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BRAZIL—Fiscal Policy

The New (No) Fiscal Target

Tatiana Pinheiro*
tatiana.pinheiro@santander.com.br
5511-3012-5179

- **We are revising downward our forecast for the central government primary deficit in 2016 to 2.3% of GDP (BRL142.1 billion) from 1.8% of GDP (BRL108 billion), mainly because of the reduction in the probability of an additional fiscal package.**
- **The primary balance downward revision is bad news in the short term, in our opinion, because it is still far from our primary balance estimate that is required to stabilize the debt ratio to GDP, a surplus of 2-3% of GDP range.**
- **In our opinion, an over-delivery, i.e., a smaller primary deficit, depends on if the government underestimates revenue or on a revenue surprise**
- **However, the government also announced some measures that mitigate the gross debt ratio to GDP upward trend—good news for the long term, in our view.**
- **We see the gross debt ratio to GDP peaking at 75.5% of GDP in 2017.**

Introduction

The Congressional Budget Commission approved the new fiscal target for 2016 on May 25. According to that, the central government (National Treasury +BCB + Social Security) primary balance can achieve a deficit BRL170.5 billion this year (2.75% of GDP), which is far from our estimate for the primary balance required to stabilize the debt ratio to GDP—a surplus of 2-3% of GDP range. (For further details, see our report, *The Fiscal Maze III: Insurgent*, dated October 29, 2015.).The primary target for the total public sector, including regional states, is a deficit BRL 163.9 billion (2.65% of GDP).

The central government primary balance downward revision is bad news for the short term, in our view. However, the government also announced some measures intending to reduce the gross debt ratio to GDP and to limit the spending growth pace in the long term, which is good news for the long term.

Main measures proposed by the government as a Constitutional amendment, which require a three-fifth majority of votes and have to be voted on twice, in both the Lower House and Senate, follow:

- Prepayment of BRL100 billion in the BNDES loans to the National treasury (in installments: BRL40 billion in 2016; BRL30 billion in 2017, and BRL30 billion in 2018)
- Limit the spending growth to inflation of the previous year (in other words, no longer spending growth in real terms)
- Unwinding of the Sovereign Wealth Fund (Fundo Soberano) (an impact of BRL2 billion revenue on the primary balance)

These measures can mitigate the gross debt ratio to GDP upward trend. We revised our debt ratio to GDP. Previously, we forecast that the gross debt ratio to GDP would peak at 75.9% of GDP in 2017. If the prepayment of BNDES can be made fulfilling the fiscal responsibility law, which means it does not characterize a BNDES loan to the National Treasury, we forecast the gross debt ratio to GDP peaking at 75.5% of GDP in 2017, and intensifying the downward trend from 2018 onward. Our assumptions are: the reversal of the current primary deficit to a surplus of 2% of GDP from 2018 onward; real interest rate at 4% from 2017 onwards, and real GDP growth at 2.5% from 2017 onward.

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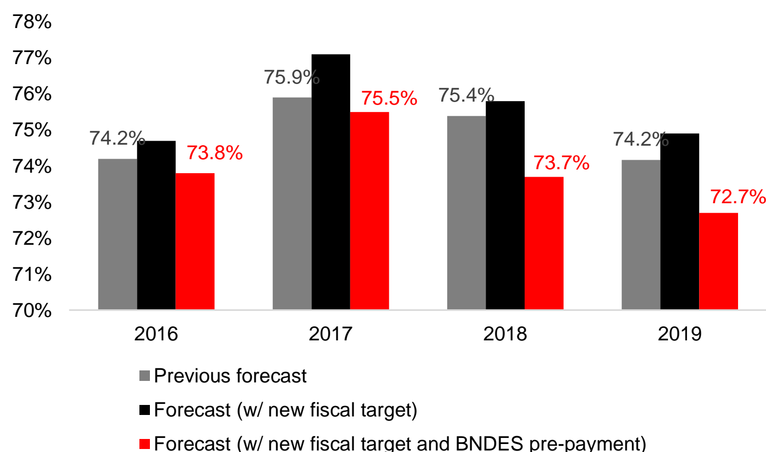

Sources: Ministry of Finance and Santander estimate.

The New (No) Fiscal Target

According to the new economic team, the reasons for the downward revision of the central government primary balance were: the worse-than-expected recession (due expenses and committed expenses): (1) the downward revision of real GDP growth to -3.8% from -1.9% would produce a tax collection shortfall of around BRL77.3 billion; and (2) the previous under-estimation of spending would produce overspending of ~BRL86.7 billion (expenses due of ~BRL56.6 billion and committed expenses of ~BRL30 billion).

Budget Evolution

	2014 (effective)	2015 (effective)	2015/2014	2016 Budget (after cuts)	2016 Budget (after cuts)/ 2015 (effective)	2016 Budget Target (new Law)	2016 Budget Target (new Law)/ 2015 (effective)	Total Adjustment
Total Revenues	1,224,041	1,251,038	2.2%	1,411,000	**12.8%**	1,286,900	**2.9%**	(124,100)
Tax collection	764,724	798,826	4.5%	862,800	**8.0%**	785,500	**-1.7%**	(77,300)
Social security revenues	337,503	350,272	3.8%	360,400	**2.9%**	356,900	**1.9%**	(3,500)
Concession/Dividends/Others	141,359	130,197	-7.9%	189,100	**45.2%**	145,800	**12.0%**	(43,300)
Transfer to Reginal Governments	210,165	215,759	2.7%	225,300	4.4%	209,000	-3.1%	(16,300)
Net Revenues	**1,013,875**	**1,035,280**	**2.1%**	**1,185,700**	**14.5%**	**1,077,900**	**4.1%**	**(107,800)**
Total Expenditures	**1,031,086**	**1,150,265**	**11.6%**	**1,161,700**	**1.0%**	**1,248,400**	**8.5%**	**86,700**
Mandatory Spendings	731,100	828,750	13.4%	949,600	**14.6%**	979,600	**18.2%**	30,000
Non-Mandatory Spendings	299,986	321,515	7.2%	212,200	**-34.0%**	248,900	**-22.6%**	36,700
Aid for Regional government + Committed investments expenses net from Foreign asset repatriation revenue						19,900		19,900
Fiscal Balance of central gov't (primary balance)	**(17,211)**	**(114,986)**		**24,000**		**(170,500)**		**(194,500)**
Fiscal Balanceof central gov't (primary balance) % GDP	**-0.37**	**-1.95**		**0.39**		**-2.75**		

Sources: Ministry of Finance.

The market consensus saw this new target as a strategy of the government known as "under promise and over deliver." However, note that the difficulty of cutting spending in a recessionary environment is worse when expenses are allowed by Congressional approval. There is low incentive to deliver a smaller primary deficit—cut spending—after Congress has

approved a larger primary deficit. Moreover, regarding the new budget, the spending nominal growth at 8.5% seems realistic, given the mandatory spending used to be pressured by the expected inflation plus population growth. Therefore, in our opinion, over delivery, i.e., a smaller primary deficit, depends on the government underestimating revenue or on a revenue surprise.

We detail the factors that led to a worsening of the primary balance, according to the government's expectation a total fiscal gap of BRL194.5 billion. (1) It revised down its estimates for revenue by about BRL55 billion, no longer incorporating revenues from tax increases (tax collection of external asset repatriation, tax on banking operation, positive impact of the end of some tax exemptions and asset sales). (B) It reduced the expectation for social security contribution, and non-administrative revenue by about BRL46.8 billion , and increased the mandatory spending and part of non-mandatory spending due to the recessionary environment. (C) It increased part of defense, health, non-mandatory spending due to committed expenses by about BRL36.7 billion. (D) It included in the budget estimate the aid for regional government and committed investment expenses of about BRL19.9 billion.

Total Adjustment (BRL in Millions and % of GDP)

	Government estimate	% GDP
- tax collection shortfalls	**(55,300)**	**(0.89)**
Asset repatriation	(35,000)	(0.56)
CPMF (tax on banking operation)	(10,200)	(0.16)
the end of other tax exemptions	(6,100)	(0.10)
asset sales	(4,000)	(0.06)
- reduction of social security contribution	**(3,500)**	**(0.06)**
- non-administrative (asset selling, concession, dividends from state-owned firms), revenues shortfalls	**(43,300)**	**(0.70)**
- recession impact on revenues net transfers for regional states	**(5,800)**	
- increase of mandatory spending	**(30,000)**	**(0.48)**
- unfreeze of non-mandatory spending	**(21,200)**	**(0.34)**
- Aid for Regional government + Committed investments expenses	(19,900)	(0.32)
- public defense spending	(3,500)	(0.06)
- public health spending	(3,000)	(0.05)
- high priority investment	(9,000)	(0.15)
Total of adjustments	**(194,500)**	**(3.14)**

Sources: Ministry of Finance and Santander estimate.

Where is the under estimation?

We agree that is very difficult to increase taxes, especially in a recessionary environment. (For further details, see our report, *The Clash of Titans: Desirable versus Feasible,* dated May 12, 2016.) Thus, it is better to not consider revenues stemming from the reintroduction of CPMF (tax on banking operation) and from the end of tax exemptions. We also agree that the recessionary environment pressures mandatory spending, such as unemployment insurance and social assistance. Finally, it is reasonable, in our opinion, to expect that the former government administration had committed an important amount of current spending (non-mandatory spending) and investments, given the recent primary balance performance.

Therefore, we believe the government is under estimating the federal revenue, especially the revenue stemmed from external asset repatriation rule. We believe the growing global integration among national tax authorities makes the timing right for the success of an asset repatriation program since it will become progressively more risky to use and transfer illicit resources. We expect individuals or companies to take advantage of the amnesty to unlock liquidity of undeclared assets abroad. Therefore, we expect a tax collection of BRL 70 billion stemming from external asset repatriation, which is BRL 35 billion higher than the previous government's expectation. On the other hand, we foresee lower non-administrative revenues and higher revenues

transfers for regional states due to the GDP contraction this year. Because of that, the fiscal adjustment gap is around BRL166.1 billion, in our view, instead of the BRL194.5 billion estimated by the government.

Total Adjustment (BRL in millions and % of GDP)

	Government estimate	% GDP	Santander estmate	% GDP	Difference %GDP
- tax collection shortfalls	**(55,300)**	**(0.89)**	**14,700**	**0.24**	**1.13**
Asset repatriation	(35,000)	(0.56)	35,000	0.56	1.13
CPMF (tax on banking operation)	(10,200)	(0.16)	(10,200)	(0.16)	-
the end of other tax exemptions	(6,100)	(0.10)	(6,100)	(0.10)	-
asset sales	(4,000)	(0.06)	(4,000)	(0.06)	-
- reduction of social security contribution	**(3,500)**	**(0.06)**	**(3,500)**	**(0.06)**	**-**
- non-administrative (asset selling, concession, dividends from state-owned firms), revenues shortfalls	**(43,300)**	**(0.70)**	**(55,300)**	**(0.89)**	**(0.19)**
- net transfers for regional states	**(5,800)**	**(0.09)**	**(7,800)**	**(0.13)**	**(0.03)**
- increase of mandatory spending	**(30,000)**	**(0.48)**	**(30,000)**	**(0.48)**	**-**
- unfreeze of non-mandatory spending	**(21,200)**	**(0.34)**	**(21,200)**	**(0.34)**	**-**
- Aid for Regional government + Committed investments expenses	(19,900)	(0.32)	(51,028)	(0.82)	(0.50)
- public defense spending	(3,500)	(0.06)	(3,500)	(0.06)	-
- public health spending	(3,000)	(0.05)	(3,000)	(0.05)	-
- high priority investment	(9,000)	(0.15)	(9,000)	(0.15)	-
Total of adjustments	**(194,500)**	**(3.14)**	**(166,128)**	**(2.68)**	**0.40**

Sources: Ministry of Finance and Santander estimate.

Conclusion

We are revising downwards our forecast for the primary deficit in 2016 to 2.3% of GDP (BRL142.1 billion) from 1.8% of GDP (BRL108 billion), mainly because of the reduction of the chances of an additional fiscal package. Our forecast for primary balance is a smaller primary deficit than expected by the government, only because non-recurring revenue (external asset repatriation), thus we believe that the government's estimate for the current fiscal gap is right. We reduce the savings expected from an additional fiscal package to 0.2% of GDP (which is only the increase of tax on the gasoline price) from 0.7% of GDP. Without an additional fiscal package, the primary deficit could reach 2.5% of GDP this year, by our estimate.

Santander Forecast for 2016 Primary Balance

Non Recurring revenues and expenditures	1.6
Impact of the Economic Cycle	(1.9)
Spending Growth	(0.8)
2015 Fiscal Package (remanant Effect)	0.5
New Fiscal Package	0.2
2016 Primary Surplus	(2.3)

Source: Santander estimate.

2016 Primary Balance (w/o Fiscal Package)

Non Recurring revenues and expenditures	1.6
Impact of the Economic Cycle	(1.9)
Spending Growth	(0.8)
2015 Fiscal Package (remanant Effect)	0.5
New Fiscal Package	-
2016 Primary Surplus	(2.5)

Source: Santander estimate.

For 2017, we are revising our primary result estimate to a surplus of 0.1% of GDP; previously it was 0% of GDP. We assume (1) the impact of GDP recovery and the positive impact on revenues and spending, and (2) nonrecurring revenues stemming from repatriation asset (0.2% of GDP) plus revenues from asset sales (0.8% of GDP).

We maintain our view that a continuous fiscal adjustment from 2017 onward stemming from the structural measures, such as the disengaging of social spending, and short-term measures, is required. Structural changes that add 1% of GDP per year in the upcoming years are needed in order to raise the primary result to a surplus of 2% of GDP, and to reduce the interest rate to below 9%, by our estimate.

CONTACTS / IMPORTANT DISCLOSURES

Macro Research			
Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@bzwbk.pl	48-22-534-1888
Sergio Galván*	Economist – Argentina	sgalvan@santanderrio.com.ar	54-11-4341-1728
Maurício Molan*	Economist – Brazil	mmolan@santander.com.br	5511-3012-5724
Juan Pablo Cabrera*	Economist – Chile	jcabrera@santander.cl	562-2320-3778
Brendan Hurley	Economist - Colombia	bhurley@santander.us	212-350-0733
David Franco*	Economist – Mexico	dafranco@santander.com.mx	5255 5269-1932
Tatiana Pinheiro*	Economist – Peru	tatiana.pinheiro@santander.com.br	5511-3012-5179
Piotr Bielski*	Economist – Poland	piotr.bielski@bzwbk.pl	48-22-534-1888
Marcela Bensión*	Economist – Uruguay	mbension@santander.com.uy	5982-1747-5537
Fixed Income Research			
David Duong	Macro, Rates & FX Strategy – Brazil, Peru	dduong@santander.us	212-407-0979
Brendan Hurley	Macro, Rates & FX Strategy – Colombia, Mexico	bhurley@santander.us	212-350-0733
Juan Pablo Cabrera*	Chief Rates & FX Strategist – Chile	jcabrera@santander.cl	562-2320-3778
Nicolas Kohn*	Macro, Rates & FX Strategy - LatAm	nicolas.kohn@santandergbm.com	4420-7756-6633
Aaron Holsberg	Head of Credit Research	aholsberg@santander.us	212-407-0978
Equity Research			
Christian Audi	Head LatAm Equity Research	caudi@santander.us	212-350-3991
Andres Soto	Head, Andean	asoto@santander.us	212-407-0976
Walter Chiarvesio*	Head, Argentina	wchiarvesio@santanderrio.com.ar	5411-4341-1564
Valder Nogueira*	Head, Brazil	jvalder@santander.com.br	5511-3012-5747
Pedro Balcao Reis*	Head, Mexico	pbalcao@santander.com.mx	5255-5269-2264
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