Fiscal Follow-up Report - RAF

May 2018

Full report here (portuguese)

Felipe Salto
Executive Director

May 7th, 2018

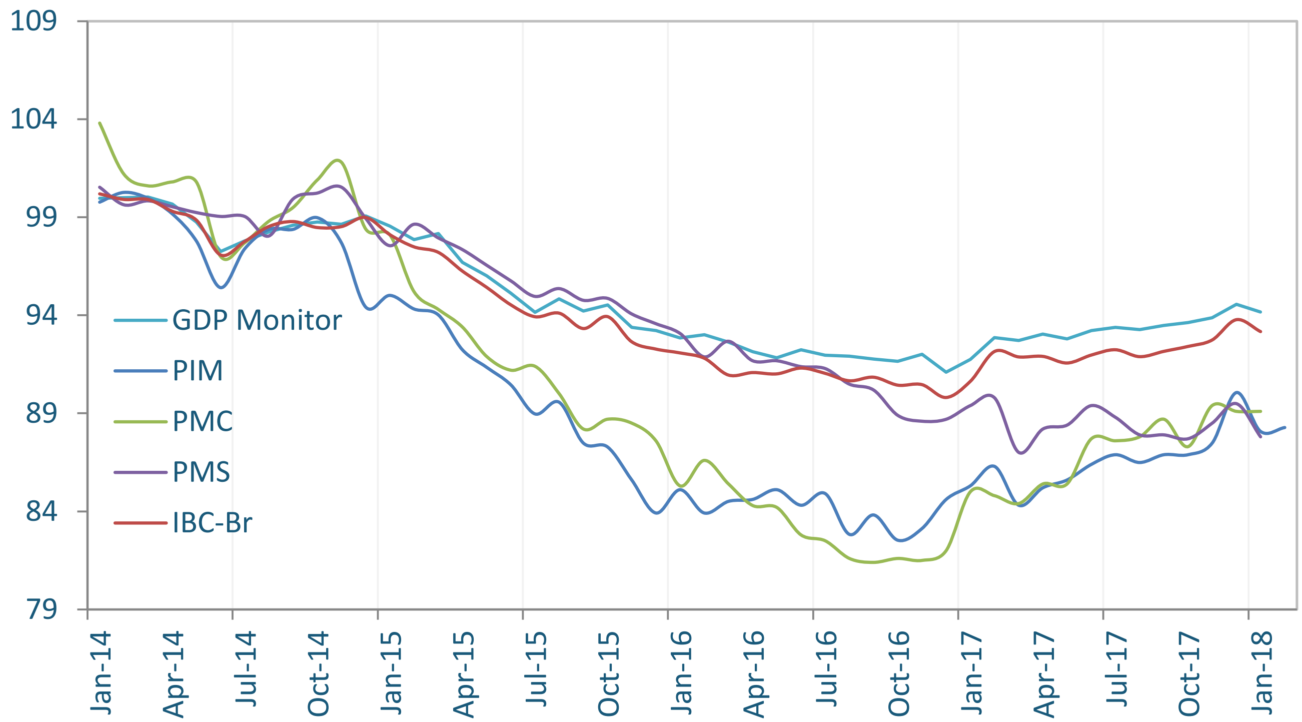
Summary

- In order to quantify the risks relating to the cyclical recovery of economic activity, we updated, in addition to the basic scenario, the macroeconomic parameters of alternative scenarios. In the basic scenario, projections for inflation and the Selic rate were reduced in function of the still very high level of economic slack.
- Output gap in 2017 was at -7.2%, a recovery of 1.27 p.p. compared to the -8.4% of 2016. The recession of 2014-2016 was the most intense, lasting and with the most slow recovery over the last two decades. The output gap recovery pace is about half of the verified on 1998-1999 recession.
- The contribution of revenues low correlated with economic activity remains substantial and accounts for approximately 65% of the collection increase. Vigorous advance of expenditures, however, was influenced by the anticipation of judicial remedies payments.
- Higher oil revenues help in updating the short-term fiscal scenario, despite higher spending with the family allowance program ("Bolsa Família"), judicial remedies and discretionary expenses. However, in the medium term the challenge of rebalancing the public accounts remains substantial.
- The 1st bi-monthly budget update little changed government tax projections to 2018. Budget execution data up to February, however, show higher than expected revenues and lower than expected expenses. Persisting the performance so far, significant official changes should occur in the next updates.
- Tax expenditure reached BRL270.4bn in 2017, which is equivalent to 4.1% of GDP or 20.7% of revenue collected by the Federal Revenue Office, and is more than twice the BRL124.3bn central government primary deficit. About 80% are concentrated in nine categories, with emphasis on Industrialized Products Tax (IPI), Contribution to Social Security Financing (COFINS) and Income Tax (IR).

Macroeconomic Context

- The performance of aggregate indicators of economic activity remained weak in February, not enough to recover the losses registered in January.

Economic activity indicators (seasonally adjusted - 1Q/2014 = 100)



Source: Central Bank

Macroeconomic Context

- First available information about the state of the economy in the second quarter brought mixed results: between March and April there was expansion of industry capacity utilization (NUCI), increase of economic uncertainty (IIE) and reduction of the confidence of economic agents.

CONFIDENCE INDICES, UTILIZATION OF INSTALLED CAPACITY AND ECONOMIC UNCERTAINTY INDEX

Indicators	Value			MoM (points)			QoQ (points)		
	Feb-18	Mar-18	Apr-18	Feb-18	Mar-18	Apr-18	Feb-18	Mar-18	Apr-18
Consumer confidence index (points)	87.4	92.0	89.4	-1.4	4.6	-2.6	2.5	2.2	1.4
Business confidence index (points)	94.6	94.8	93.4	-0.1	0.2	-1.4	4.2	2.8	0.9
Utilization of installed capacity (percentage)	75.6	76.1	76.5	0.9	0.5	0.4	0.7	0.9	1.4
Uncertainty index (points)	102.5	107.7	113.2	-7.1	5.2	5.5	-2.0	-0.1	-0.2

Source: FGV

Macroeconomic Context

- The increase of employment is still a result of informal and self-employed occupations.
- Labour market data for the quarter ended in March also showed some deceleration in the expansion trend of employment and income variables.

EMPLOYMENT BY POSITION

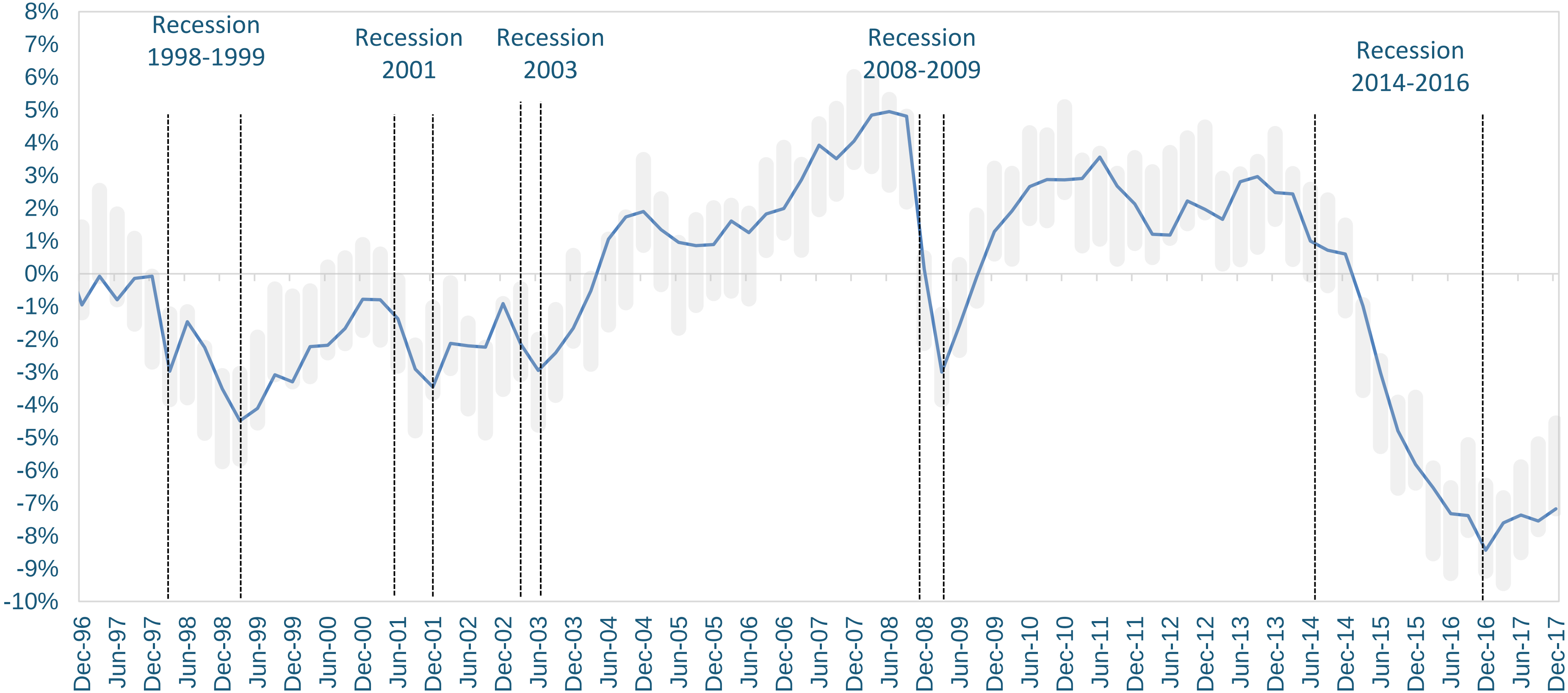
Employment indicators	Percentage in relation to employed population			QoQ			Accumulated in 12 months		
	Mar-17	Feb-18	Mar-18	Jan-18	Feb-18	Mar-18	Jan-18	Feb-18	Mar-18
Employed population	**100.0%**	**100.0%**	**100.0%**	**2.1%**	**2.0%**	**1.8%**	**0.6%**	**0.9%**	**1.2%**
Private sector: formal	37.6%	36.4%	36.3%	-1.7%	-1.8%	-1.5%	-2.6%	-2.5%	-2.3%
Private sector: informal	11.4%	11.8%	11.8%	5.6%	5.0%	5.2%	5.1%	5.3%	5.6%
Domestic worker	6.8%	6.9%	6.8%	4.4%	4.2%	2.4%	0.7%	1.4%	1.4%
Public sector	12.2%	12.3%	12.4%	2.9%	3.3%	3.2%	1.3%	1.3%	1.6%
Employer	4.6%	4.8%	4.8%	4.3%	5.5%	5.7%	7.4%	6.8%	7.1%
Self-employed	24.9%	25.4%	25.3%	4.4%	4.4%	3.8%	1.7%	2.3%	2.9%
Percentage of workers that contribute to Social Security	**65.0%**	**63.7%**	**63.8%**	**-0.5%**	**-0.5%**	**-0.1%**	**-1.6%**	**-1.5%**	**-1.1%**

Source: IBGE.

Macroeconomic Context

- IFI estimates indicate that Brazilian economy operated approximately 7.2 p.p. below its potential in the fourth quarter of 2017.

OUTPUT GAP AND PLAUSIBILITY INTERVAL



Source: IFI.

Macroeconomic Context

- High level of idleness is one of the factors that explain the benign inflation path for consumers.

CONSUMER INFLATION

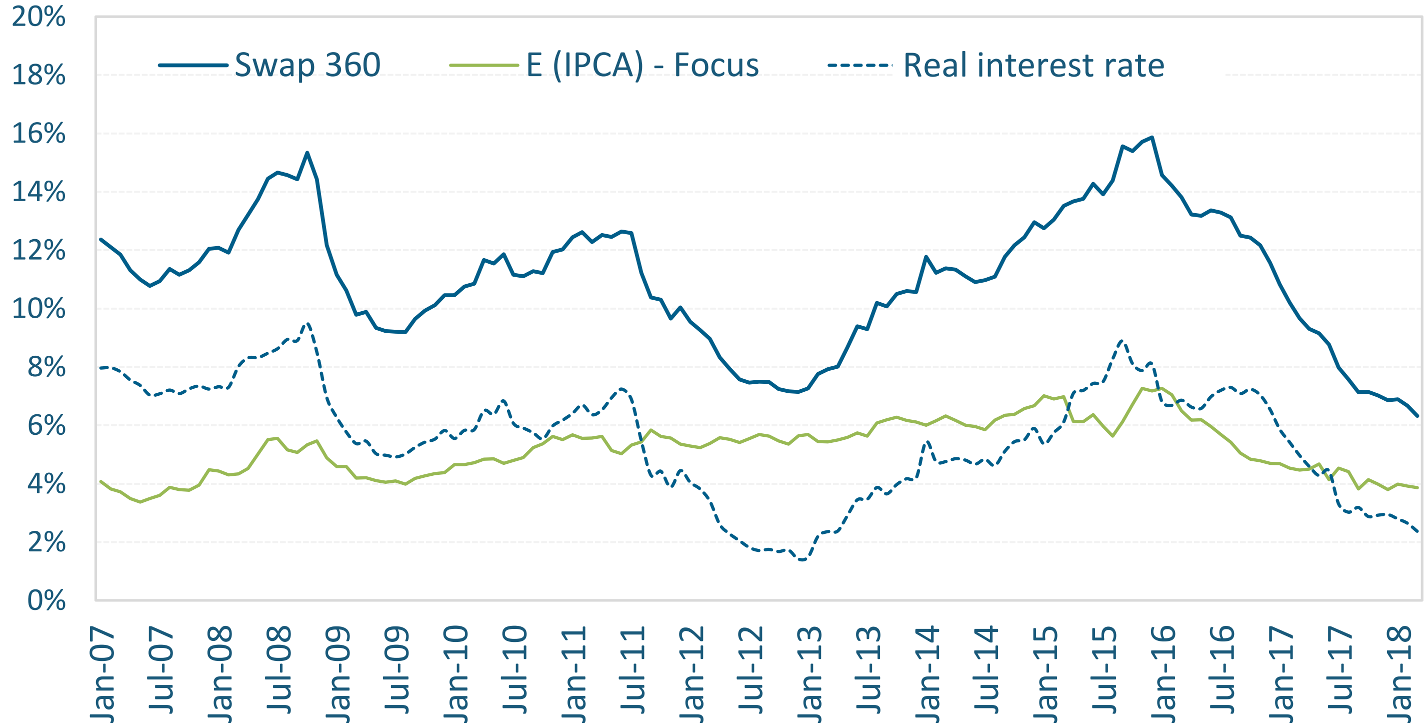
Consumer inflation	Accumulated in 12 months					
	Oct-17	Nov-17	Dec-17	Jan-18	Feb-18	Mar-18
National Consumer Price Index - INPC	**1.83%**	**1.94%**	**2.07%**	**1.87%**	**1.81%**	**1.56%**
Extended National Consumer Price Index - IPCA	**2.70%**	**2.80%**	**2.95%**	**2.86%**	**2.84%**	**2.68%**
Administered prices	6.59%	7.76%	7.99%	7.35%	7.32%	7.05%
Market prices	1.47%	1.22%	1.35%	1.42%	1.41%	1.26%
Food-at-home	-5.06%	-5.30%	-4.86%	-3.95%	-3.82%	-4.29%
Industrial	1.11%	0.93%	1.04%	0.92%	0.90%	1.18%
Services	4.88%	4.58%	4.53%	4.32%	4.22%	3.95%
Average of core inflation measures	**3.54%**	**3.34%**	**3.39%**	**3.16%**	**3.07%**	**2.96%**

Source: IBGE.

Macroeconomic Context

- At the end of March, the yearly *ex ante* real interest rate reached 2.4%. This rate has decreased sharply. After reaching around 9% in mid-2015, it is now in one of the lowest levels of the time series, which should stimulate investment and consumption in the medium term.

Ex ante real interest rate



Source: Anbima and Central Bank.

Macroeconomic Context

- Due to the slow expansion of activity, the opening of labour market and the recent evolution of uncertainty, estimates for the 2018 GDP growth from the Central Bank's Market Readout Report (Focus) have decreased in recent months: 2.69% in Jan, 2.92% in Feb, 2.84% in Mar and 2.75% in Apr.
- IFI estimates remain at 2.7% and may be reevaluated with the incorporation of the results of the national accounts for the first quarter of 2018.

GPD PROJECTIONS

GDP and components (real variation)	2014	2015	2016	2017	2018	2019
Gross Domestic Product (Percentage changes)	0.5%	-3.5%	-3.5%	1.0%	**2.7%**	**2.5%**
Agricultural	2.8%	3.3%	-4.3%	13.0%	**-0.6%**	**2.8%**
Industry	-1.5%	-5.8%	-4.0%	0.0%	**3.0%**	**2.8%**
Service	1.0%	-2.7%	-2.6%	0.3%	**2.3%**	**2.4%**
Private consumption	2.3%	-3.2%	-4.3%	1.0%	**2.9%**	**2.7%**
Government consumption	0.8%	-1.4%	-0.1%	-0.6%	**0.5%**	**1.1%**
Gross fixed capital formation	-4.2%	-13.9%	-10.3%	-1.8%	**4.5%**	**4.5%**
Exports of goods and services	-1.1%	6.8%	1.9%	5.2%	**6.0%**	**5.0%**
Imports of goods and services	-1.9%	-14.2%	-10.2%	5.0%	**6.6%**	**5.6%**
Contributions to changes in real GDP						
Total domestic demand	0.4	-6.4	-4.9	0.9	**2.7**	**2.5**
Net exports	0.1	2.9	1.5	0.1	**0.0**	**0.0**

Source: IBGE.

Macroeconomic Context

- We updated, in addition to the basic scenario (1), the macroeconomic parameters of alternative scenarios (2-optimistic and 3-pessimistic)

MACROECONOMIC VARIABLES ESTIMATES

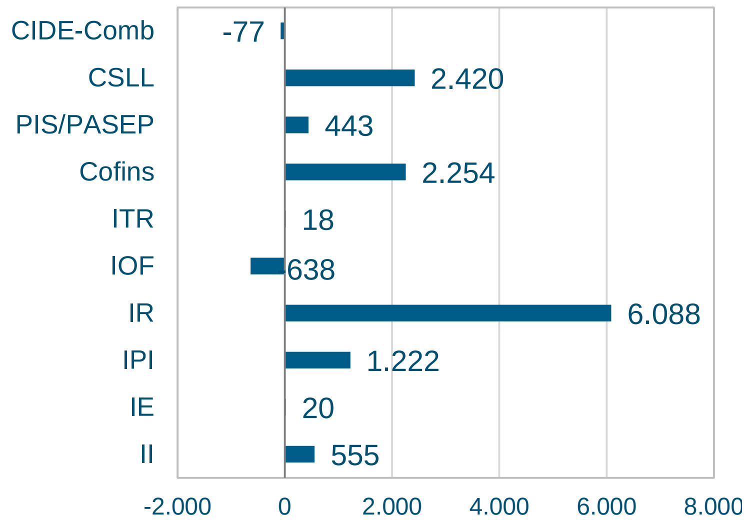
Scenario 1	2014	2015	2016	2017	2018	2019	Average 2020-2030
Nominal GDP (BRL Billion)	5,779	5,996	6,259	6,560	6,974	7,428	11,021
Real GDP Growth	0.5%	-3.5%	-3.5%	1.0%	2.7%	2.5%	2.3%
IPCA	6.41%	10.67%	6.29%	2.95%	3.5%	3.9%	4.1%
Employment (% growth)	1.5%	0.2%	-1.8%	0.0%	1.4%	1.8%	1.1%
Total wages (% growth)	2.8%	0.5%	-3.4%	2.3%	3.0%	2.8%	2.0%
Exchange rate R$/US$ (end-of-period)	2.66	3.90	3.26	3.31	3.45	3.55	3.83
Real interest rate	5.0%	3.2%	7.0%	3.9%	2.6%	3.5%	4.3%
Selic (end-of-period)	11.8%	14.3%	13.8%	7.0%	6.3%	7.5%	8.5%
Risk premium (EMBI-BR) - end-of-period	259	523	328	240	265	261	239
Scenario 2	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**Average 2020-2030**
Nominal GDP (BRL Billion)	5,779	5,996	6,259	6,560	6,977	7,463	11,665
Real GDP Growth	0.5%	-3.5%	-3.5%	1.0%	3.1%	3.4%	3.4%
IPCA	6.41%	10.67%	6.29%	2.95%	3.2%	3.4%	3.8%
Employment (% growth)	1.5%	0.2%	-1.8%	0.0%	2.3%	3.4%	1.3%
Total wages (% growth)	2.8%	0.5%	-3.4%	2.3%	4.1%	4.8%	2.6%
Exchange rate R$/US$ (end-of-period)	2.66	3.90	3.26	3.31	3.33	3.34	3.45
Real interest rate	5.0%	3.2%	7.0%	3.9%	2.7%	2.5%	3.1%
Selic (end-of-period)	11.8%	14.3%	13.8%	7.0%	6.0%	6.0%	7.0%
Risk premium (EMBI-BR) - end-of-period	259	523	328	240	234	220	194
Scenario 3	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**Average 2020-2030**
Nominal GDP (BRL Billion)	5,779	5,996	6,259	6,560	6,989	7,449	11,578
Real GDP Growth	0.5%	-3.5%	-3.5%	1.0%	1.9%	1.4%	1.3%
IPCA	6.41%	10.67%	6.29%	2.95%	4.6%	5.1%	5.9%
Employment (% growth)	1.5%	0.2%	-1.8%	0.0%	1.3%	1.5%	1.0%
Total wages (% growth)	2.8%	0.5%	-3.4%	2.3%	2.7%	1.7%	1.5%
Exchange rate R$/US$ (end-of-period)	2.66	3.90	3.26	3.31	3.71	3.85	4.81
Real interest rate	5.0%	3.2%	7.0%	3.9%	3.8%	4.2%	5.7%
Selic (end-of-period)	11.8%	14.3%	13.8%	7.0%	8.5%	9.5%	11.9%
Risk premium (EMBI-BR) - end-of-period	259	523	328	240	349	354	366

Source: IBGE and Banco Central.

2018 Budget

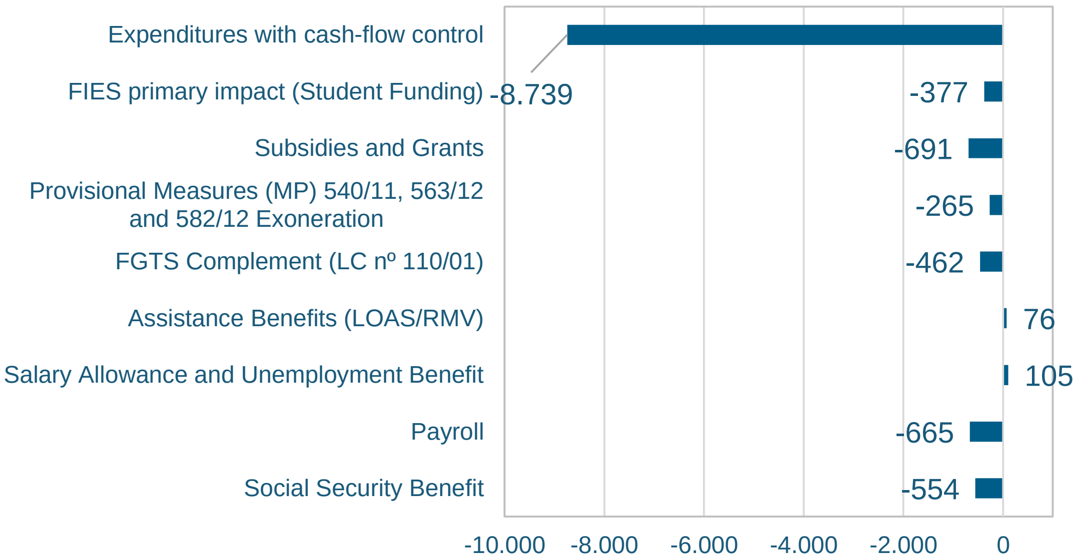
- Government's 1st bi-monthly budget update little changed fiscal projections to 2018
- Budget execution data until February, however, show higher than expected revenues (6.4% higher than projected) and expenses below predicted (-5.4%)
- Persisting the performance observed so far, significant changes should occur in the next updates.

Revenue collected by the RFB - collection minus projected - Jan-Feb/2018 (BRL Million)*



Source: Ministry of Planning.

Primary expenditure - executed minus projected - Jan-Feb/2018 (BRL Million)



*Cide-Comb: Contribution on Intervention in the Economic Domain (CIDE) – Fuels; CSLL: Social Contribution on Net Corporate Profits; Contribution to the Social Integration Program and Civil Service Asset Formation Program; Contribution to Social Security Financing; ITR: Rural Property Tax; IOF: Tax on Credit Operations, Exchange and Insurance; IR: Income tax; IPI: Industrialized Products Tax; IE: Export Tax; II: Import Tax.

2018 Budget

- IFI projects a primary deficit of BRL141.8bn in 2018, BRL15bn lower than government's forecast (BRL157bn)
- The difference lies mainly in spending, particularly in so-called “expenditures with cash-flow control”. While the IFI projects growth of 2% compared to 2017, the Government projects an 11% advance.
- But it is to note that part of government’s projected spending is reserved to absorb fiscal risks regarding privatization revenues from Eletrobrás. Excluding the reserve, government and IFI figures get closer.

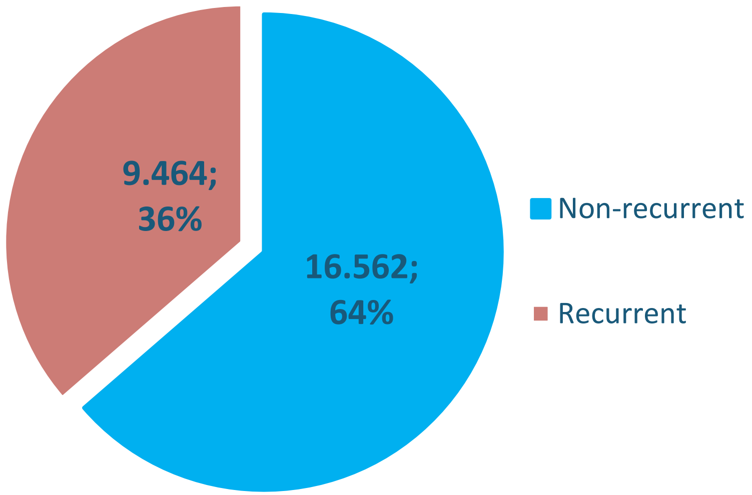
R$ billion

Breakdown	Budget Law	Feb Update (Decree 9.276/18)	Mar Update (Decree 9.323/18)	IFI	IFI - Decree 9.323/18	
					Dif.	Dif. %
I. TOTAL REVENUE	1,462.1	1,460.7	1,462.9	1,461.8	-1.1	-0.1
Collected by the RFB	890.3	880.9	894.0	891.3	-2.7	-0.3
Net Social Security Revenues	405.3	403.3	395.7	398.4	2.7	0.7
Not collected by the RFB	166.5	176.4	173.2	172.0	-1.1	-0.6
II. TRANSFERS BY REVENUE SHARING	244.2	243.9	246.1	241.7	-4.4	-1.8
III. NET REVENUE (I-II)	1,217.8	1,216.8	1,216.9	1,220.1	3.3	0.3
IV. TOTAL EXPENDITURE	1,373.4	1,371.6	1,374.3	1,361.9	-12.4	-0.9
IV.1 Compulsory Expenses	1,091.4	1,090.1	1,093.1	1,086.4	-6.7	-0.6
Social Security Benefits	596.3	592.4	592.4	588.4	-4.0	-0.7
Payroll	296.9	302.6	302.6	303.1	0.5	0.2
Salary Allowance and Unemployment Benefit	62.6	56.9	56.9	56.4	-0.5	-0.9
Assistance benefits (elder and disabled)	56.0	55.9	55.9	56.3	0.4	0.6
Other compulsory expenses	282.0	281.5	85.4	257.8	-23.4	-8.3
IV.2 Expenses with cash-flow control	-155.5	-154.8	281.2	-141.8	15.6	-9.9
V. CENTRAL GOV. PRIMARY BALANCE	1,462.1	1,460.7	-157.4	1,461.8	-1.1	-0.1

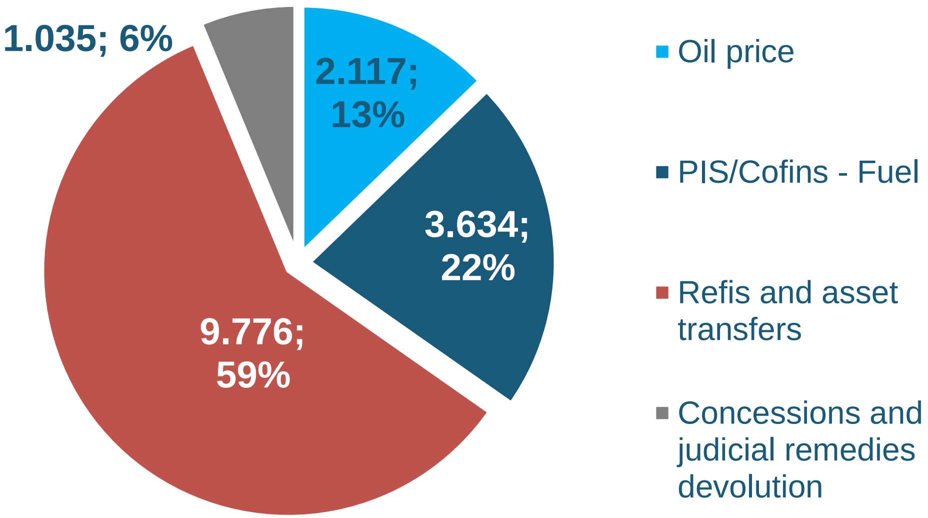
Revenue

- Gross revenue grows in real terms 7.6% or $26 billion in the quarter compared to the same period of 2017.
- The expansion of revenues with low correlation with economic activity, of BRL16.6bn, is substantial.
- Recurring revenues shows real growth of 2.9% or R $9.5 billion against the first quarter of 2017.
- Year-to-date, about 65% of the revenue growth is due to events with low correlation with the activity.

Gross revenue growth – QoQ (BRL Million)



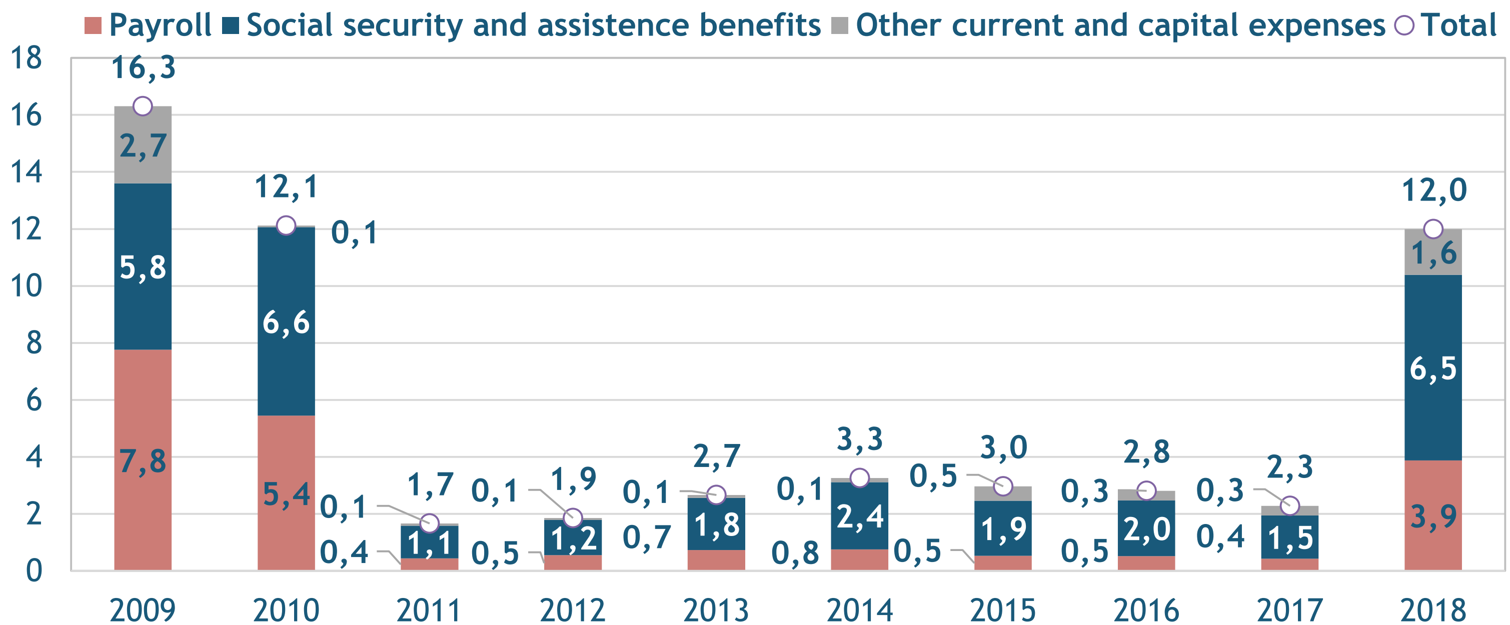
Revenue low correlated with activity – growth breakdown – QoQ (BRL Million)



Expenditure

- Primary expenditure register real growth of 12.6% or BRL12.7bn in March versus March/17.
- Judicial remedies payed in advance, BRL10.3bn, is the main driver for this growth.
- Until March, primary expenditure grew 4.6% or BRL13.9bn.
- Year-to-date, judicial remedies payments reaches BRL12bn.
- Excluding judicial remedies, expenditure would have advanced 1.4% in real terms or BRL4.1bn.

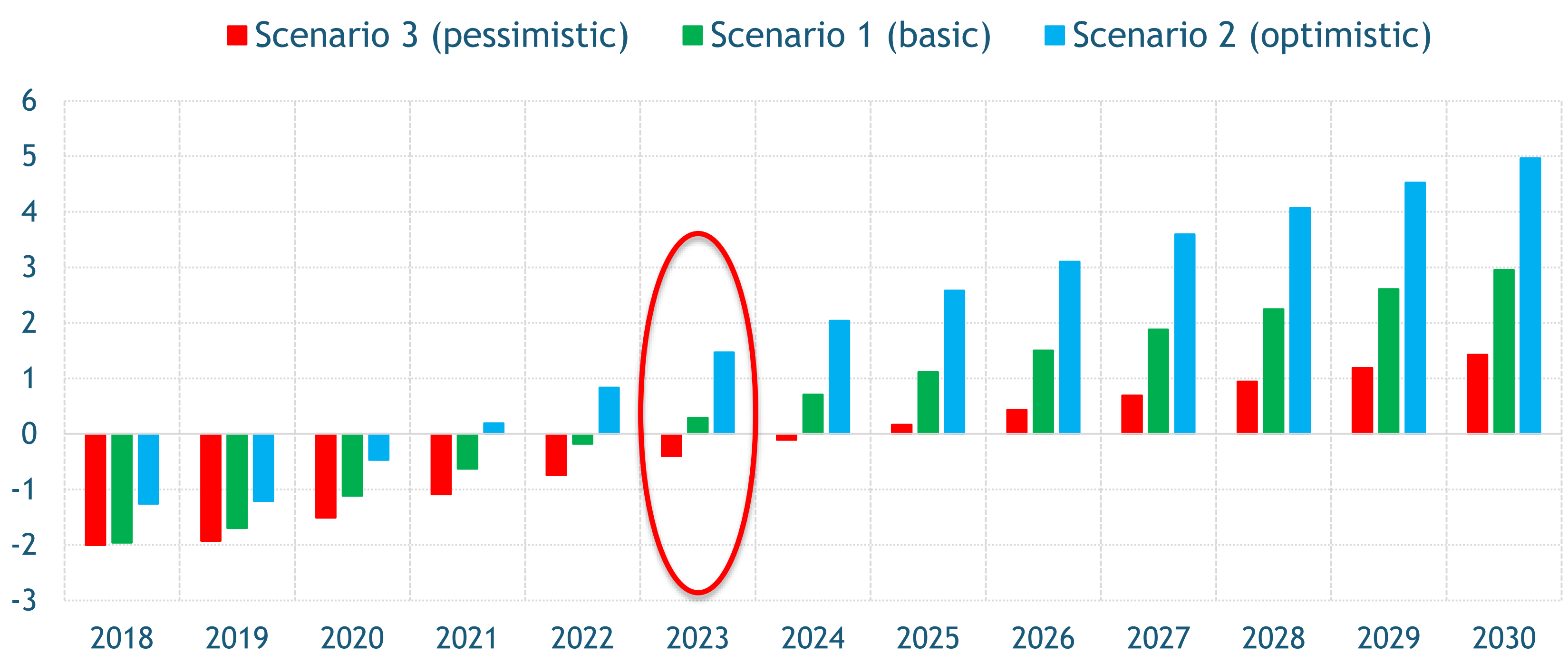
Breakdown of judicial remedies payments in the first quarter (BRL Billion)



Fiscal Scenario

- Primary surplus is not expected until 2023 in our basic scenario (1). In the optimistic scenario (2), primary surplus occurs in 2021
- In the basic scenario, revenue collected by the Federal Revenue Office grows 3.1% and 2.8% above inflation in 2018 and 2019, respectively. Net revenue in turn should register real growth of 1.9% in both periods.
- Oil price rebound to over US$65/barrel favors fiscal performance in this and next year
- Revenues from tax regularization programs ("Refis"), of BRL23.5bn this year and BRL21.3bn in 2019 impact fiscal balance.

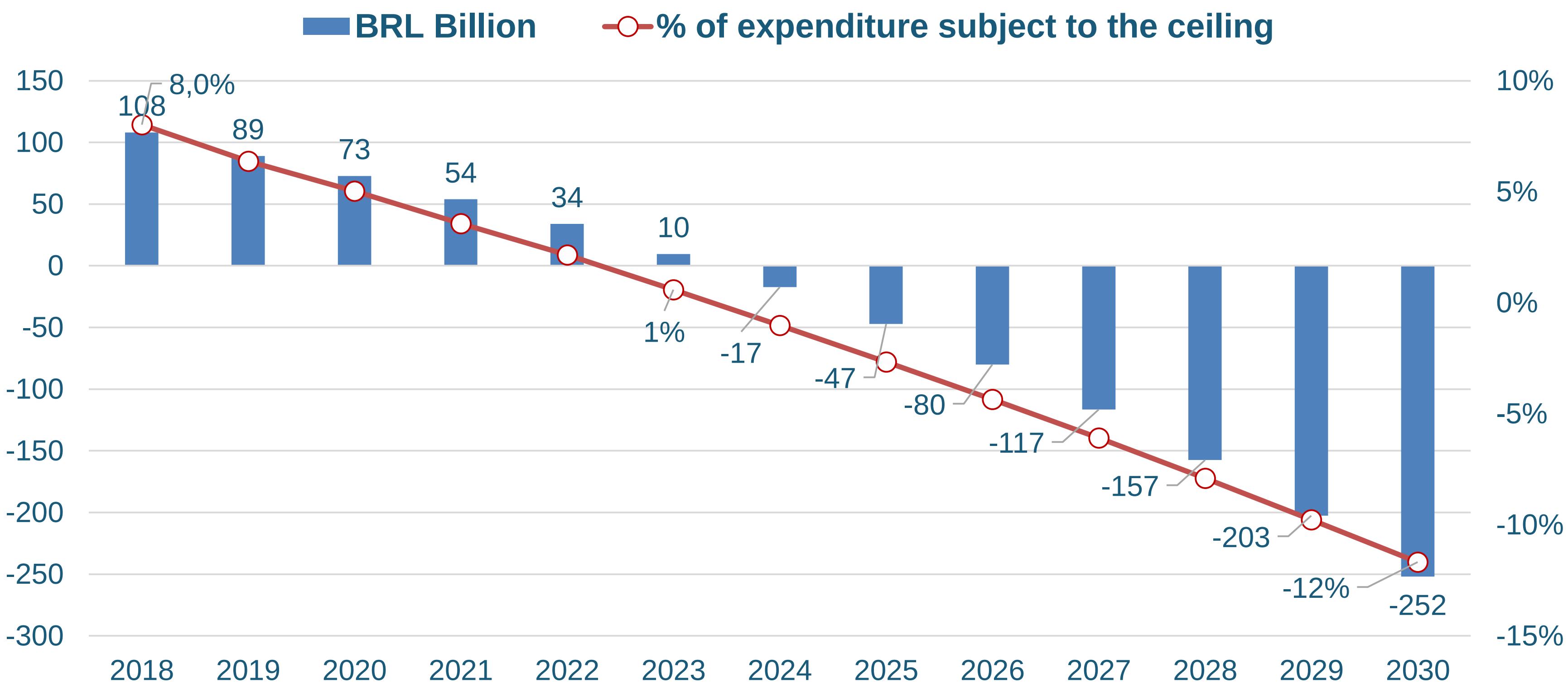
Evolução do Resultado Primário nos 3 Cenários da IFI (em % do PIB)



Fiscal Margin

- Fiscal Margin should be close to its lower limit already in 2019, endangering the maintenance of public bodies and the implementation of public policies, and putting in risk the fulfillment of the primary expenditure ceiling.

Fiscal Margin trajectory (*proxy* for fiscal policy capacity of cutting expenditure in the short term



Fiscal Scenario

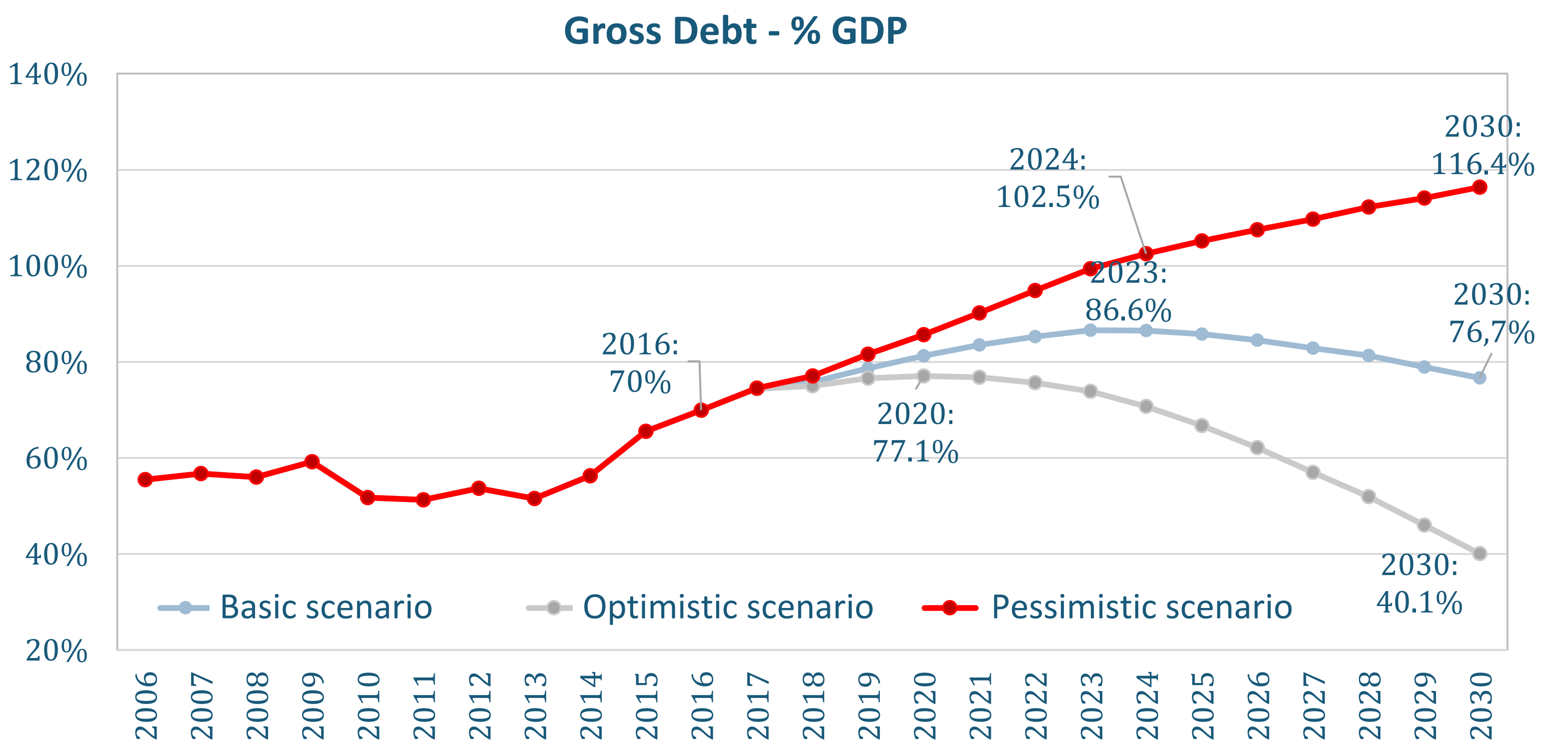
- Projected performance indicates a certain stability of net revenue in relation to GDP, while expenditure will need to be adjusted from 19.45% of GDP to 15.03% of GDP.
- If spending adjustment does not occur, alternative measures with the same fiscal effect must be adopted.

FISCAL PERFORMANCE IN EACH SCENARIO (% GDP)

Scenario 1 (basic)	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
Net Revenue	17.65	17.50	17.40	17.47	17.55	17.63	17.70	17.73	17.75	17.77	17.76	17.75	17.75	17.75
Primary Expenditure	19.45	19.54	19.20	18.72	18.33	17.98	17.60	17.23	16.85	16.49	16.11	15.74	15.38	15.03
CG Primary Balance	-1.81	-2.03	-1.80	-1.25	-0.78	-0.35	0.10	0.51	0.90	1.28	1.65	2.01	2.37	2.71
Consolidated Primary Balance	**-1.69**	**-1.96**	**-1.70**	**-1.12**	**-0.63**	**-0.18**	**0.29**	**0.71**	**1.11**	**1.50**	**1.88**	**2.25**	**2.61**	**2.95**
Central Gov. (above-the-line)	-1.81	-2.03	-1.80	-1.25	-0.78	-0.35	0.10	0.51	0.90	1.28	1.65	2.01	2.37	2.71
Local Governments	0.13	0.10	0.13	0.15	0.17	0.19	0.21	0.22	0.23	0.24	0.24	0.25	0.25	0.25
Federal State-owned Enterprises	-0.01	-0.02	-0.02	-0.02	-0.02	-0.02	-0.02	-0.02	-0.02	-0.01	-0.01	-0.01	-0.01	-0.01

Debt projections

- Gross debt is still expected to advance to 86.6% of GDP in the basic scenario (1), and then begin to fall slowly (considering that the fiscal adjustment is maintained and improved).



Source: IFI.

Tax expenditure (benefits)

- Definition: tax expenditures are indirect expenses of the Government made by the tax system, in order to meet social and economic goals and are an exception to the reference tax system, reducing the potential collection and consequently increasing the disposable income of taxpayers.
- Difficulties in measurement:

  a) to identify all tax breaks in the tax system and to evaluate whether it fits into one of the categories of tax expenditure

  b) to measure tax expenditure, that is to say, the loss of revenue that arises from it.

Tax expenditure (benefits)

- Revenue loss of the Union derived from tax expenses: BRL270.4bn in 2017, 20.7% of revenue collected by the Federal Revenue Office (RFB) or 4.1% of GDP.
- There was a sharp increase from 3.5% to 4.4% of GDP, from 2012 to 2014, followed by some fall in the 2016-2017 biennium.
- Along with public spending and the revenue loss derived from the economic downturn, the increase in tax expenditure was responsible for the brusque deterioration of central government's primary balance in recent years.

REVENUE LOSS DERIVED FROM TAX EXPENDITURE

	2011	2012	2013	2014	2015	2016*	2017*
Revenue loss - RL (BRL Billion)	152,4	181,7	223,3	256,2	270,1	263,7	270,4
RL/Revenue collected by the RFB (%)	16,2	18,3	20,3	22,3	22,7	20,8	20,7
RL/GDP (%)	3,5	3,8	4,2	4,4	4,5	4,2	4,1

*Source: RFB. *RFB estimates.*

Tax expenditure (benefits)

- Revenue loss by categorie: highly concentrated in few itens.

MAIN TAX BENEFITS – 2015

Categories	Revenue Loss (BRL Million)	Weight in total (%)	Accumulated weight (%)
Micro and small companies tax regime (Simples Nacional)	69,205.5	25.63	25.6
Payroll exemption	25,199.1	9.33	35.0
Income tax exemption (individuals)	23,854.7	8.83	43.8
Manaus Free Zone and Free Trade Zones	23,231.9	8.60	52.4
Farming and Agroindustry – Food basket exemption	21,700.3	8.04	60.4
Non-profit organizations	19,505.1	7.22	67.7
Income tax base deductions (individuals)	15,353.4	5.69	73.3
Workers benefits	9,951.6	3.69	77.0
Savings and Real Estate Credit Bonds	7,500.9	2.78	79.8
Medicines, Pharmaceutical products and Medical equipment	6,619.1	2.45	82.3
Total	222,121.6	82.25	

Source: RFB.

Tax expenditure (benefits)

- Problems of the current legal framework: easy to create and enlarge and absence of evaluation and deadlines
  - ✓ Flexible interpretation of article 14 of the Fiscal Responsibility Law – LRF (estimate of revenue loss and compensation) and paragraph 6 of article 150 of the Federal Constitution (absolute reserve of law and specific law).
  - ✓ Absence of a clear definition of responsibilities for the bodies involved. Often there is no designated manager body.
  - ✓ There is no periodic review, or drawing that allows it, with purposes, indicators and goals.
  - ✓ Absence of deadlines or renewal terms. Once in the legal framework, tax benefits became perpetual, which tends to raise public revenue loss over time.

Tax expenditure (benefits)

- Consequences of tax expenditure:

  ✓The numerous existing tax benefits make tax system more complex, more vulnerable to avoidance and evasion and difficult to evaluate.

  ✓Tax benefits compete with direct spending, so that the introduction of a new benefit means passing over a direct expenditure.

  ✓Tax benefits make tax burden fall on other taxpayers shoulders.

  ✓Tax benefits allow for bypassing control mechanisms that focus on direct spending, for example expenditure limits set by LRF and EC 95/2016.

  ✓The perpetuation of tax expenditures creates restrictions for the creation or extension of meritorious tax expenses.