



Monthly Report
January

Economic growth contributes to increase revenue in 2007

THIS EDITION ANALYSES, WITH EMPHASIS IN THE FINANCIAL SECTOR, THE EXCEPTIONAL RESULT OF TAX REVENUE IN 2007 - NOTICEABLY THE REVENUE GROWTH RESULTED FROM A MORE INTENSIVE IPOs PROCESS, INFLUENCED BY THE STRONG EXPANSION OF ECONOMIC ACTIVITY AND ACTIONS OF THE TAX ADMINISTRATION INCREASING TAX PRESENCE. IN ADDITION, IT DETAILS THE SET OF MEASURES ADOPTED BY THE GOVERNMENT IN THE BEGINNING OF 2008 TO COMPENSATE FOR THE LOSS OF CPMF – TEMPORARY CONTRIBUTION ON FINANCIAL ACTIVITIES WHICH COLLECTION WAS DISCONTINUED SINCE JANUARY 1ST, THIS YEAR, AMONG THEM THE INCREASE IN IOF – TAX ON FINANCIAL OPERATIONS ALIQUOTS FOR CREDIT, EXCHANGE AND INSURANCE AS WELL AS THE CSLL (CONTRIBUTION ON NET PROFIT) OF THE FINANCIAL SECTOR. IN AN INTERVIEW TO SINOPSE, THE FORMER SECRETARY OF THE INTERNAL REVENUE SERVICES AND TAX CONSULTANT EVERARDO MACIEL COMMENTS ON THESE MEASURES AND THEIR EFFECTS.

Federal revenue breaks a record in 2007

Federal revenue coming from taxes and contributions managed by the Internal Revenue Services and other revenues (fees and contributions controlled by other government agencies) broke a new record in 2007, R\$ 615 billion, considering the IPCA update. This value is R\$ 61 billion more than in 2006 (R\$ 554 billion) and close to the GNP of the third quarter of 2007 (R\$ 645.2 billion). In regard to revenue specifically managed by the IRS there was an actual growth of 12.19% compared to last year. This percentage represented more than a double of GNP



variation in the third quarter of 2007 (5.7%), compared to the same period in 2006.

According to the Analysis Report of the IRS, the excellent performance in this period is a consequence of factors related to the economic growth and to the effective work of IRS in recovering due debts and maintenance of the regular flow, since there was no increase in tax aliquots in the last two years. As regards to the economic factors that have influenced revenue stands out the higher sales and profitability of companies, growth in industrial production, formalization of labor market and growth in employment.

Taxes related to the financial sector that showed actual positive variation as to the IPCA and increase in total participation of taxes collected by the IRS, in comparison to 2006, were: CSLL – Contribution on Net Profit, IRPJ – Corporate Income Tax and PIS contribution by financial entities (see table).

In regard to total collection (financial entities and other companies) of CSLL and IRPJ, it is important to mention that this performance is mainly due to profitability increase in relevant sectors of the economy – the 220 largest companies listed in the Stock Exchange had, in January to September 07 period, 46% growth in profits. Another factor that contributed to the good performance was the significant increment in IPOs in 2007, both in number of companies and value amount.

Government adopts measures to compensate for the loss of CPMF

In the beginning of 2007, the government announced the PAC – Program to Accelerate Growth, which objective is to foster investments in the private sector and accelerate the country's development, and one of its pillars is tax exemption. While PAC anticipated for that year the continuity of the tax reform started in December 2003, it did not advanced. To guarantee tax stability in next years, a Constitutional Amendment Proposal was presented, by the end of 2007 to extend both CPMF and DRU (Separation of Federal Revenues) until 2011, since both would expire on 12/31/07. Since the Senate rejected CPMF expansion, the contribution was discontinued on January 1, 2008, with an estimated revenue loss of about R\$ 40 billion in 2008, considering that the total collected with this contribution was R\$ 37 billion in 2007. CPMF was created in 1997 and since then it has been continually expanded and charged.

Yet the expansion until 2011 of the DRU – a mechanism that allows the government to freely spend 20% of major taxes revenue – was approved by the Congress after a wide negotiation with the opposition. To get the approval, the government had to undertake a set of commitments that should be accomplished in the next months, among them the tax reform discussion in February, and no tax



package to compensate for the loss in revenue due to the non-expansion of the CPMF.

However, in January 3, the government announced a set of measures to compensate for this loss: an increase in IOF aliquots for credit, exchange and insurance operations, and in CSLL for the financial sector, with a revenue estimated around R\$ 10 billion (see table with the main changes in tax legislation); reduction in public finance expenses and investments (about R\$ 20 billion), as well as the possibility of incrementing revenues due to economic growth (estimated in R\$ 10 billion).

It is worth to mention that the credit market has been growing by leaps and bounds in the last two years, thus becoming a good source of resources. The growth of these operations, both by individuals and corporations, was the main factor to contribute to the increase in total IOF collection in 2007. The IRS estimates that in 2008 IOF will reach R\$ 16 billion, the double of 2007. The raise in the CSLL aliquot for the financial sector, from 9% to 15%, shall exceed in R\$ 2 billion what was collected in 2007 (R\$ 35.143 billion). Therefore, the additional IOF and CSLL revenues in 2008 shall reach the total government target (R\$ 10 billion).

As for the reduction in government expenses there is no precise definition on programs that will be affected, only the commitment to preserve projects under the PAC and social programs. Expenses reduction includes parliamentary amendments, involves negotiations in order to share the burden of the adjustments among the three powers estimated in R\$ 20 billion, and shall be included in the budget project for 2008, expected to be voted in February. However, it is possible that the government sets this value down due to the estimate increase in this year's collection.

In fact, factors related to the economic growth shall continue to contribute to revenue performance in 2008, since it is expected to continue to have an expansion on income, employment and formalization of the labor market, as well as industrial production growth and companies' profitability. The combined result of these factors shall contribute for good tax revenue, but not as formidable as in 2007. Besides the CPMF loss, the market expects less dynamism in IPOs. The uncertainty of the impacts of a possible American recession on the world economy growth should also be considered.



Changes in Tax Legislation

IOF – Legal Base: Decrees # 6.339, of 01/03/08 (Official Gazette of 01/03/08), and 6.345, of 01/04/08 (Official Gazette of 01/07/08), that changed the Decree # 6.306, of 12/14/07 (Official Gazette of 12/17/07).

• IOF – Credit

- Raised the IOF aliquots from 0.0041% to 0.0082% for individuals' credit operations and added 0.38% on all credit operations regardless operation term and creditor (article 7).
- Raised to 0.38% IOF aliquots on the following credit operations (article 8):
 1. where the borrower is a cooperative;
 2. executed between the credit cooperative and its members;
 3. exports as well as production support or export incentive;
 4. rural, directed to investment, funding and trade;
 5. executed by loans office where jewelry, precious stones and other items are pawned;
 6. executed by financial institution, related to the transfer of the National Treasury resources directed to the finance of supply and inventory adjustment;
 7. executed with Finame's resources;
 8. executed under the support of the Policy to Guarantee Minimum Prices – Federal Government Loan (EGF);
 9. related to public bonds loan when it remains in custody at SELIC as a guarantee to a third party for the performance of services and public works;
 10. executed by BNDES – National Bank for Economic and Social Development or its financial agencies with that bank's resources or funds managed by that bank;
 11. related to the transfer of assets under chattel mortgage with third-party subrogation of the rights and obligations of the debtor, provided that all financial conditions of the original agreement are maintained;
 12. related to advanced payment of the individual life insurance policy surrender value and capitalization bonds;
 13. related to advance in export exchange contract;
 14. related to share purchase or participation in company in the scope of PND – National De-Statization Program;
 15. resulting from the transfer of resources of a Federal Government program tied to public issue of securities;
 16. related to advanced return of IOF unduly charged and paid by the responsible while waiting for the requested restitution, provided that there is no charge of remunerative fees;
 17. executed by financial agency with resources from federal, state or municipal programs established with the objective of implementing income and employment generation programs under the terms of article 12 of Law 9.649/98.

• IOF – Exchange

- Raised aliquots on the following exchange operations referring to financial transfers to or from abroad (article 15):
 - on the incoming amount resulting from or directed to currency loans with average minimum duration up to ninety days: from 5 to 5.38%;
 - on exchange operations directed to fulfill the obligations of credit card managing companies or commercial or multiple banks in the quality of credit card issuers resulting from the acquisition of goods and services abroad carried out by their users: from 2 to 2.38%;
 - on exchange operations tied to services imports: from 0 to 0.38%;
 - on exchange operations tied to goods and services exports: from 0 to 0.38%
 - on other exchange operations: from 0 to 0.38%.

CSLL – Legal Base: MP nº 413 (Provisional Measure), of 01/03/08 (Official Gazette of 01/03/08), and Normative Instruction #810, of 01/21/08 (Official Gazette of 01/22/08);

- Raised the CSLL aliquot for financial entities from 9% to 15%, with effects from May 1, 2008 on (article 17). The Normative Instruction # 810 defined the transition rules.



Interview – Everardo Maciel

Good results have as common factors the efficiency of the collection machine

THE FORMER SECRETARY OF THE INTERNAL REVENUE SERVICES AND TAX CONSULTANT EVERARDO MACIEL ANALYSES IN AN INTERVIEW TO SINOPSE ANDIMA, THE GOOD RESULTS ACHIEVED BY THE FEDERAL REVENUE IN THE LAST YEARS AND THE IMPACT OF THE MEASURES ADOPTED BY THE GOVERNMENT TO COMPENSATE FOR CPMF DISCONTINUATION.

Do you believe that the set of measures adopted by the government to compensate for the loss in CPMF collection will be enough to ensure fiscal balance?

There are tax nature measures such as the increase in IOF and CSLL aliquots that will probably be successful, except for eventual judicial impugment. The remainder corresponds to R\$ 30 billion, of which R\$ 10 billion are considered efforts of the collection. This expression is a euphemism usually used when it is not clear what tax will be increased. As for the cut down of R\$ 20 billion, I really root for it and I hope the government surprises me, but it is a difficult task.

Considering that the cut down in 2008 budget might not be approved by the Congress, what alternatives could be implemented during the year to recover the R\$ 40 billion referring to the CPMF?

The IRS has taken no steps that could allow to recover the corresponding amount of expenses cut down of R\$ 20 billion. In case the measures are not approved, the Budget will be affected and also the primary surplus. As an “effort of the collection”, some solutions could be adopted in the scope of tax transaction, which is foreseen in the National Tax Code and already used in other opportunities with the objective of regenerating revenue and at the same time, of solving larger judicial disputes. These were, for instance, the legislative solutions involving the constitutionality of the Contribution on Net Profit and the taxation of pension funds revenue. Some big judicial litigations still remain, such as the IPI – Tax on Industrialized Products credit-premium and the calculation basis of PIS/Cofins, that could be solved with the use of this instrument.



What were the main factors that influenced the record results achieved by tax revenue in the last years? In your opinion, will this picture be maintained throughout 2008?

These results were achieved by means of a combination of variables that changed overtime. There is a common factor in the last 13 years that is the improved performance of the collection machine. In addition, in each year it was introduced a different variable to produce records in collection. For example, in 2002, there was an expressive volume of atypical revenue resulting from the settlement of the pension funds judicial dispute. In another moment, the key factor was a change in PIS and Cofins taxation, going from a strictly cumulative solution to a non-cumulative. Naturally, in 2008, with the discontinuation of the CPMF, there will be a reduction in revenue compared to 2007.

Many analysts say that the Brazilian tax burden is one of the key obstacles to a steeper country's growth. In your opinion, what structural measures could be adopted to improve the Brazilian tax system efficiency in order to ensure the desired tax balance?

I do not agree with the idea that the tax burden is the predominant factor hindering the Brazilian development. It is one fact, but there are others such as the extremely high burden of social security; payroll taxation; extremely obsolete labor legislation, inexistence of good discipline in regulatory agencies and, above all, infrastructure deficiency. However, there are relevant problems within the Brazilian tax system. I mention some, with no ranking of importance: accumulation of ICMS credit in exports and the huge diversity in aliquots and calculation basis of the ICMS – Tax on Circulation of Goods and Services; the complexity of PIS/Cofins; and excessive taxation on payroll. I would say these are the most relevant deficiencies of the Brazilian tax system, and they are in sharp contrast to its qualities – among them the income tax on corporations in Brazil which with no doubt is one of the most qualified in the world.



Interview – Paulo Valle

Debt profile minimizes volatility

IN INTERVIEW TO SINOPSE ANDIMA, THE SECRETARY-ASSISTANT OF THE NATIONAL TREASURY, PAULO VALLE, COMMENTS ON THE SEVERAL ASPECTS RELATED TO PUBLIC DEBT MANAGEMENT, AMONG THEM THE CHALLENGE REPRESENTED BY THE RECENT INTERNATIONAL FINANCIAL CRISIS.

What effects the higher volatility seen in the last months in the international market caused in the management of the domestic securities debt?

Indicators show that the risk aversion seen in 2007 generated a volatility higher than, for example, that seen in May 2006. This crisis originated in the American real estate market reached the main global markets, and Brazil was obviously also affected.

Here, however, the effects of the crisis were considerably minimized whether by the robustness of the fundamentals of the Brazilian economy as a whole, including the public debt profile itself, or by the National Treasury guideline of keeping a liquidity buffer that would allow it to not access the market in high volatility periods. In this period, the Treasury did not accept the prices asked by dealers, therefore avoiding adding volatility during more turbulent moments. Volumes issued were reduced and some auctions were even cancelled.

These measures, associated with the agents' perception on the country's situation, were reflected on the indicators for July and August. Public bonds rates, as well as DI's, that increased about 150 basis points in the peak of the crisis, are today close to the pre-crisis levels. The accumulated average cost in 12 months and the domestic debt average term kept a positive pathway: June's cost was 13.66% and dropped to 13.45% p.a. in August; and duration went from 34.43 months to 35.26 months in the period.

This shows that if not negligible, the effects of the international crisis are quickly disappearing, not affecting the Treasury financing strategy. Once again we see investors differentiating the country, believing in the robustness of Brazilian economy fundamentals and in the work that is being carried out.



In the last years there was a considerable advance in the market structure of the domestic debt. In your opinion, what should be the next steps for this segment to get even closer to the developed markets?

With no doubt, all data previously mentioned also reflect the maturity of Brazilian financial market, which is showing important improvements. An evidence is that during the May 2006 crisis, which generated a lower volatility than this year's, the Treasury had to provide price parameters to the NTN-B market, and this was not necessary in 2007.

At the government side there is still need to improve information transparency and communication with the market, by means of direct contact with investors and publishing monthly reports, communications and relevant data. In addition, we must keep the policy of issuing securities that act as reference, with well-defined vertices, and to take actions that foster public bonds liquidity and expansion of the investors base. An important instrument to increase liquidity is the continuous improvements of the dealers system, for example, with incentives to market maker spread in electronic system.

At the market side it is necessary to foster the development of the repo segment, the securities loan, that can even improve the profitability of funds and other operations, as the possibility of being short in public bonds. In addition, the industry should continue to try to change its liabilities' profile, leaving indexation and lengthening maturities. And there will come the time when it will be necessary to discuss the market standardization vis-à-vis international practices, an initiative that can also contribute to improve efficiency and liquidity.

The legislation of the decreasing Income Tax according with the investment term brought a relative disadvantage to fixed income assets investments up to 720-day duration. What is your opinion on the effects of this rule on the government's objective of expanding federal securities debt and diversifying investors base, to whom securities liquidity is essential?

First, we should not forget that the decreasing taxation gives the investor a higher net return in the long run, what by itself contributes to the development of a long-term investment culture in the country. Due to our history of instabilities, the natural evolution of the investment horizon for the final investor could be too slow without this incentive.

The new taxation also allowed the expansion of the debt profile, since a great part of the market saw in this new taxation an opportunity to get higher net returns. This certainly contributed for the average duration of the domestic debt, that used to be of 27.37 months in December 2005, to reach 35.26 months in August of this year, and the average duration of public bonds issue to go from 23.87 months to 55.86 months.



But much more important is to remember that the tax measure was taken in the context of Investment Account, and therefore it should be analyzed as part of a whole. The additional taxation of 2.5% over capital gains in short term tends to be more than compensated by the 0.38% exemption over the total capital, generated by the Investment Account. In our point of view, these measures allowed non-financial corporations and individuals to change their portfolios with lower costs while generating incentives to expand investment terms.

In the last seven years, the strategy for debt management has been to reduce the portion of SELIC and exchange-indexed bonds and to increase the portion of fixed inflation pegged bonds. How does the Treasury see this evolution?

This is a guideline published in 2001, in the Financing Annual Plan of the federal public debt that is aligned with the best international debt management practices. The reduction in the portion of SELIC and exchange-indexed bonds implies a significant reduction in debt risks that, in last analysis, are the risks imposed to the society.

Today, facing any volatility, the public debt profile acts to minimize its consequences and not to maximize them, as it used to be in the country's economic history. Such a stress exercise as the one in PAF, for example, shows that today a shock of three standard deviation in interests and exchange-rates would have an impact of 5% of the GNP on the debt. The same shock applied to the debt composition in 2002 would have had an impact of about 26%.

It is important to highlight, however, that the change in the debt profile that the National Treasury is promoting is based on gradualism since it takes into consideration the costs and benefits of this measure. Although we pay a premium in the short run for the placement of fixed bonds instead of SELIC-indexed bonds, at the medium term, for example, this leads to a perception of lower risk and therefore to structurally lower financing costs, allowing for decreases even more dramatic than the SELIC itself. From January to July 2007, the average cost of the debt had a 25% reduction compared to the same period of last year.

For comparison purposes, the SELIC went back about 22% in the same period. This reduction in the average cost of the federal public debt, detailed in the Monthly Report, together with the dramatic decrease in its risk exposure and the statement of rating agencies about the importance of the change in profile for the continuous improvement of the Brazilian evaluation confirms the power of this strategy.