

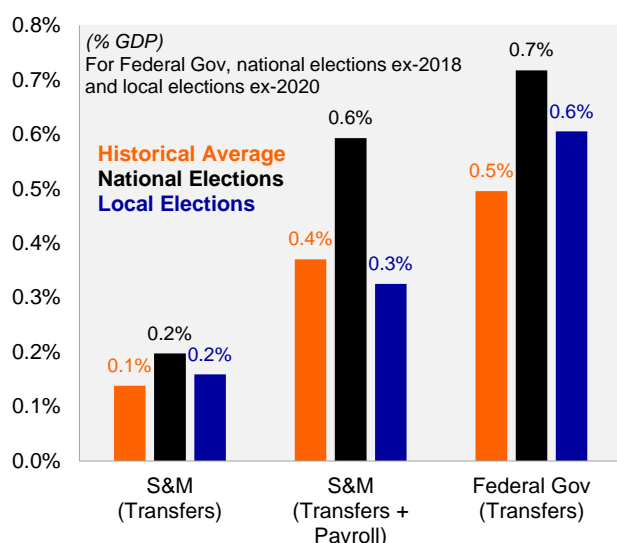
## States and Municipalities: Electoral Fiscal Impulses and Risks for 2026

- ▶ A recurring question in election years is how much subnational governments can boost economic activity through additional fiscal stimulus. In this report, we analyze the historical pattern of increases in these expenditures and their composition, the current fiscal situation of the entities and the most debated sources of funds for stimulus next year.
- ▶ In years of national elections, the fiscal impulse from States and Municipalities is, on average, 0.2 pp of GDP above the historical average of 0.4 pp of GDP. While the deterioration of their primary balance in recent years (which occurred despite an increase in federal transfers) suggests a more limited room for stimulus, there are potential sources of stimulus given i) the high level of cash balances, ii) the possibility of the federal government easing their debt limits, and iii) the approval of PEC 66/2023 with looser rules for the payment of court-ordered debt. The use of these sources involves caveats, but even so we believe their use could enable a stimulus in line with the historical pattern of elections. Although this is an important factor to be monitored and represents an upside risk to our 2026 growth scenario, the final magnitude of these risks is relatively small compared to the GDP surprises of recent years.

**In years of national elections, regional governments implement a fiscal impulse of 0.6 pp of GDP (see chart), on average 0.2 pp of GDP higher than the historical impulse of 0.4 pp of GDP and that observed in 2024, the latest available data.** There is also no major differentiation between the stimulus coming from the states and that coming from the municipalities (0.2 pp in the historical average and 0.3 pp. in national elections for each of the groups). The increase in spending by these entities in election years is close to what occurs to the federal government, which reinforces the importance of a more detailed analysis of their potential spending next year.

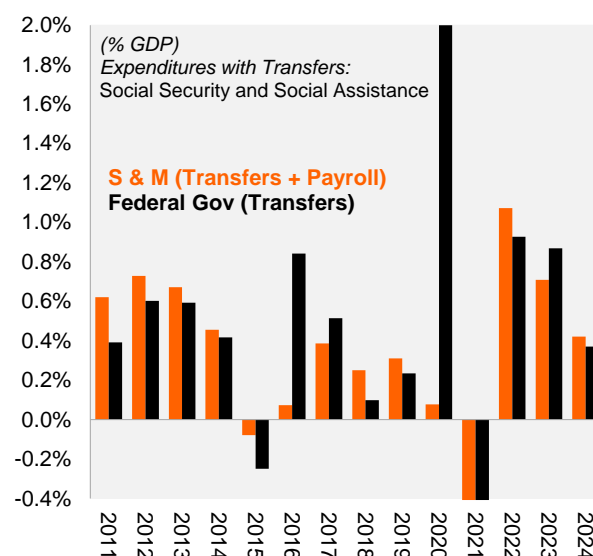
### Fiscal Impulse is higher for both Central Gov and S&M in election years

(S&M: 2011-2024; Central Gov: 2005-2024)



Source: National Treasury, Itaú

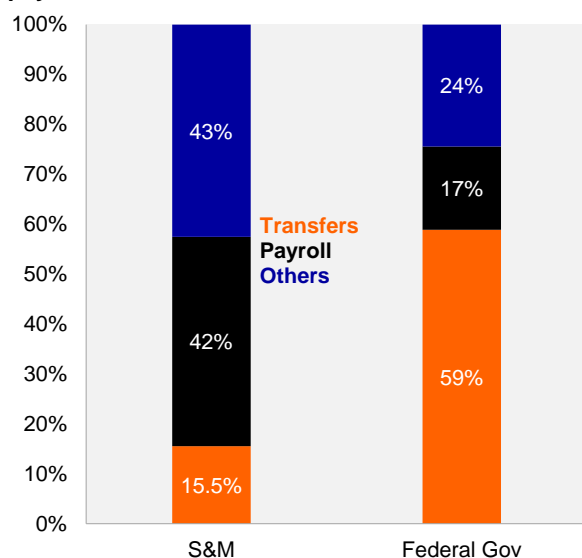
### Fiscal Impulse moderated in 2024



Source: National Treasury, Itaú

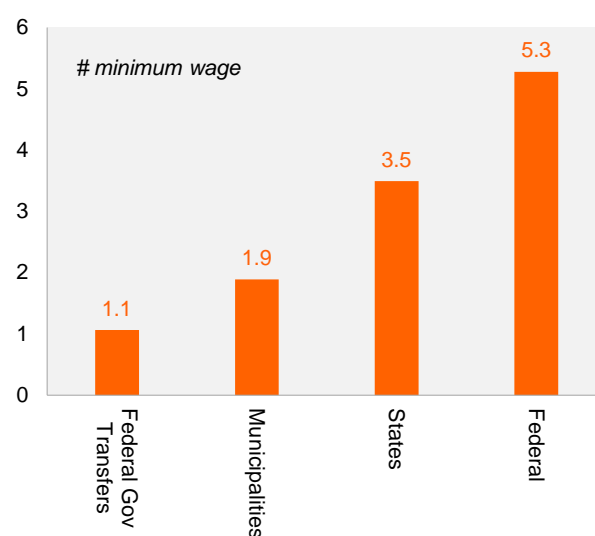
**It's worth noting that we consider as a subnational fiscal impulse both transfers to households and payroll expenses.** The impulse is measured by the 12-month cumulative real values, divided by nominal GDP. Transfers to households (Social Security and Social Assistance) are historically the most correlated with economic activity at the federal level. However, for regional governments, we believe it is also necessary to include payroll expenses, given their high share in total spending by these entities (1st chart) and that the wages of regional public employees are significantly lower than that of federal employees and closer to the minimum-wage (2nd chart), implying a lower savings rate and, therefore, a higher fiscal multiplier when there are wage hikes and new hires. Specifically, we consider a multiplier of 1 for transfer expenses (in line with the estimated for the federal government) and a multiplier of 0.9 for payroll expenses (in line with the average savings rate for the wage bracket of these entities).

**Primary expenditure of S&M has a larger share of payroll than those of Central Gov**



Source: National Treasury, Itaú

**Median Public Sector wages at subnational level are lower than in federal level**

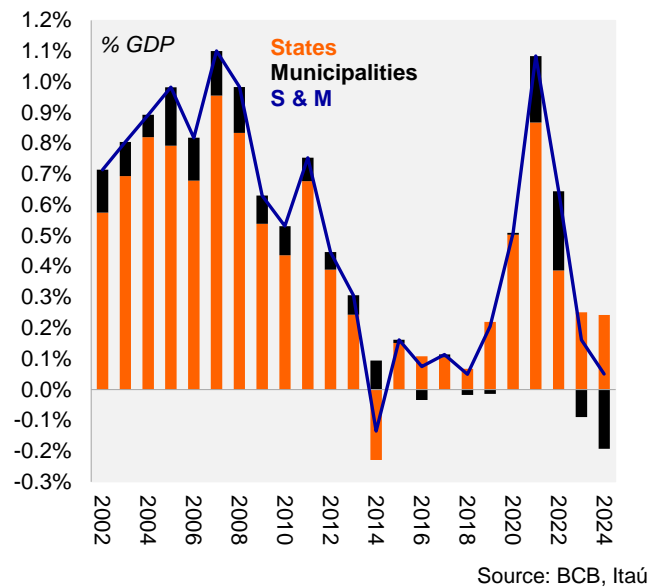


Source: Ipea, MPS, MTE, Itaú

**For 2026, the current fiscal situation of these entities indicates a very limited space for stimulus, around 0.1 p.p. of GDP, the current level of primary surplus.**

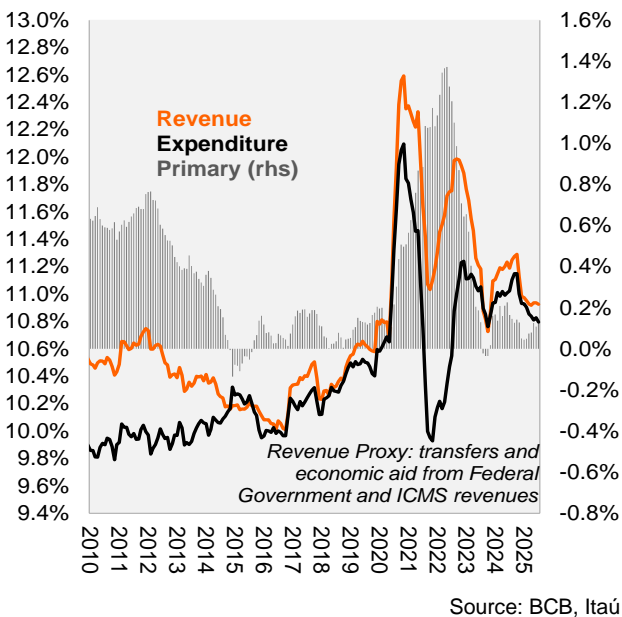
**After posting significant primary surpluses during the 2020-2022 triennium (average 0.7% of GDP), regional governments are now showing fiscal results similar to those obtained in the pre-pandemic period (0.1% of GDP in 2024 and the 2016-2019 average).** The deterioration has been accompanied by some divergence across government levels: while states are performing better than previously (0.2% in 2024 and 0.1% in the 2016-2019 average), there has been a deterioration in municipalities (-0.2% in 2024 and 0.0% in the 2016-2019 average).

Primary Result of S&M deteriorating recently

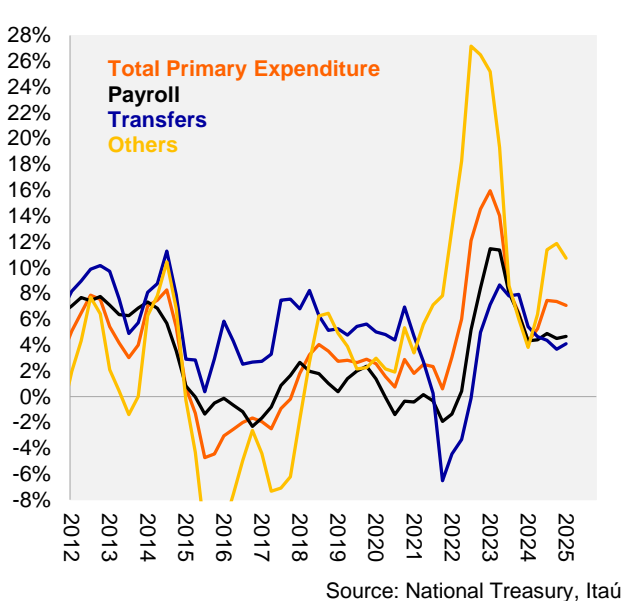


**The deterioration is driven by rising expenditures, despite higher revenues.** In the first chart below, we calculate an approximation of the revenue and expenditure breakdown for states and municipalities, based on the primary balance reported by the Central Bank, ICMS tax revenue disclosed by Confaz, and transfers from the federal government to these entities reported by the Treasury. The current expenditure level is close to the highs observed during the pandemic period, with spending recently expanding, mainly since the second half of 2024, with a slight reversal at the margin. The second chart shows that expenditure growth has been recently driven by items other than transfers and payroll, which suggests a proportionally smaller impact on economic activity than implied by the deterioration in the fiscal accounts of these entities.

Deterioration in primary result driven by higher expenditures

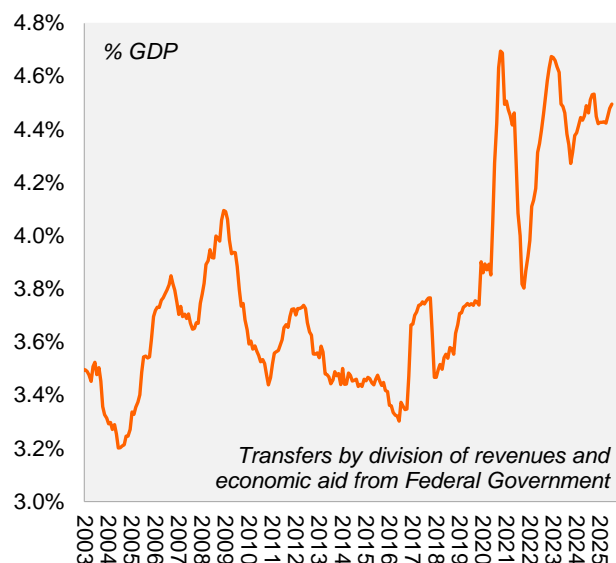


Real growth of primary expenditure has been driven by items other than payroll and transfers



**The recent deterioration occurred despite the higher level of income transfers and the support from the federal government to States and Municipalities.** There was both an increase in the tax base with the growth of revenue lines shared with the federal government, such as oil royalties collection (amid production increases), income tax and IPI in the Constitutional participation funds (amid federal government efforts to increase revenues overall), as well as an increase in the percentage transferred in one of these funds (the FPM) with the approval of EC 112/21 and extraordinary transfers to replenish revenues and compensate for losses from reduced fuel taxation. The greater dependence on the federal government represents a fiscal risk going forward, given the history of the 3 branches of the Union aiding regional entities.

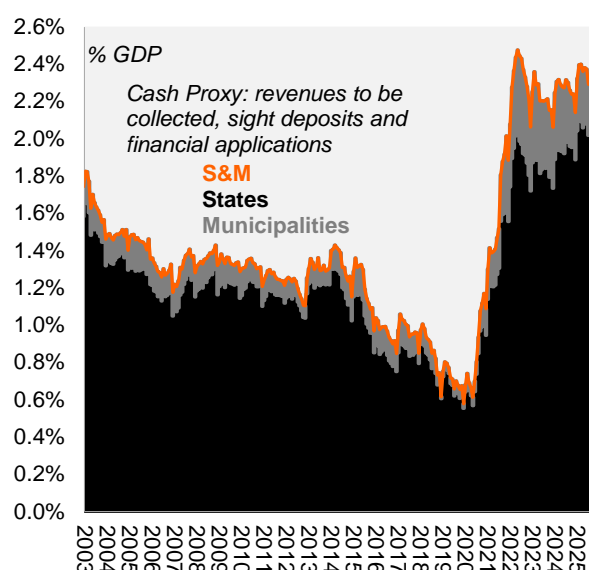
**Revenues from S&M coming from the Federal Government close to maximum levels**



Source: National Treasury, Itaú

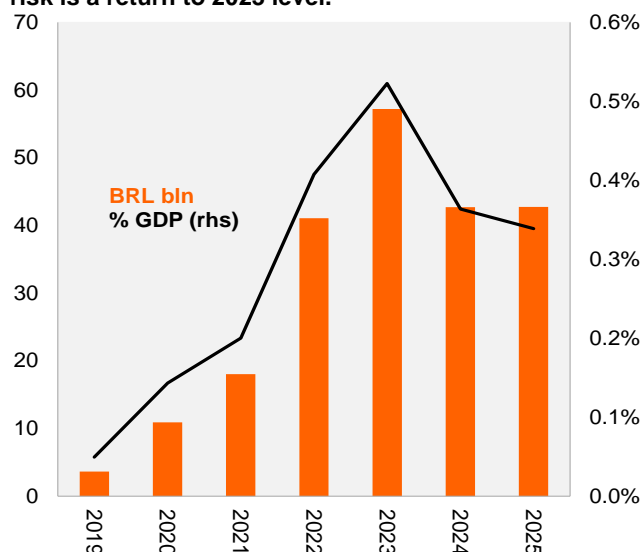
**Despite the current unfavorable situation, we believe that additional stimulus measures from regional governments may still occur, given three sources of resources: i) high levels of cash balances, ii) possibility of easing the debt limits for these entities, which are established by the federal government and iii) approval of PEC 66/2023 with looser rules for the payment of court-ordered debt.**

**Regarding the first factor, the cash position of regional governments today is more comfortable, around 1.7 pp of GDP above the 2019 level, mainly in the States, although their rapid and full use seems difficult.** We note that the cash level has stabilized at this high level since 2022 (which was also a national election year) and that historically the largest negative cash variation for regional governments was around 0.3% of GDP, suggesting that, despite the availability of a high amount, the full use of these resources is unlikely, probably reflecting mandatory earmarks and/or commitment of these resources to longer-term projects.

**S&M cash proxy close to maximum levels since 2022**

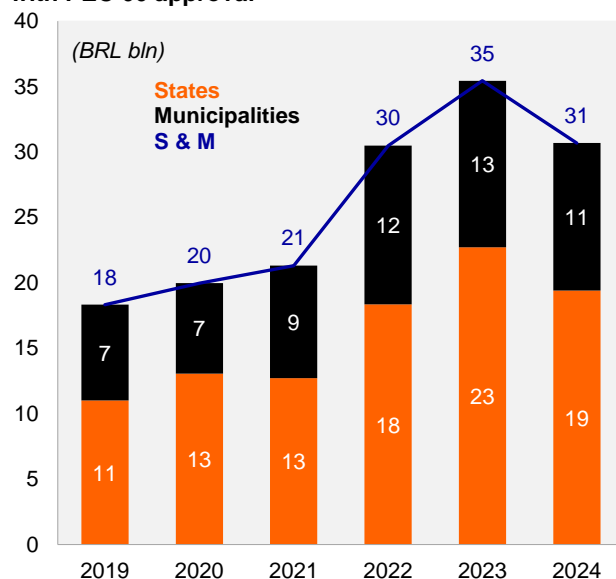
Source: BCB, Itaú

**Regarding debt limits for government borrowing, some flexibility is possible to levels close to the recent 2023 peak.** The credit operations limit increased by around 0.3 pp of GDP since 2019. Over the past 2 years, there has been relative moderation at the margin, which could be reversed next year driven by election-year spending pressures.

**Limits for S&M debt issuance increased recently. The risk is a return to 2023 level.**

Source: National Treasury, Itaú

**Finally, we estimate that PEC 66 creates room for an increase in expenditures of around 0.15% of GDP (BRL 22 billion).** The law recently approved by Congress brought the following changes: i) reduction of the Selic correction to IPCA + 2%, ii) removal of the deadline for installment payments of the debt balance (previously set until 2029), and iii) limitation of the annual payment of court-ordered debt by States and Municipalities to a percentage of their Net Current Revenue, ranging from 1% to 5%, increasing in relation to the debt balance as a proportion of revenue. For the States, we estimate that the new rules will generate a reduction in court-ordered debt expenditures of around BRL10 billion in 2026. For the Municipalities, in a recent study, the CNM indicated savings of around BRL12 billion.

**S&M: Court-Ordered Debt Payments can have a relief with PEC 66 approval**


Source: CNJ, Itaú

We calculate potential fiscal stimulus scenarios for 2026, considering the use of the space allowed by current primary balance, assumptions for the 3 factors described above and the percentage of spending directed towards transfers to households and payroll expenditures (see table). We model three scenarios for the share of spending directed to household transfers: 16% (same as the current composition of regional government expenditures), 25% and 40% as more optimistic scenarios for the composition of these potential stimuli. For payroll expenditures, we assume 42% (also the same as the current composition) and 60% as a more optimistic scenario. As assumptions for the factors, we consider for factor (i) the use of 50% of the additional cash since 2019 (0.75% of GDP), maximum historical annual variation (0.3% of GDP) and average variation in election years (0.1% of GDP), for factor (ii) stability or convergence to the recent 2023 maximum and for factor (iii) total use or 50% of the fiscal space opened by the PEC.

Fiscal Impulse from States and Municipalities in 2026			
Scenarios	% Transfers to HH % Payroll		
	16%	25%	40%
	42%	60%	60%
<b>Scenario 1 (1.0% GDP)</b> i) Cash: 50% of additional vs 2019 (0.75% GDP); ii) Lending operations limit = 2023 (0.1% GDP); iii) Total use of fiscal space PEC 66 (0.15% GDP)	0.6%	0.9%	1.1%
<b>Scenario 2 (0.6% GDP)</b> i) Cash: max. historical annual delta (0.3% GDP); ii) Lending operations limit = 2023 (0.1% GDP); iii) Total use of fiscal space PEC 66 (0.15% GDP)	0.4%	0.6%	0.7%
<b>Scenario 3 (0.2% GDP)</b> i) Cash: avg. delta in election years (0.1% GDP) ii) Lending operations limit stable (0.0% GDP); iii) 50% use of fiscal space PEC 66 (0.07% GDP)	0.2%	0.2%	0.3%

**We consider as the most plausible scenario a fiscal impulse of around 0.6% of GDP in 2026, which is in line with the average for election years and 0.2 pp above the historical contribution and what was observed in 2024, the latest available data.** This scenario contemplates an annual variation in cash consistent with the maximum historical level, an increase in the credit limit for regional governments to the 2023 level and full use of the space enabled by PEC 66 in 2026. Additionally, the scenario contemplates higher than historical use for transfer expenditures (25%) and payroll (60%), to be monitored with possible announcements of stimulus, adjustments and hirings by subnational entities.

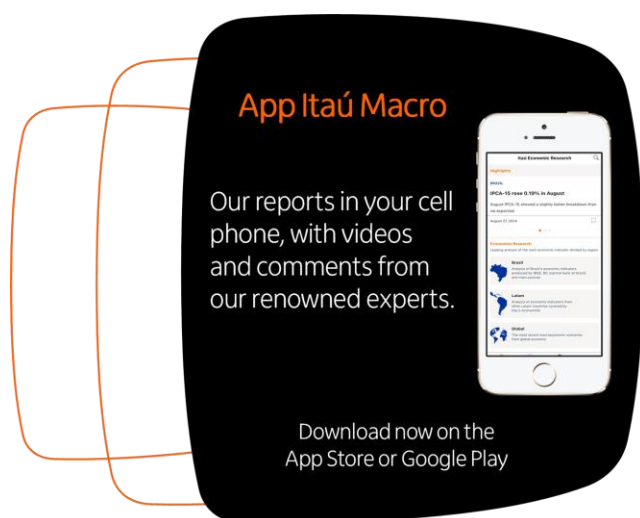
**In summary, regional governments may be an additional source of demand stimulus for next year, considering the historical pattern of election years and cyclical factors that could increase fiscal space in the short term and boost their contribution to growth by 0.2 pp of GDP, despite the deterioration of their current fiscal situation. Nonetheless, while important to monitor, the magnitude of the effect remains modest compared with recent GDP surprises.**

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