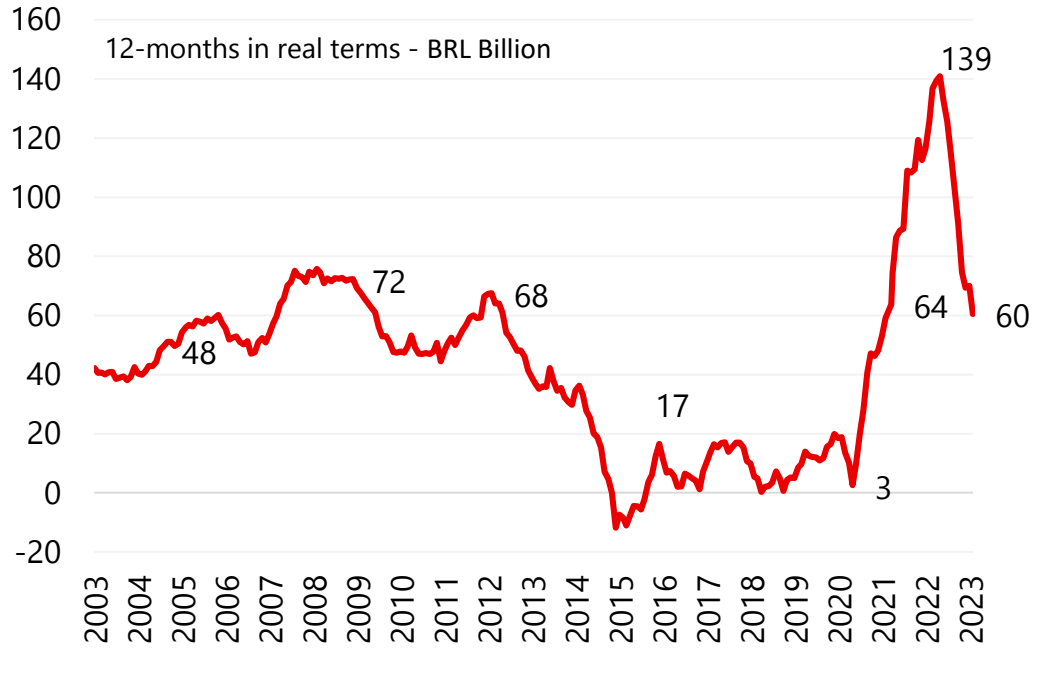
- The public sector posted a primary deficit of BRL26.5 billion in February, below our forecast of BRL33 billion. This was the highest deficit for February in general. The subnational entities' primary result was the main surprise to our forecast. Regional governments registered a surplus of BRL12 billion beating our call of BRL7.4 billion. We observed a 5.7% YoY drop in states revenue in nominal terms, considering the impact of legislation that limited ICMS (VAT) tax on essential goods. We believe it likely that the disbursement of expenditures continued to surprise to the downside in the month. Despite the positive performance in the year, we expect regional governments to show moderate values going forward due to the tax break effect.

Public Sector – 12m % GDP



Sources: Brazilian Central Bank, Santander.

Regional Gov. – Primary Result

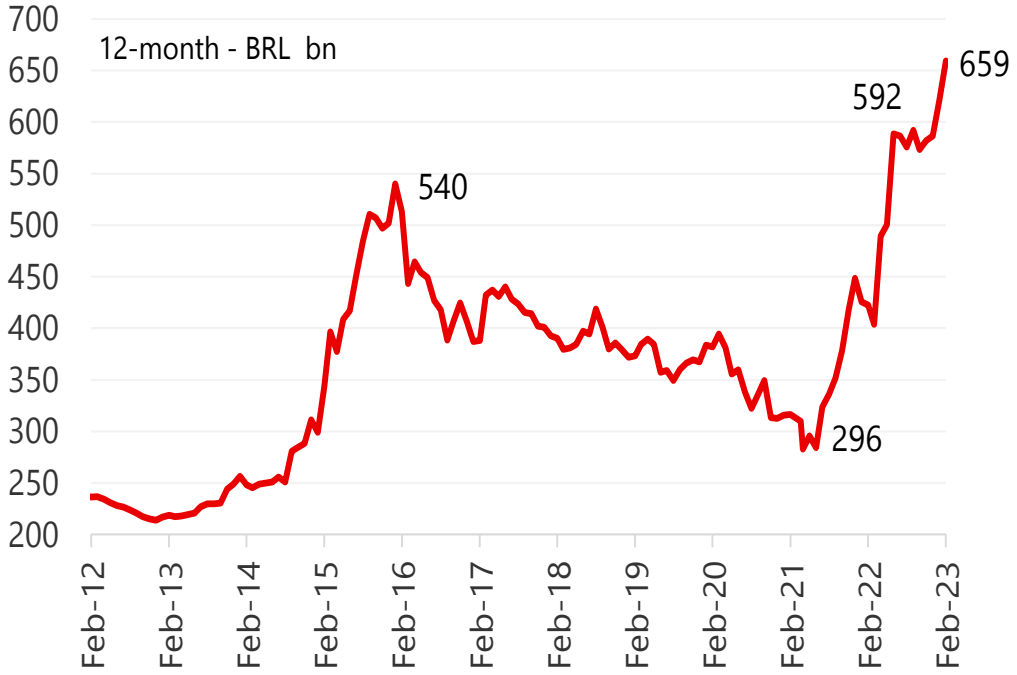


Sources: Brazilian Central Bank, Santander.

Increase in Interest Payments should pressure the debt ahead

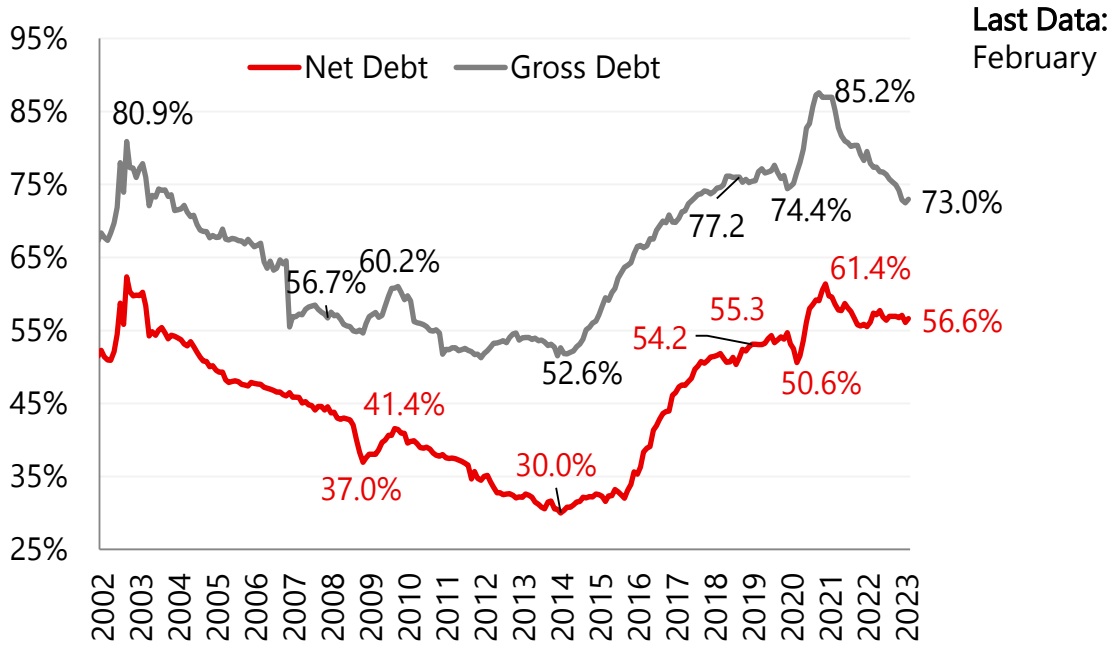
- Interest payments totaled BRL64 billion in February, compared to BRL26 billion in the same month of last year. In a 12-month reading, the nominal result totaled -BRL565 billion (5.6% of GDP). For 2023, we expect an increased cost of debt, owing to the more elevated Selic rate. Thus, we expect the nominal result to reach close to 8.7% of GDP this year.
- Debt data registered a rise in February. Gross debt reached 73% of GDP (+0.5 pp in the month), reflecting the interest accrual (+0.6pp). Net debt was 56.6% of GDP, a rise of 0.5pp. Voluntary deposits in the Central Bank (not included in debt statistics) reduced 0.2pp to 0.6% of GDP.

Nominal Interest Result – BRL billion



Sources: Brazilian Central Bank, Santander.

Public Sector Debt (12m % GDP)



Sources: Brazilian Central Bank, Santander.

Public Debt Scenario and Simulations

05

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 **80%**
- We see the neutral interest rate hypothesis at 5.0%, this implies a larger primary surplus needed to stabilize the debt.
- Not considering the effects of the cyclical recovery, the long-term outlook will require a remaining 3.0p.p. of GDP primary fiscal adjustment, just to stabilize the ratio debt-to-GDP around the level of ~80% of GDP.

- **Current situation:**

. Real interest rate (ex-ante) 1-year: 7.6%,
. GDP: 0.8% in 2023 and 0.5% in 2024

Liquidity reserves close to 8 months of debt maturities

Increase in debt cost (Selic + IPCA)

- **Steady-state:**

According to our hypothesis:
. Real interest rate at +5.0%
. Potential GDP at +1.5%,

. The primary surplus must reach >2% of GDP to maintain the gross debt stable.

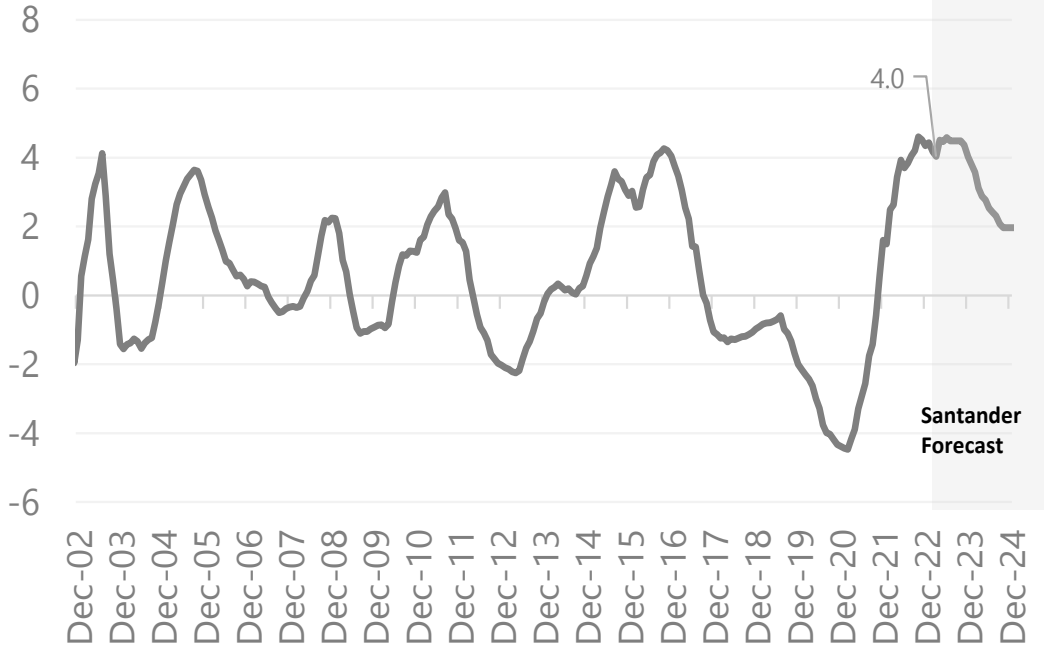
		Real Interest Rate						
		1.0%	*2.0%*	*3.0%*	*4.0%*	*5.0%*	*6.0%*	*7.0%*
GDP Growth	*0.0%*	0.8	1.6	2.4	3.2	4.0	4.8	5.6
	1.0%	0.0	0.8	1.6	2.4	3.2	4.0	4.8
	1.5%	-0.4	0.4	1.2	2.0	2.8	3.5	4.3
	1.8%	-0.6	0.2	0.9	1.7	2.5	3.3	4.1
	2.0%	-0.8	0.0	0.8	1.6	2.4	3.1	3.9
	2.5%	-1.2	-0.4	0.4	1.2	2.0	2.7	3.5

Sources: BCB, Santander.

MONETARY POLICY: Unfavorable Waters to Navigate

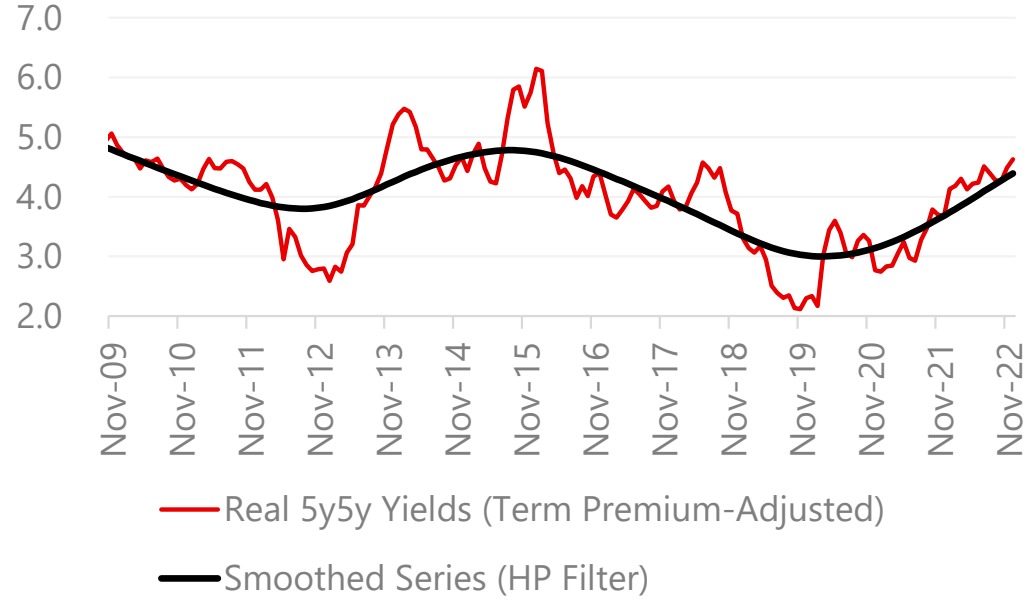
- The gap between 18-month ahead IPCA forecasts and the calendar-adjusted target remains high, running above 100bps.
- Our asset-based proxy for the neutral level of real interest rate is moving towards 5%.

Neutral Rates Could Be On The Rise



Sources: Brazilian Central Bank, Santander.

Neutral Rates Could Be Rising Further

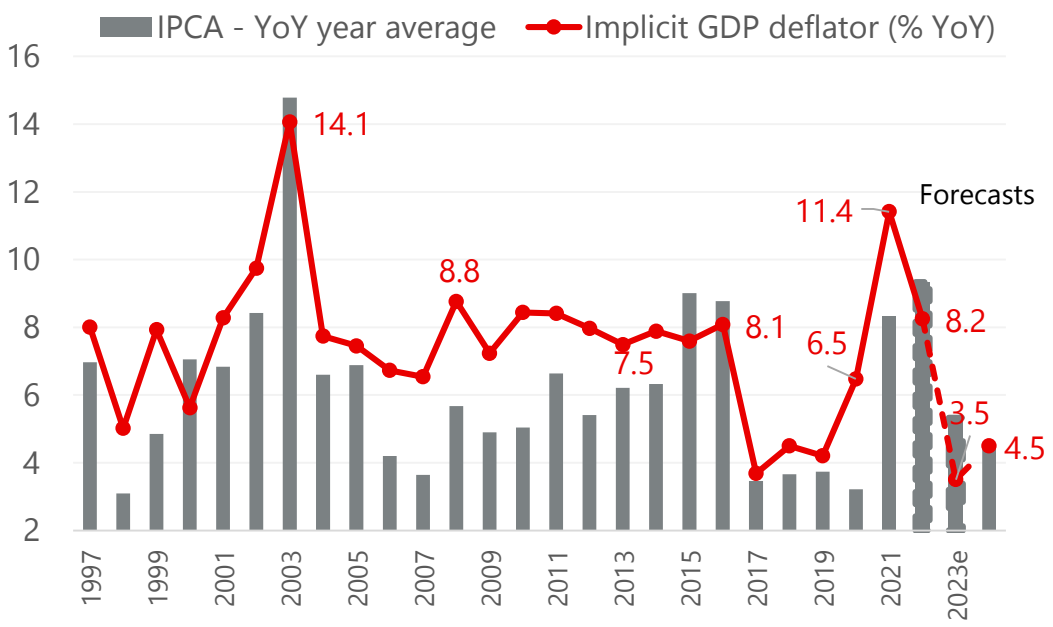


Sources: Brazilian Central Bank, Anbima, Santander.

GDP Deflator Impact – Inverse effect on 2023 on lower IGP-M

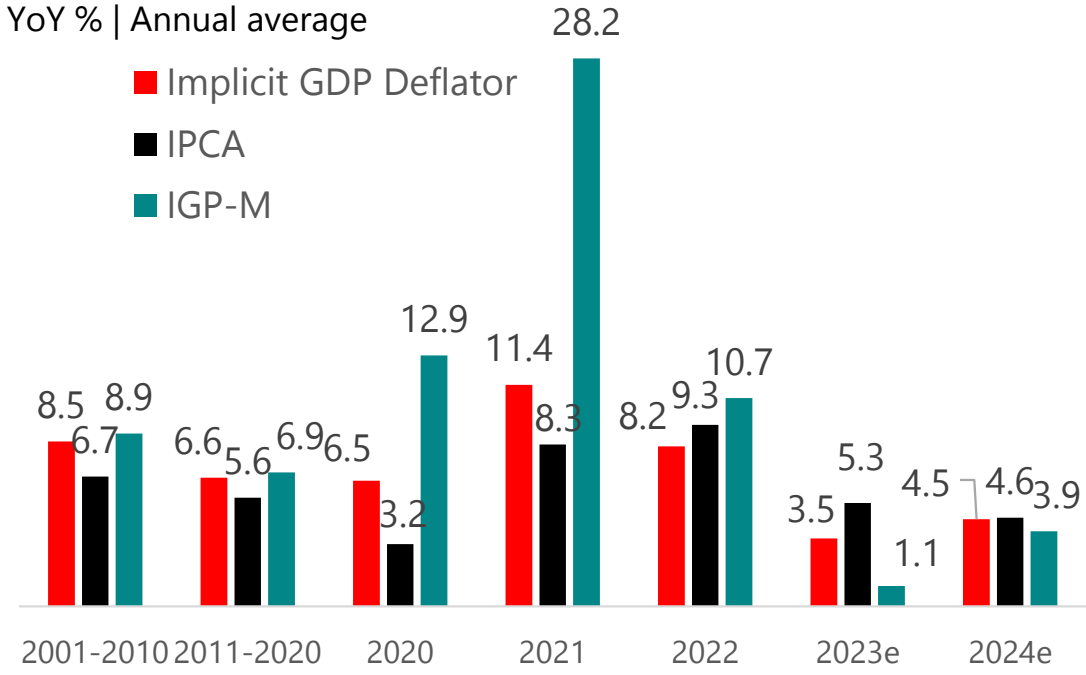
- After helping the increase in Nominal GDP, we estimate that the GDP Deflator will be lower than the IPCA numbers.

IPCA and GDP Deflator



Sources: IBGE, Santander.

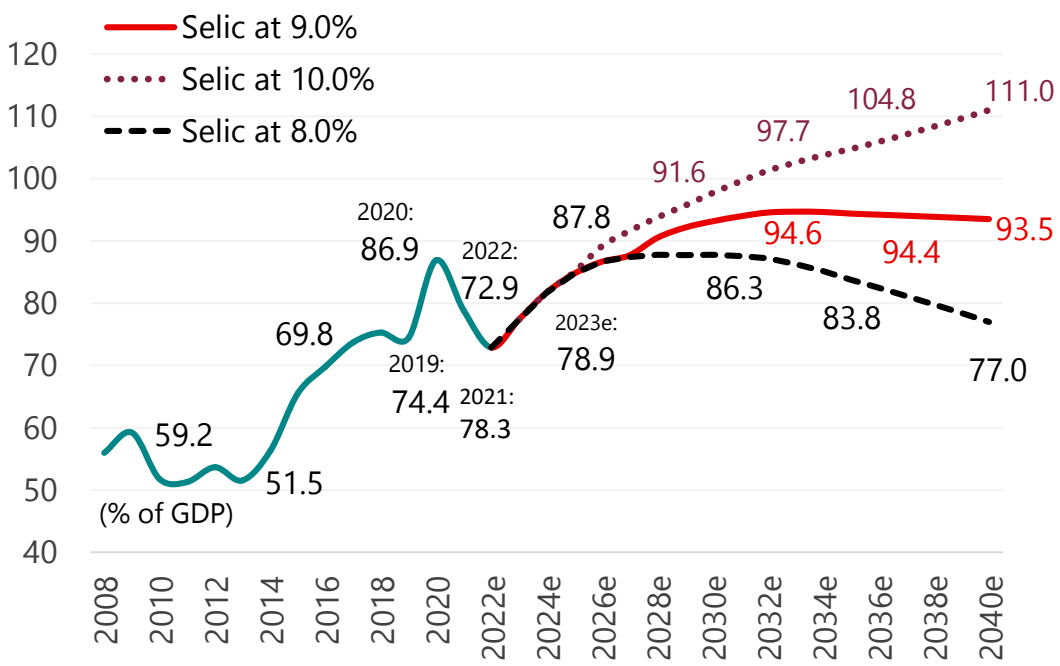
IPCA, IGP-DI and GDP Deflator



Sources: IBGE, FGV, Santander.

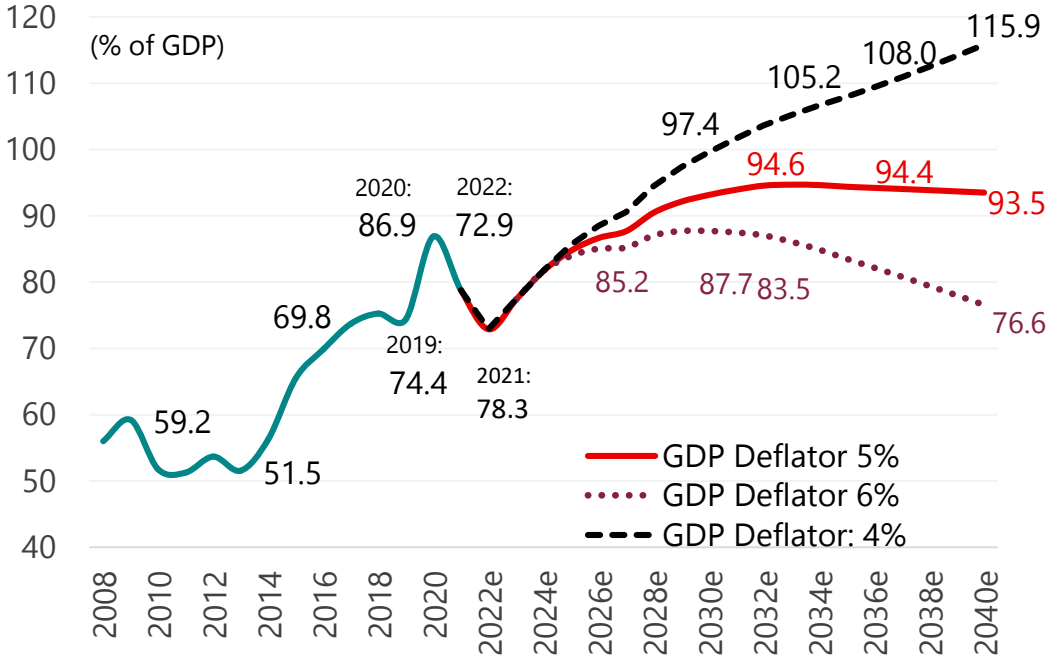
Debt Scenarios: Sensitivity to Changes in the Long Run Macro-outlook

Government Debt – Simulations for Selic Rate Hypotheses



Sources: BCB, Santander

Government Debt– Simulating for GDP Deflator Hypotheses



Sources: BCB, Santander.

Notes: Debt issuances: we added a spread of + 1.0 pp in addition to the Selic rate in the models.
2023 GDP Deflator: 3.5% | GDP: 0.8% | Selic Rate (avg): 13.6% | BNDES payment: zero | Voluntary Deposits 1.0% of GDP
2023-40: GDP deflator: 5.0% | Potential GDP: 1.5% | Neutral Real Rate: 5.0%

Debt Management – Debt cost on the rise, liquidity reserves to navigate uncertainties

06

Annual Borrowing Plan 2023

- In our view, the outlook for debt management remains challenging in the medium-term, considering the higher level of domestic debt, in context of an increase in the debt cost and the uncertainty about the fiscal consolidation ahead. In addition, it will be important the level of liquidity reserve and favorable market conditions. In the short-term, the liquidity debt cushion is at a comfortable level to navigate the uncertainties.
- Debt issuance reached BRL61.4 billion in the month, concentrated in fixed rate (45%) and floating rate (40%) bonds. The issuance was a tad lower than the last 12-month average of BRL81.7 billion. Weekly bond issuances reached ~BRL19 billion up to February. For 2023, we estimate ~BRL25 billion in issuances would be required per week to keep liquidity reserves stable until the end of the year.

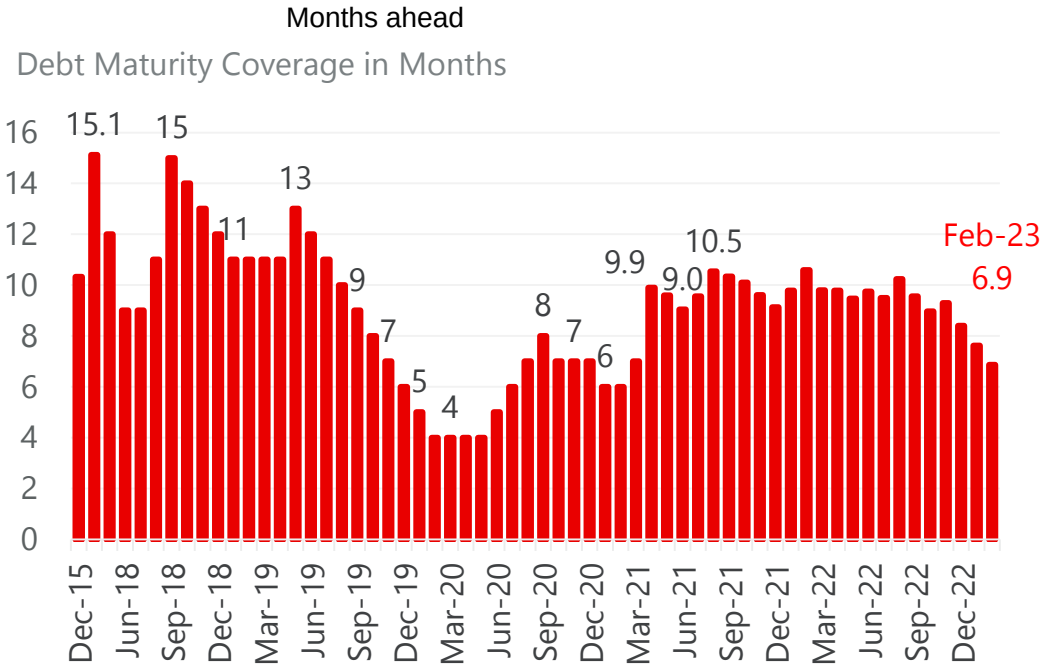
Annual Borrowing Plan (PAF 2023)									
	2020	2021	2022	Jan-23	Feb-23	PAF 2023 range		PAF 2022 range	
Outstanding volume (BRL billion)						Min	Max	Min	Max
Federal Public Debt	5,010	5,614	5,951	5,767	5,856	6,400	6,800	6000	6400
Composition (%)									
Fixed-rate	34.8	28.9	27.0	23.5	23.7	23	27	24	28
Inflation-linked	25.3	29.3	30.3	31.7	31.3	29	33	27	31
Floating-rate	34.8	36.8	38.3	40.5	40.6	38	42	38	42
FX	5.1	5.0	4.4	4.3	4.3	3	7	3	7
Maturity Structure									
% maturing in 12 months	27.6	21	22.1	22.6	22.5	19	23	19	23
Average maturity (years)	3.6	3.8	3.0	4.0	4.0	3.8	4.2	3.8	4.2

Sources: National Treasury; Santander

Treasury's Cash Position at comfortable level to navigate the uncertainties

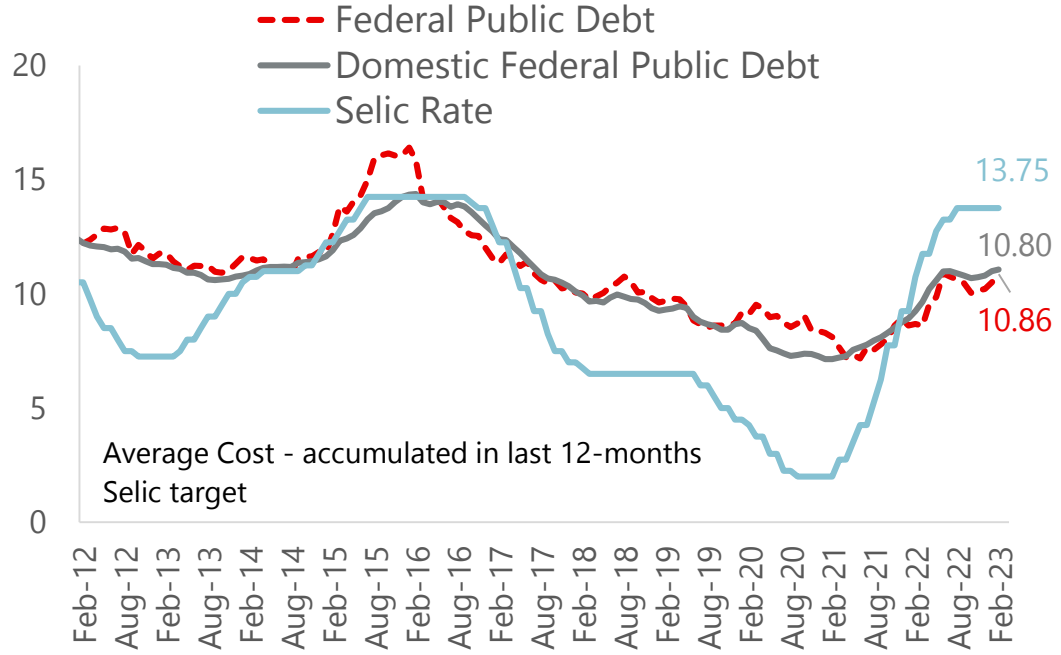
- Public debt liquidity reserves rose BRL42 billion in February (+4.4% MoM in nominal terms), reaching BRL996 billion and reflecting the net issuances in the month and the National Treasury result. This level of liquidity reserves covers close to 6.9 months of debt maturities (from 7.6 in January, 8.4 in December and 9.3 in November). Despite the increase in nominal terms, the higher level of debt maturing months ahead, statistically reduced this value. According to the National Treasury, this level of liquidity index is already in 9.1 months of debt maturities up to March 24, with higher issuances and higher bond maturities in the month.

Liquidity cushion coverage of domestic debt



Sources: National Treasury, Santander.

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

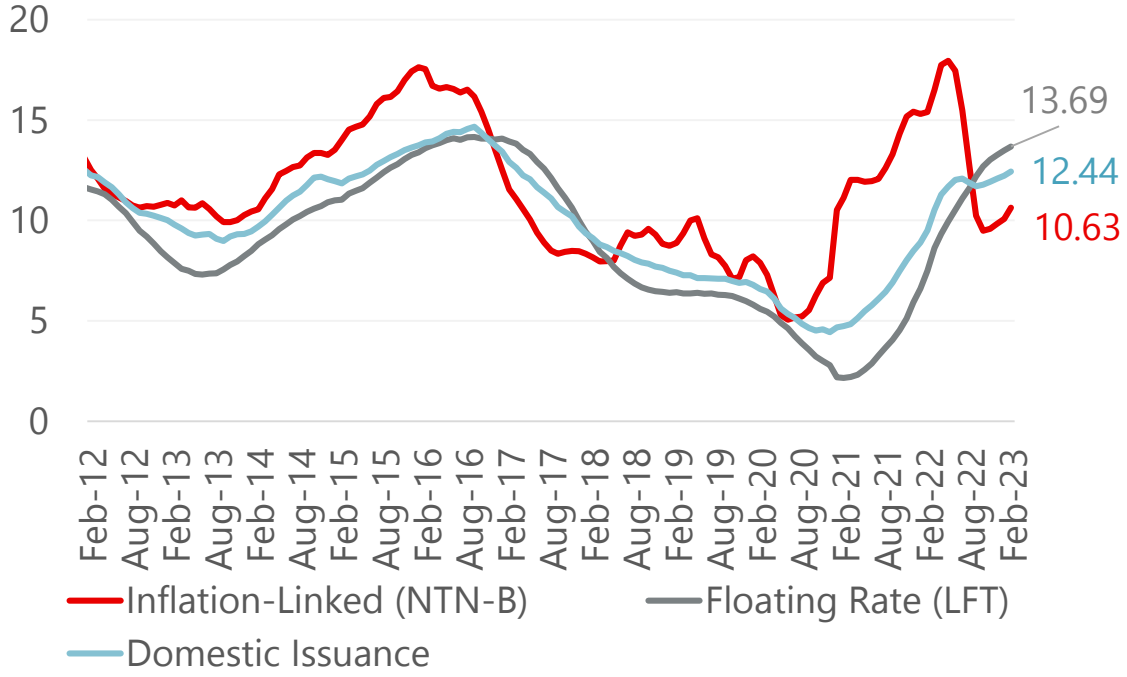


Sources: National Treasury, Santander.

At the margin there is an increase in debt cost related to Selic

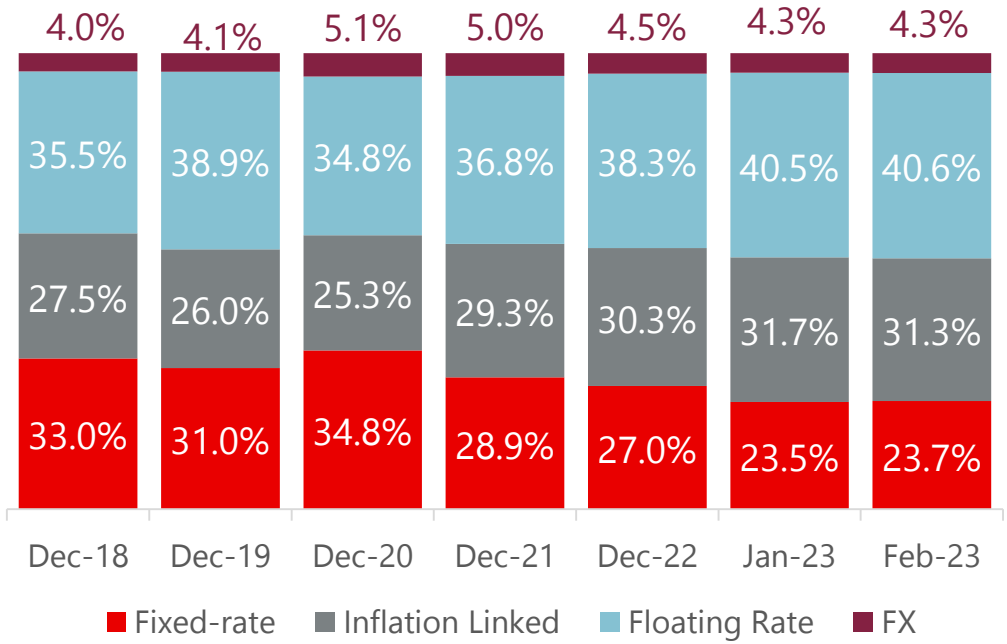
- The cost of new domestic issuances rose slightly to 12.4% p.a. in February vs. 12.2% p.a. in January. The debt cost of LFT bonds accumulated in the last 12 months increased to 12.5% (from 12.4% in January and 4.5% in December 2021), and the current level of Selic rate (13.75%) could create additional pressure on debt costs in the coming months, in our view.

Average Debt Cost in the last 12 M (Accum.)



Sources: National Treasury, Santander.

Debt Profile - %

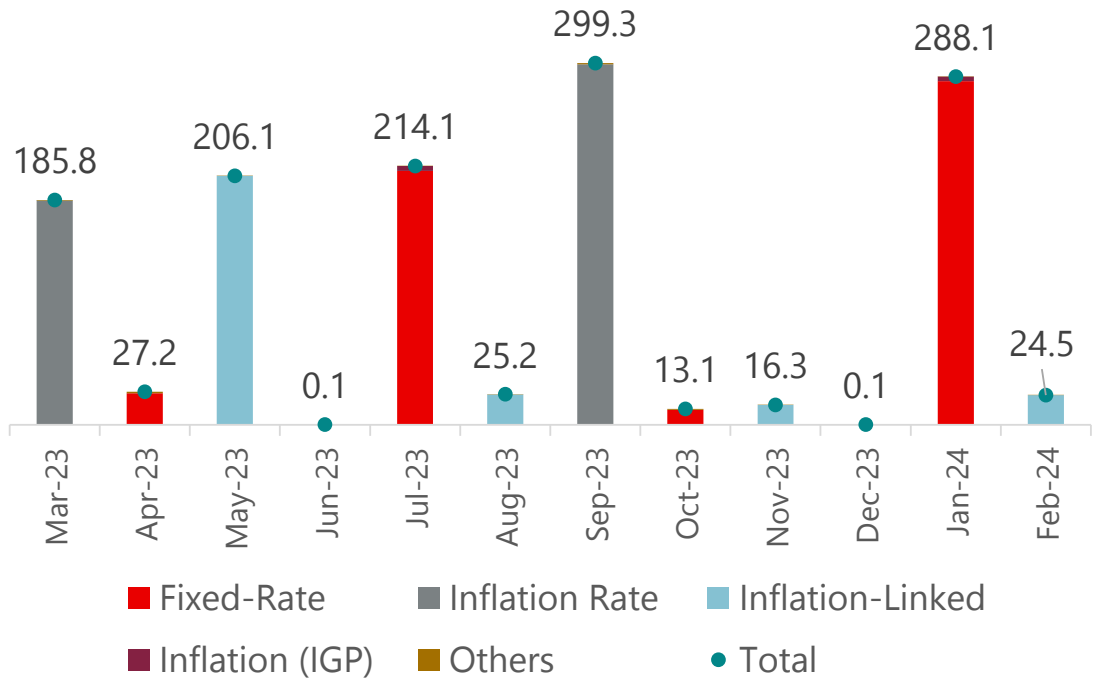


Sources: National Treasury, Santander.

Fiscal – The debt is at a higher level

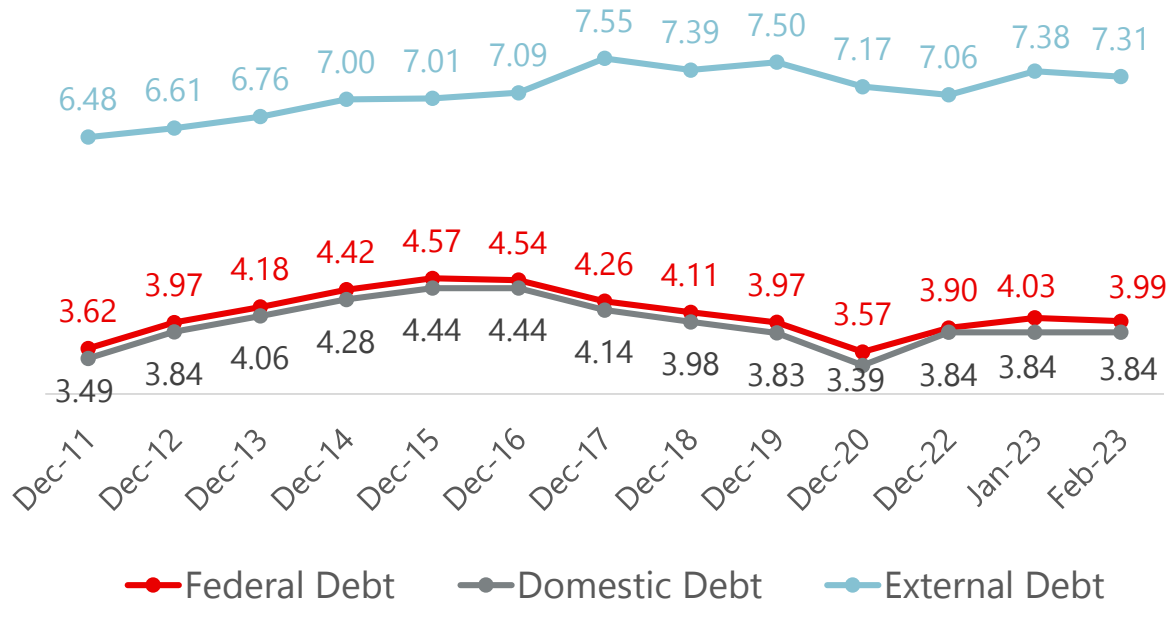
- Despite the increase in liquidity reserves the debt maturity level is still challenging. Structural reforms will help to increase debt maturity and reach a sustainable primary surplus.

Debt maturity - (BRL billion)



Sources: National Treasury, Santander

Average Maturity (years)



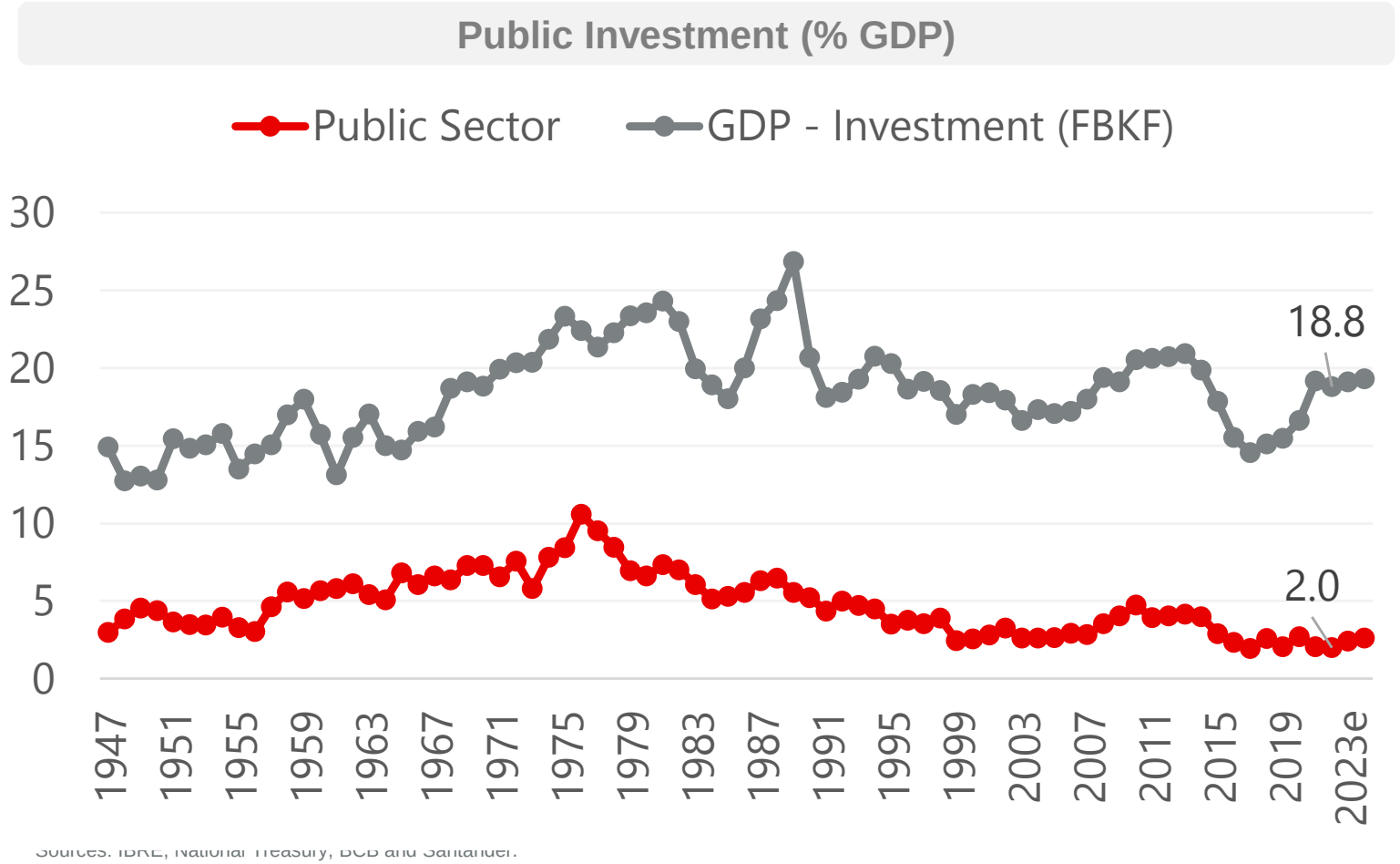
Sources: National Treasury, Santander.

Others

07

Public Investment at low levels

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

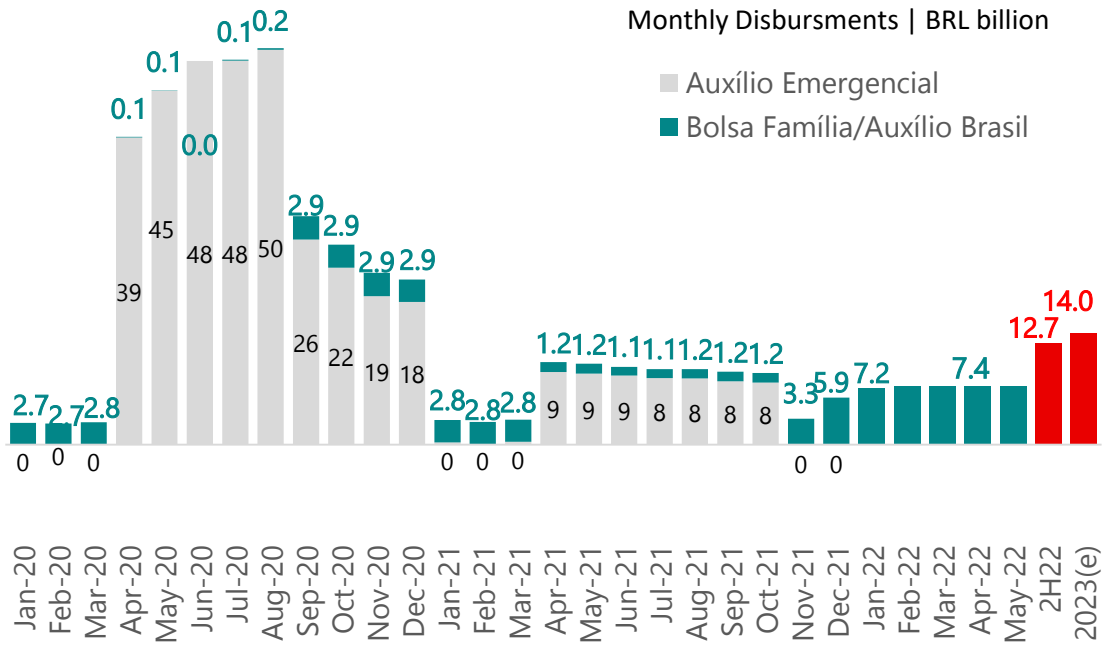


Sources: IBRE, National Treasury, BCB and Santander.

Fiscal Policy: increase in the welfare program outlays

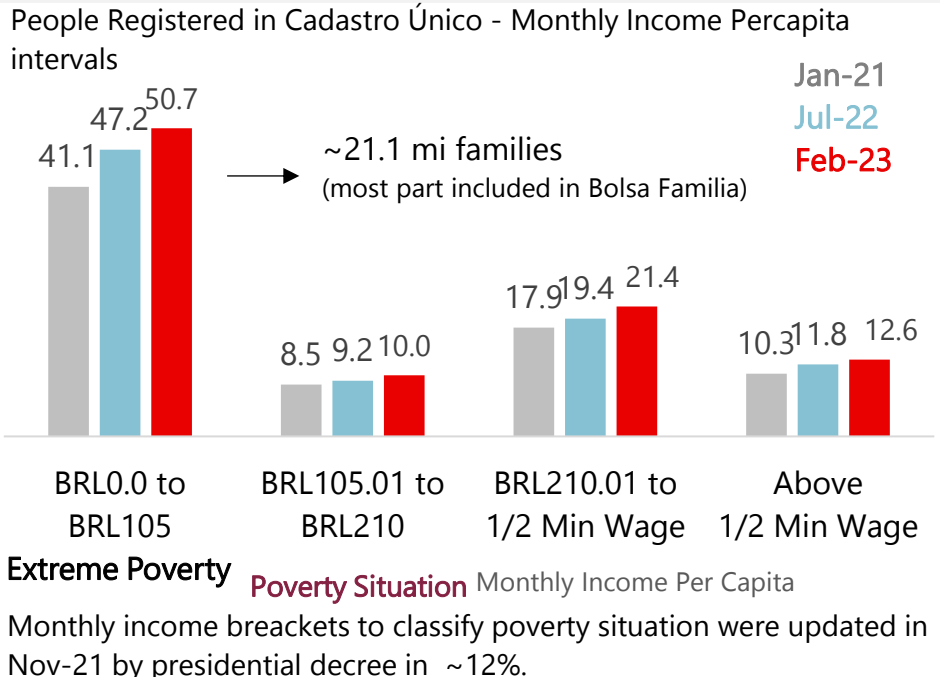
- With the review of the registry, which eliminated mainly families consisting of a single person, 1.48 million beneficiaries were excluded from Bolsa Família and 694.2 thousand families included, of which 335.7 thousand with children up to 6 years old.
- We have increased the total disbursement estimate for the welfare program (Bolsa Família) by BRL15 billion, to BRL165 billion.
- In March, 21.1 million families, from 5,570 Brazilian municipalities, will receive an average amount of BRL670, the all-time high. In February, they were BRL607 (we see it rising to BRL710 with the teenager benefit to be added in mid-2023. In addition, the more than BRL14 billion in investment represents the program's monthly record.

Welfare Program Outlays



Sources: Ministry of Economy, Santander

Cad Único – Gov. Database

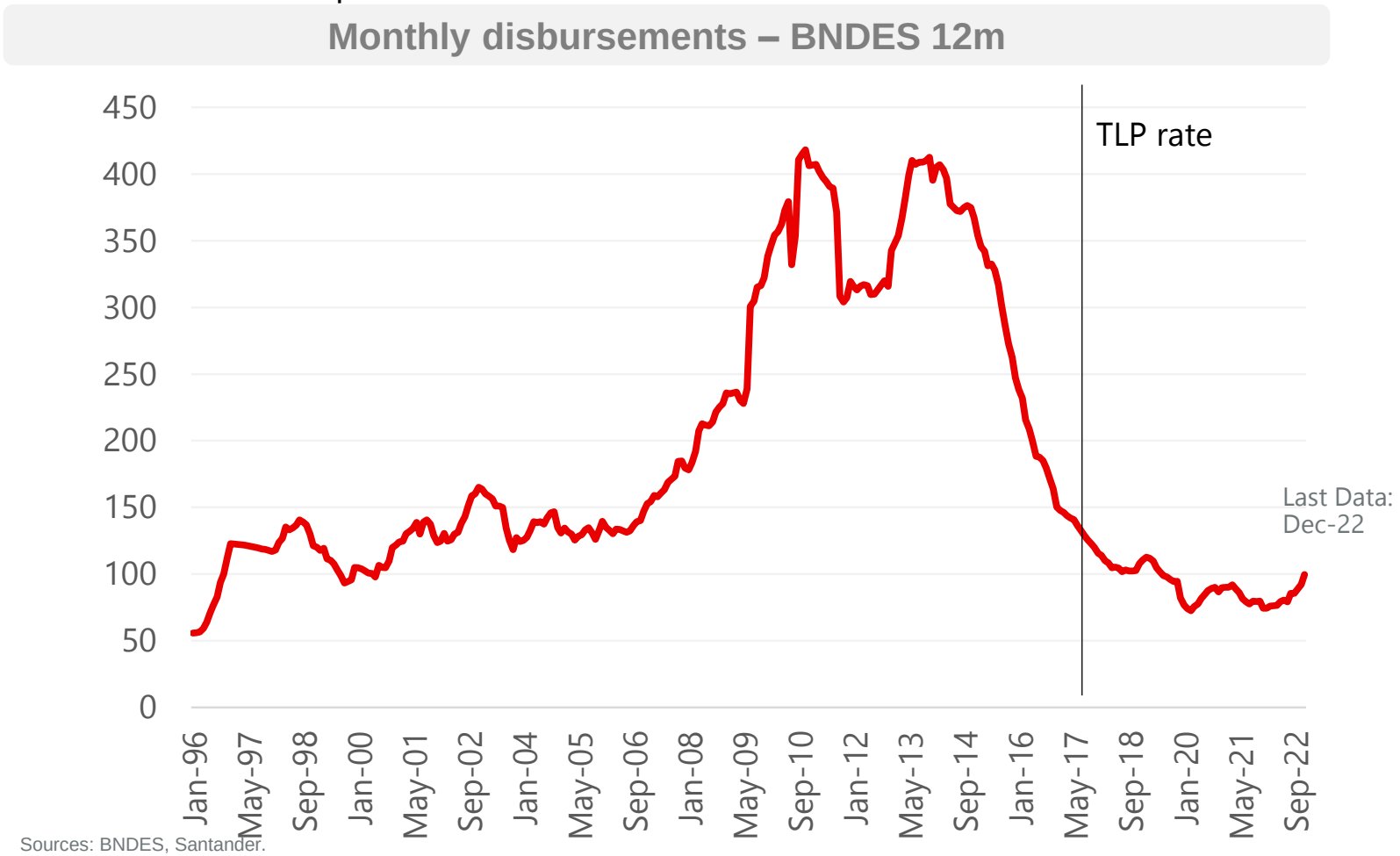


Monthly income breackets to classify poverty situation were updated in Nov-21 by presidential decree in ~12%.

Sources: *Ministério da Cidadania,* Santander

BNDES – Public Bank

- According to the new president of BNDES the plan “is to return to the historic level of BNDES disbursements since the beginning of the implementation of the Real, which is 2% of GDP. For this, we want to double the size of the BNDES by 2026 so that we can fulfill its role in economic and social development”



Sources: BNDES, Santander.

Tax Reform Proposal – New VAT tax

08

Tax Reform: General Proposals

Main Differences between PEC 45 and PEC 110

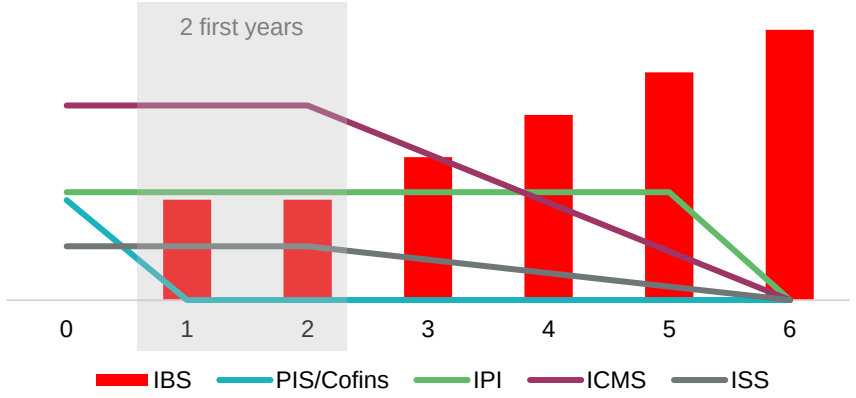
	PEC 45 / 2019	PEC 110 / 2019
Legislative Process	Lower House; approved by the *CCJ* (legal committee) in May 2019.	Senate; Still not approved by the *CCJ* (legal committee).
Main Proposal	***IBS*** (*PIS* + *Cofins* + *IPI* + *ICMS* + *ISS*) and **selective tax**	***CBS*** (*Cofins* + *PIS*), ***IBS*** (*ICMS* + *ISS*) and **selective tax** (*IPI*)
Tax Rates	Uniform rate for all goods and services; tax rate could differ between states and municipalities	Uniform rate for all goods and services; tax rate could differ between states and municipalities
Fiscal Benefits	Allows for temporary benefits for certain activities. Does not eliminate *Simples* and *Zona Franca* taxes.	Admits the possibility of special taxation regimes and exemptions or reduced rates. Does not eliminate *Simples* and *Zona Franca* taxes.
Tax Burden	No increase in tax burden	No increase in tax burden
Transition Period for Taxpayers	6 years	7 years for *IBS*
Transition Period for Revenue Sharing	50 years	40 years

Tax Reform: General Proposals

Transition Period for Companies

- Transition would take place over six (PEC 45) or seven years (PEC 110), while maintaining the same taxable income level;
- For PEC 45, *PIS* and *Cofins* would be eliminated in the first two years, and the *IBS* rate would be fixed in order to offset federal revenue;
- Starting in the third year, there would be a gradual reduction in other taxes and an increase in *IBS*, in order to maintain collection levels. The transition would be complete in six years.

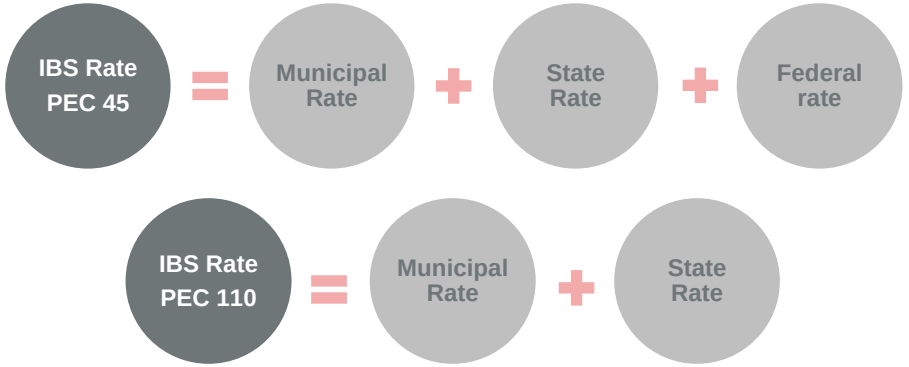
IBS (VAT) Transition Timeline Example – PEC 45



Source: Federal Gov., Congress and CCiF; Santander.

States' and Municipalities' Jurisdiction

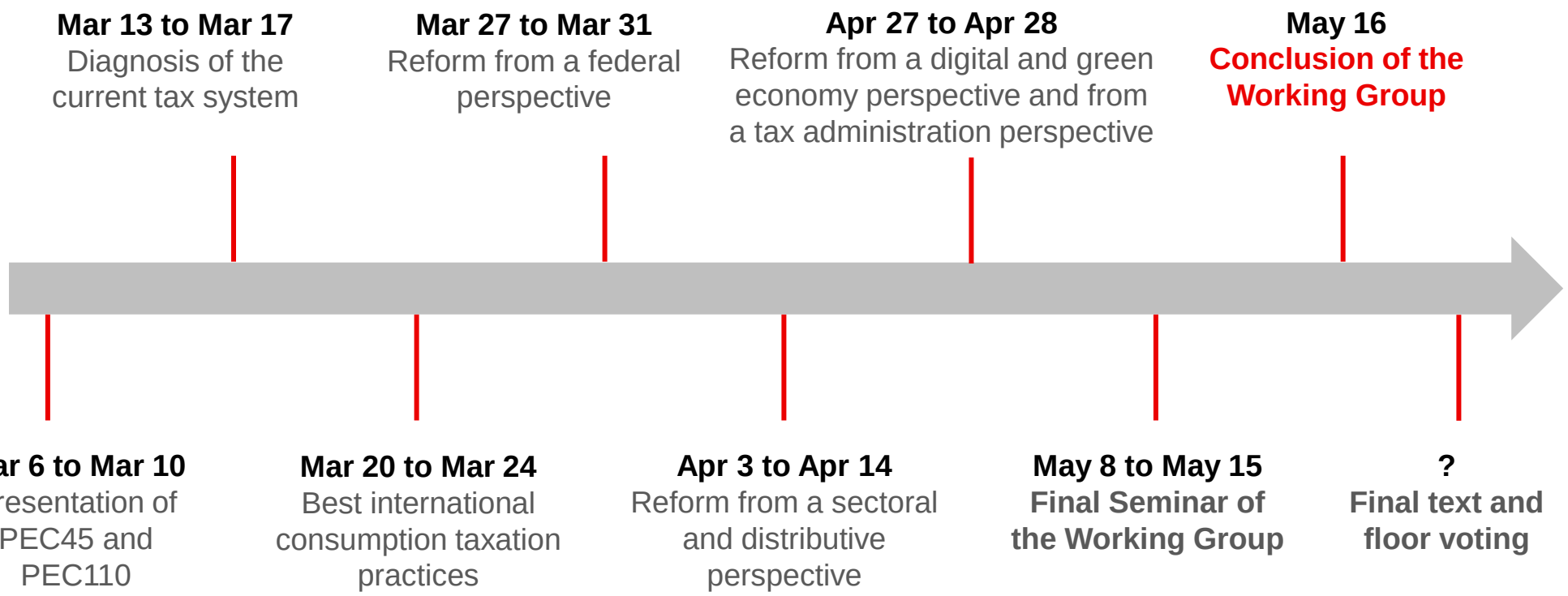
- The idea is to **maintain federal authority** while allowing states and municipalities to independently regulate IBS rates.
- **As a result, the tax rate could differ among states and municipalities but would be the same for all goods and services inside each federal entity.**
- In interstate or intercity operations, the tax rate in the state and municipality of the good or service's **DESTINATION** would be applied.



Sources: *CCiF and Pra Ser Justo*.

Tax Reform: Legislative Debate – Constitutional Amendments

Expected Calendar – Lower House Working Group

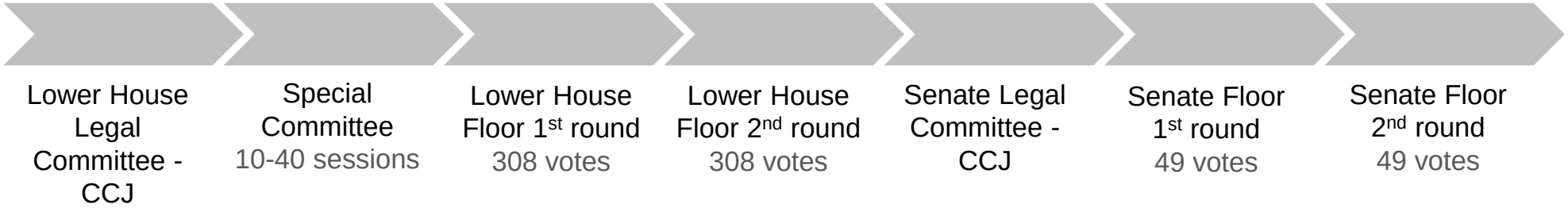


Working Group with 15 members:
Coordinator: Reginaldo Lopes (PT-MG), **Rapporteur**: Aguinaldo Ribeiro (PP-PB)

Others: Saullo Vianna (União Brasil-AM), Mauro Benevides Filho (PDT-CE), Glaustin da Fokus (PSC-GO), Newton Cardoso Júnior (MDB-MG), Ivan Valente (PSOL-SP), Jonas Donizette (PSB-SP), Sidney Leite (PSD-AM), Luiz Philippe de Orleans e Bragança (PL-SP), Vitor Lippi (PSDB-SP) e Adail Filho (Republicanos-AM), Pedro Paulo (PSD), Tabata Amaral (PSB-SP), RS deputy

Tax Reform: General Proposals

Legislative Process – Constitutional Amendment (PEC)



Lower House's working group, created to analyze and discuss Tax Reform

Total Number of Deputies: 513 (3/5 for the proposals to be approved; 308 votes)
Total Number of Senators: 81 (3/5 for the proposals to be approved; 49 votes)

Complementary law approval (PLP): 50% + 1

Changes in the Senate return to the Lower House for review
There is no presidential veto for a PEC approved by Congress

The Process of Changing the Tax System in Brazil

- First, the constitutional amendment must be approved; after that, the Complementary Law must be approved, with the VAT tax value and definition of specifics of the new system

Possible implementation schedule

Approval of Broad Tax Reform (PEC)

2023

Complementary Law: defining the tax value

2H23 or 1H24

One year to implement the VAT Federal System

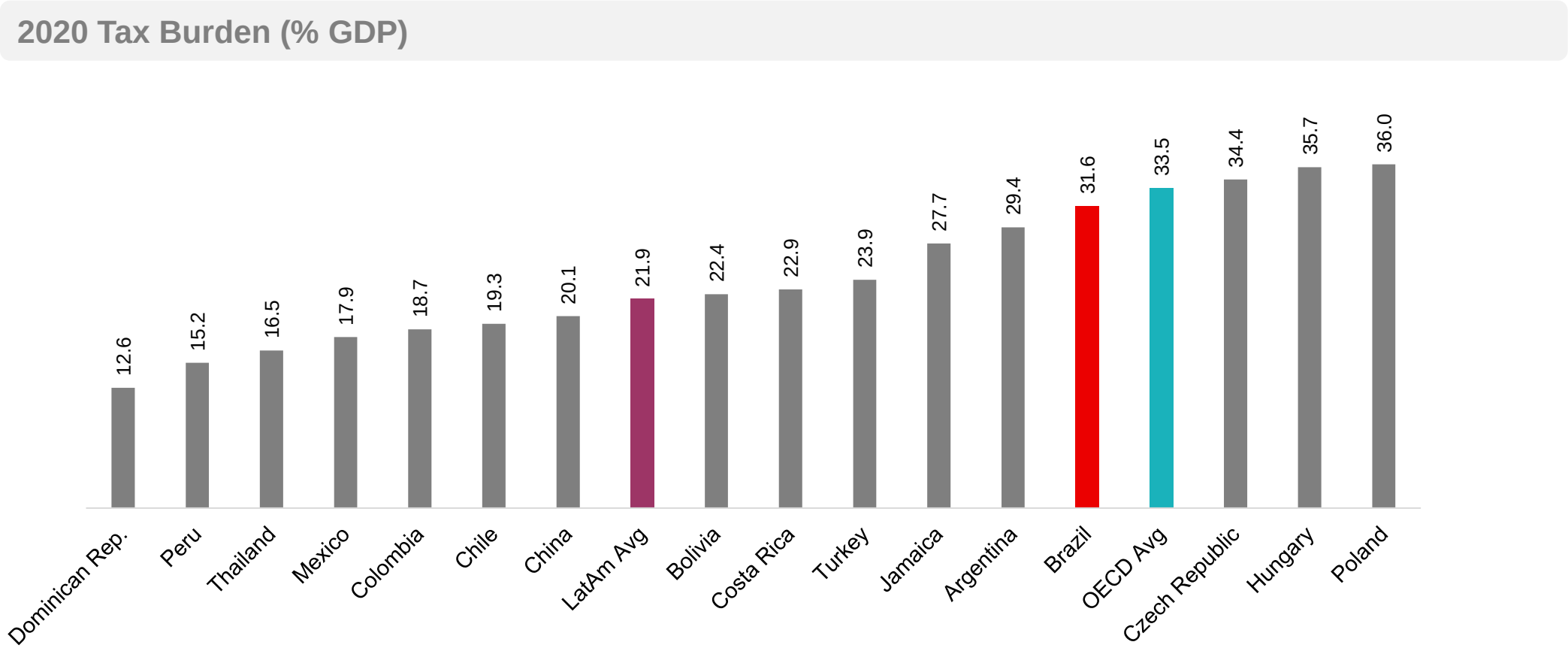
2025

Change in Subnational Entities Tax System

2027

Brazil: One of the Highest Tax Burdens Among Emerging Markets

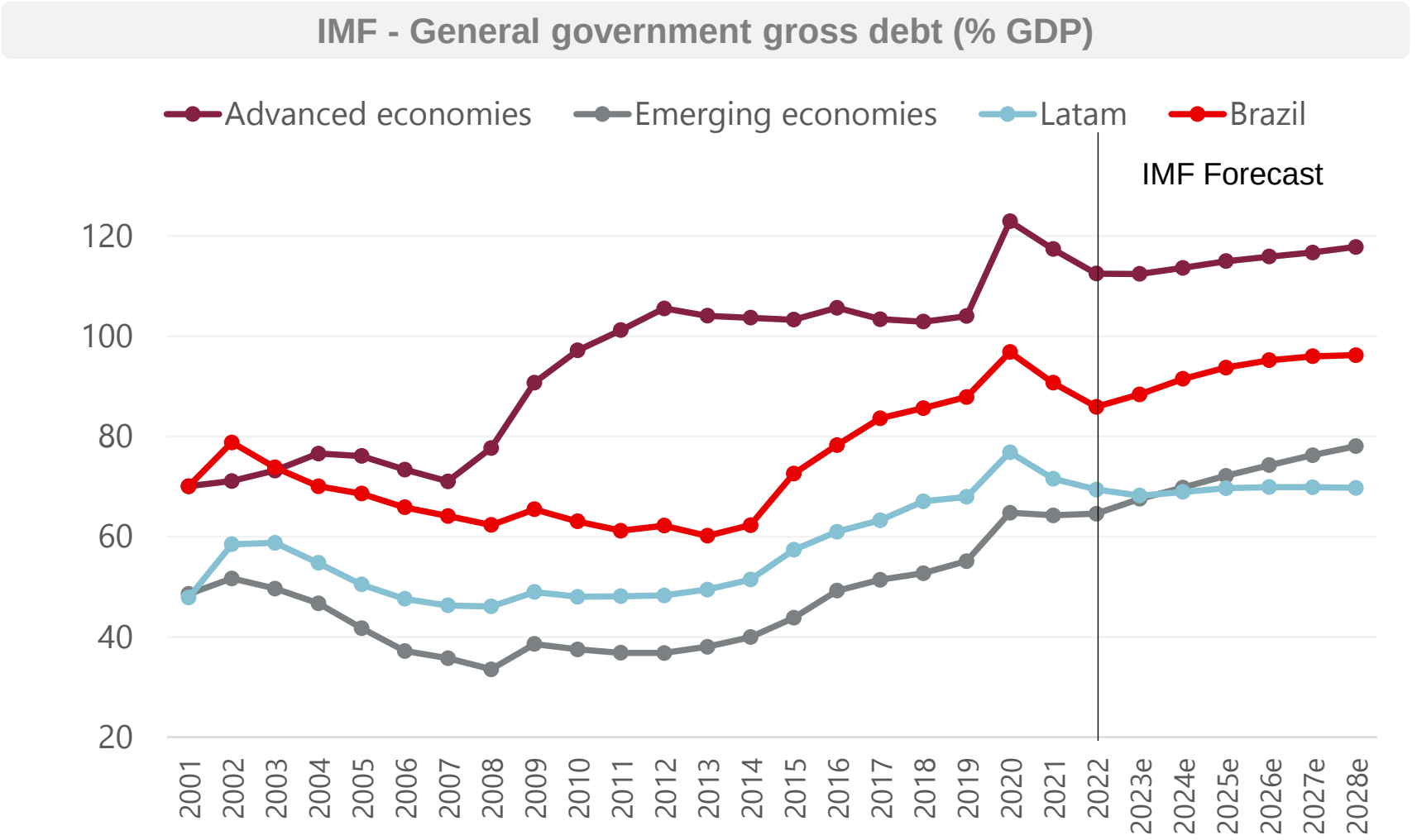
- Considering OECD data, Brazil's tax revenue was 31.6% of GDP in 2020, the 4th highest among emerging economies.
- From 1990 to 2020: Brazil's tax revenue rose 3.9 pp, compared to LatAm (4.2 pp) and OCDE countries (2.7 pp).



International Comparison

08

International Comparison – IMF Gross Debt Forecast

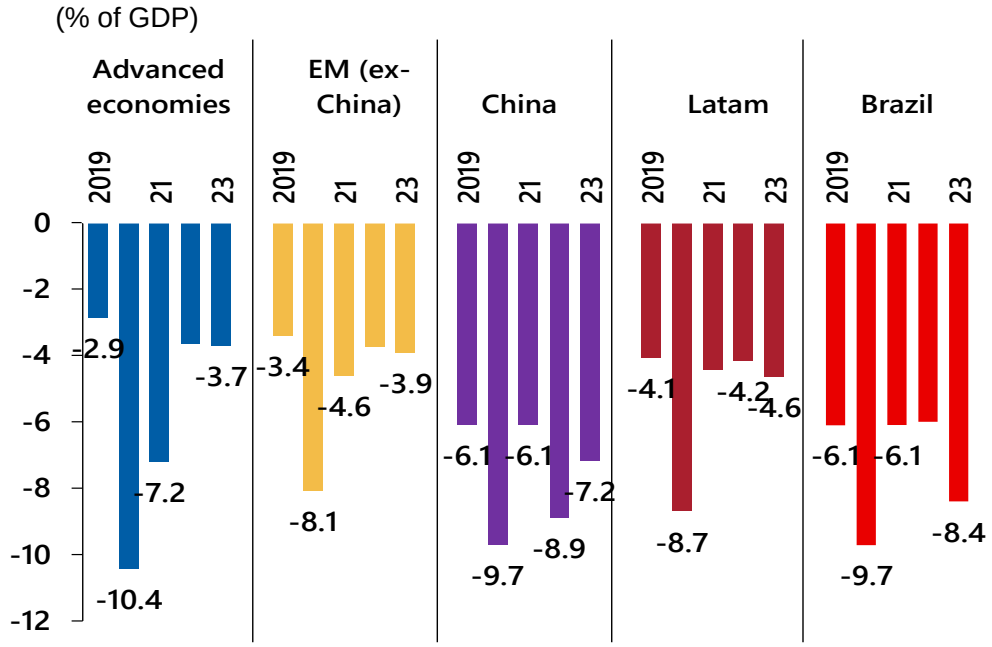


Sources: IMF, Santander.

International Comparison – Increase in interest rates

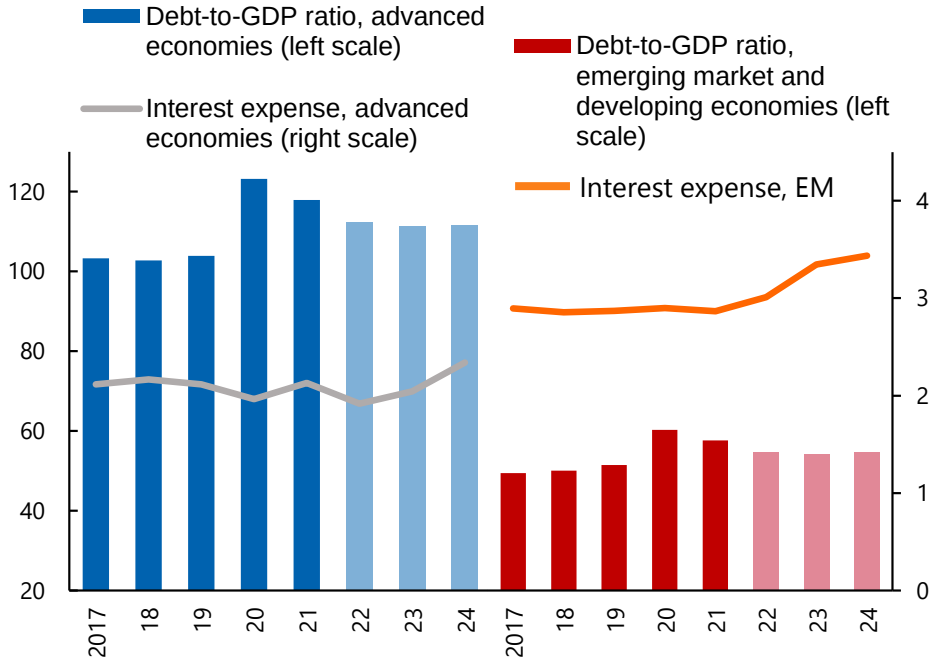
- The effect of current monetary tightening on fiscal accounts

National Budget Balances by Income Group



Sources: IMF, Santander.

National Gross Debt and Interest Expense by Income Group

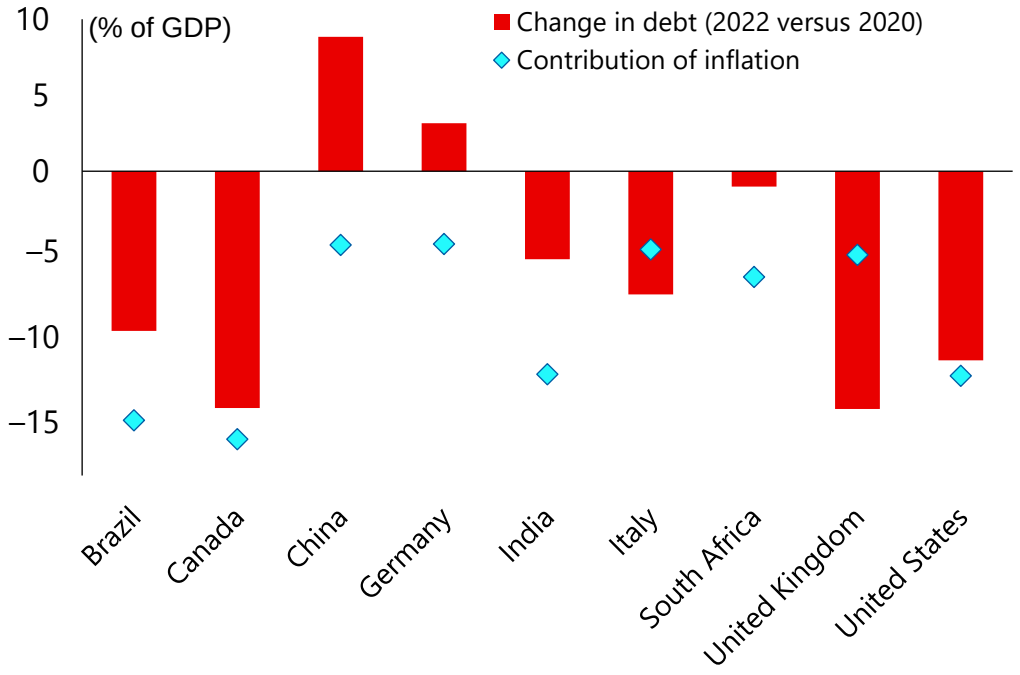


Sources: IMF, World Economic Outlook; IMF staff calculations. Note: China is excluded. Bars for 2022–24 are projected data.

International Comparison – Inflation impact on Fiscal

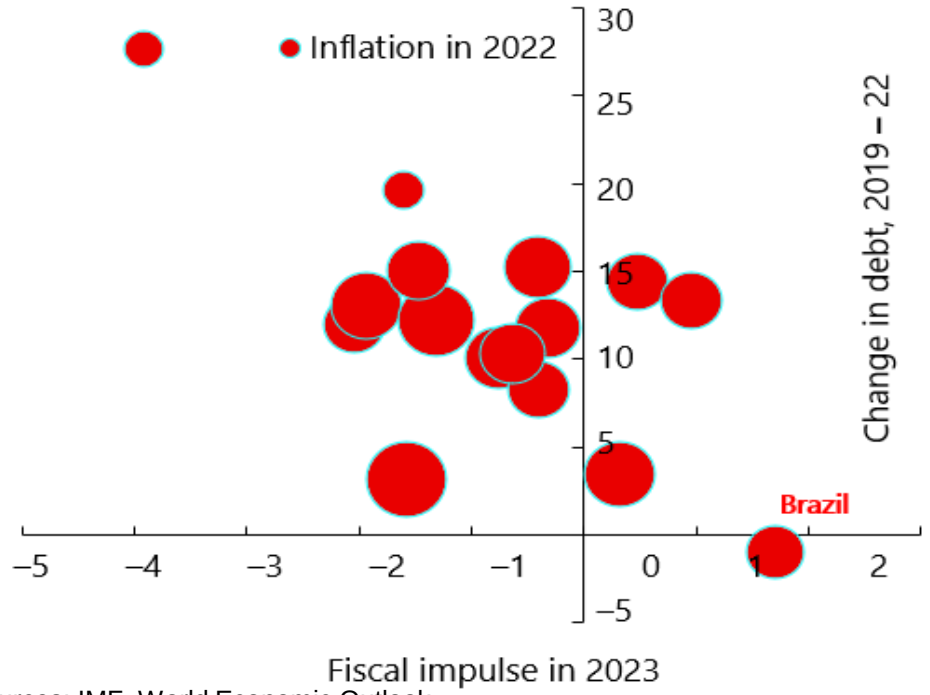
- Inflation had an effect on fiscal accounts.

Effect of Inflation Shock on the Debt Ratio



Sources: IMF, Santander.

Fiscal Impulse, Inflation, and Debt for G20 Countries



Sources: IMF, World Economic Outlook.
Note: Includes Spain; excludes Argentina, Russia, Saudi Arabia, and Tűrkiye. Fiscal impulse is measured by the change in the cyclically-adjusted primary balance. The size of the bubble reflects the inflation rate.

Tables - Forecasts

09

MACRO SCENARIO: Forecasts

Macroeconomic Variables		Previous		Current
GDP (%)	2023E	0.8	→	0.8
	2024E	0.5	→	0.5
	2025E	1.5	→	1.5
IPCA (%)	2023E	5.9	↑	6.1
	2024E	3.7	↑	3.9
	2025E	4.0	↑	4.5
Selic Rate (% end of period)	2023E	13.00	→	13.00
	2024E	11.00	→	11.00
	2025E	8.00	→	8.00
FX Rate - USDBRL (end of period)	2023E	5.40	→	5.40
	2024E	5.50	→	5.50
	2025E	5.55	→	5.55
Current Account Balance (% of GDP)	2023E	-3.1	→	-3.1
	2024E	-3.4	→	-3.4
	2025E	-3.1	→	-3.1
Primary Fiscal Balance (% of GDP)	2023E	-1.4	↑	-1.2
	2024E	-1.2	↑	-1.1
	2025E	-0.8	↓	-0.9
Gross Public Debt (% of GDP)	2023E	78.8	↓	77.4
	2024E	83.4	↓	81.7
	2025E	86.7	↓	84.8

Sources: Santander

Note: Previous scenario update from February 09, 2023

The forecasts refers to our latest Scenario Update

"Upping CPI Estimates...again"
(sent on April 06, 2023)

For the full report click on the link:

https://bit.ly/Std-scenreview-apr23

MACRO SCENARIO: Santander Brazil's Global Macro Assumptions – Summary

Global Macro Scenario	2018	2019	2020	2021	2022	2023E	2024E	2025E
Global GDP (%)	3.5	2.8	-3.5	5.9	3.4	2.4	2.3	2.6
China GDP (%)	6.7	6.0	2.3	8.1	3.0	5.9	5.3	5.0
US GDP (%)	3.0	2.2	-3.5	5.7	2.1	0.5	0.6	1.5
US Inflation (Core PCE, %)	2.1	1.6	1.5	4.9	5.0	3.7	2.5	2.0
US Interest Rate (FFR, %)	2.50	1.75	0.25	0.25	4.50	5.25	3.75	2.50
US Interest Rate (UST10y, %)	2.7	1.9	0.8	1.8	3.9	3.8	3.2	3.0
Dollar Index - DXY	96	96	90	96	104	102	100	100
Commodity Prices - CRB	409	401	444	571	558	514	474	445

*Core PCE is referred to the y/y variation for Q4.

Source: Santander

The forecasts refers to our latest Scenario Update

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(sent on April 06, 2023)

For the full report click on the link:

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

Simple Personal Fair

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