Global Economic Policy Lab

Brazil Country Analysis: 2019
Final Report: Brazilian Subnational Debt

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- Despite Brazil's attempts, a political framework that does not address the nation's rigid budget and constitutionally mandated spending will ultimately fail to amend the debt crisis.
- Many of Brazil's states are under significant fiscal pressure, with six – Goiás, Minas Gerais, Mato Grosso, Rio de Janeiro, Rio Grande do Sul, and São Paulo – exhibiting high-risk signs of bankruptcy.
- Until the federal government achieves significant savings from its generous pension system and other reforms, the fiscal position of Brazil's subnational governments will remain unstable.

Overview
Introduction to Brazilian Federalism

Brazil is divided into three government levels: the central government (federal), the states (26 in total plus the Federal District of Brasilia), and more than 5,500 municipalities. Following the adoption of the 1988 Constitution, Brazil became one of the most decentralized countries in the world. The push for decentralization stemmed from the desire for increased political representation for the less populated and poorer states. The Constitution, or Federative Pact, achieved this in addition to an increased role of the public sector in social services and enhanced public sector employee benefits. As of today, these subnational entities account for roughly 40 percent of Brazil's budgetary resources.

In accordance with the Constitution, Brazilian subnational governments are authorized to fulfill all functions that are not explicitly reserved for the Federal government. This level of autonomy made it difficult for the Brazilian government to secure a healthy fiscal stance throughout the nation. As a result of the poor fiscal behavior of the subnational governments, Brazil experienced severe macroeconomic instability. Expansionary state fiscal policies and a lack of effective indebtedness controls resulted in subnational debt crises in 1989, 1993 and 1997.

1989: Federal authorization allowing "Banco do Brasil" (the main public bank of Brazil) to refinance state debts for twenty years after the collapse of the stabilization plan launched in 1986. This action failed to address state fiscal issues, which continued to deteriorate due to high interest rates and rising inflation.

1993: New refinancing conditions established in 1991 are amended in 1993 to allow for refinancing of outstanding debts with federal financial institutions. However, it failed to address bonds and private bank debt.

1997: Failures from 1989 and 1993 in addressing fiscal imbalances were ultimately addressed in 1997. A new law established conditions necessary for debt renegotiation; setting targets for total debt, primary surplus, wage costs, tax collections, and included elements of debt forgiveness, interest subsidy, restructuring of maturities, and privatization.

Section 1:
Current State of Subnational Debt and Existing Regulatory Framework

Several subnational governments are in the midst of illiquidity or insolvency due to fast growing deficits. As of August 2018, three of Brazil's largest states (Rio de Janeiro, Rio Grande do Sul and Minas Gerais) have declared a "fiscal calamity" with Net Consolidated Debt to Current Net Revenue ratios of around 270 percent, 219 percent and 186 percent, respectively. Moreover, many states are experiencing liquidity constraints and are struggling to meet their fiscal obligations on time. This environment of debt instability and lack of accessible liquidity can be attributed to the rapid growth in mandatory expenditures (that cannot be unilaterally diminished or eradicated) combined with stagnating, and in some cases falling, state revenues.

Budget Rigidity and Pro-Cyclical Fiscal Policy

Existing spending mandates and budget rigidities are ultimately the cause of liquidity shortages among subnational governments and, if they remain the same, will likely lead to more insolvent states. The Brazilian budget is known for its rigidity, which can be defined by excessive earmarked revenues and the cyclicality of mandatory spending and revenue generation.

Revenue earmarking, which is outlined in the Federal Constitution, was instituted for two main reasons: (1) to ensure that governments allocate a minimum amount of the public budget to various priority sectors and (2) to avoid the risk of free-riding on constitutional transfers that are common to all levels of government; basically, budget rigidity prevents one level of government from not investing in a sector due to the expectation that others will. The most important earmarking between revenues and expenses include: transfers to municipalities; the minimum spending in health and education services (which is currently 12 percent and 25 percent of tax revenue respectively); the revenues provided by the federal government as collateral for debt; and lastly, the resources designated for the states' pension systems. Consequently, states are strained fiscally since their pool of funds is drastically limited once the above expenditures are deducted.

In addition to revenue earmarking, pro-cyclical spending surges weaken the states' ability to manage their debt effectively and maintain solvency. Expenditures on vital social services, like healthcare and education, are governed by spending mandates linked to tax revenues which are reinforced by the Constitution. As a result, when subnational governments generate substantial revenue amounts, they are forced to spend this capital instead of saving it appropriately. In contrast, during times of economic turbulence, governments are unable to reduce expenditures due to strict spending mandates, such as the national minimum wage, the teacher's salary floor and the pension system. Since personnel expenditure accounts for, on average, 61 percent of the states' Net Current Revenue, subnational governments are forced to cut investment spending to salvage what little funding they have left.

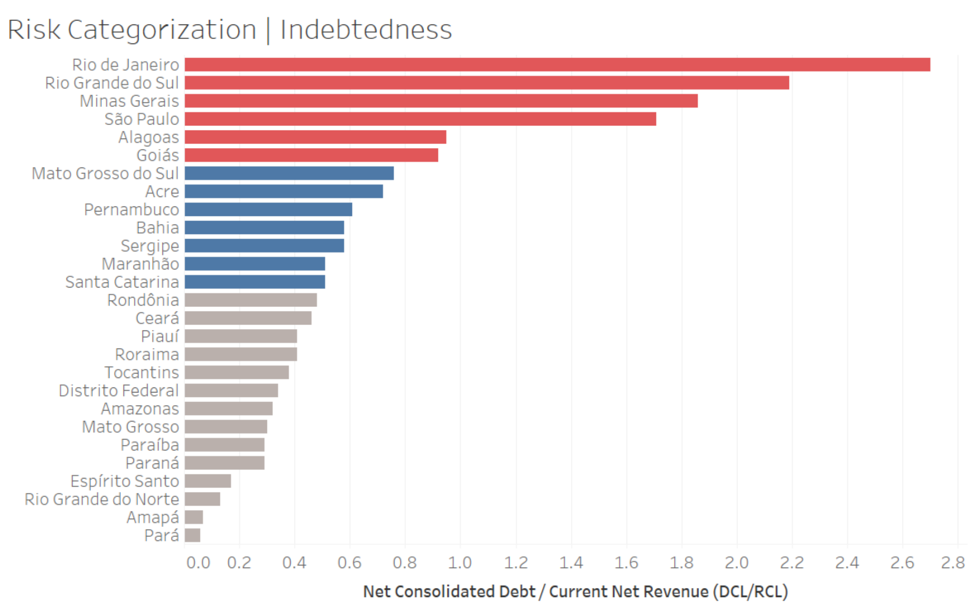
Existing Regulatory Frameworks

In an attempt to align fiscal policies across all levels of government, the Brazilian federal government created the Fiscal Adjustment Program (FAP). Prior to 2009, the FAP was designed to encourage the proper management of state debt by establishing loan parameters. In essence, the FAP sets limits on the total number of loans each state can incur depending on their fiscal capacity at the time. However, in 2009, the borrowing constraints of the FAP were weakened, thus states in sensitive fiscal situations were authorized greater access to credit. In addition to the FAP, the Brazilian government enacted the Fiscal Responsibility Law (FRL) in 2000. The FRL was put in place to facilitate responsible fiscal management among all levels of government, while also increasing government transparency regarding the spending of public funds. Despite these intentions, the FAP and FRL were only successful for about a decade as several state governments, during that time frame, became more fiscally disciplined and experienced a reduction in debt. Nonetheless, the most indebted states, such as Rio Grande do Sul, continued to experience devastating debt burdens despite the regulatory frameworks in place. With expenditures on the rise and the continued deterioration of states' fiscal positions, the Federal government created the Regime de Recuperação Fiscal in 2017 in an attempt to regain control of Brazil's fiscal stance. The purpose of the Regime de Recuperação Fiscal is to provide relief on debt repayment in exchange for fiscal adjustment; for instance, by offering reduced interest rates. However, since the regime does not attack the root problem of Brazil's subnational debt crisis (i.e. budget rigidity and constitutionally mandated spending) this attempt ultimately fails in the long run. Until there is structural reform to the Constitution, no policy or regulatory framework will give states the spending flexibility that they need in order to tackle this monstrous debt.

Section 2:
Risk Classification and Impact Analysis

Brazil's subnational fiscal concerns are not all encompassing. A number of the nation's states are in good fiscal condition, the persistence of which, however, remains a concern. To better understand this fiscal disparity, as well as to more effectively allocate resources, it is important to identify the high-risk states. The following, therefore, will assign the 27 states into three categories, defined by descending levels of risk. This categorization, in turn, will depend on three major financial indicators: indebtedness, current savings and liquidity.

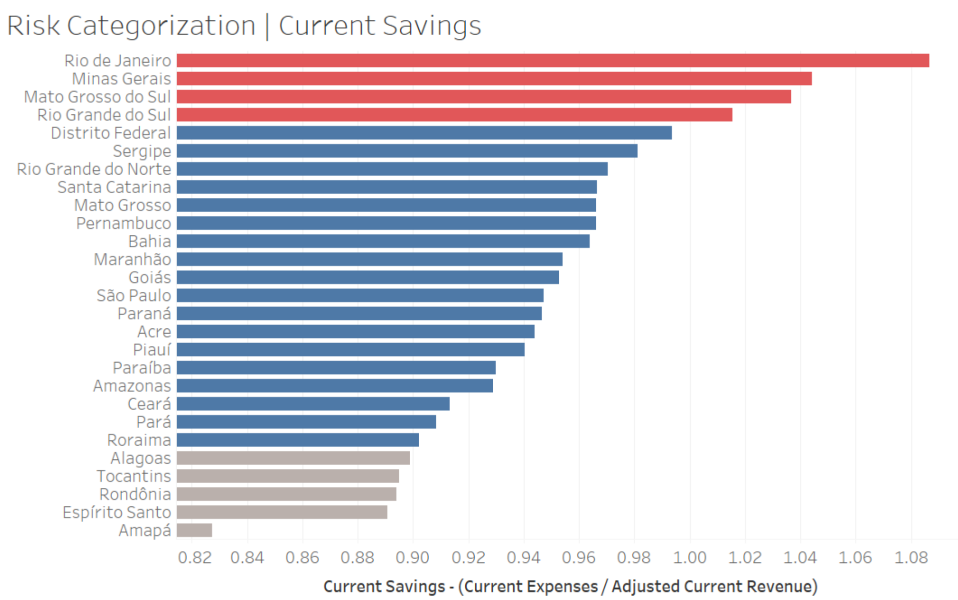
Indicator 1: Indebtedness



Risk Categorization based on Net Consolidated Debt / Current Net Revenue (DCL/RCL) | Source: http://www.tesouro.fazenda.gov.br/documents/10180/0/Boletim+de+fina%C3%A7as+dos+entes+subnacionais+vers%C3%A3o+final+2/635d1169-777c-46bf-9e98-dab987e9f6f7

The foremost indebtedness metric tracked by the Secretaria do Tesouro Nacional – the federal treasury within the Ministry of Finance – looks at the ratio of Net Consolidated Debt to Current Net Revenues (DCL/RCL). This debt ratio provides a reliable insight into a state's fiscal position by relativizing its total debt to the current revenues generated by the state, less any legal deductions owed to the Union. For the purpose of this report, the lower band of the high-risk category limit was set at DCL/RCL ratio of 80%. The medium-risk category was contained by DCL/RCL limits of 50% and <80%. All states exhibiting ratios below 50% were allocated to the low-risk category. Among high-risk states, Rio de Janeiro, Rio Grande do Sul, Minas Gerais, and Sao Paulo have the most alarming rates of indebtedness, all close to, or above, 200%.

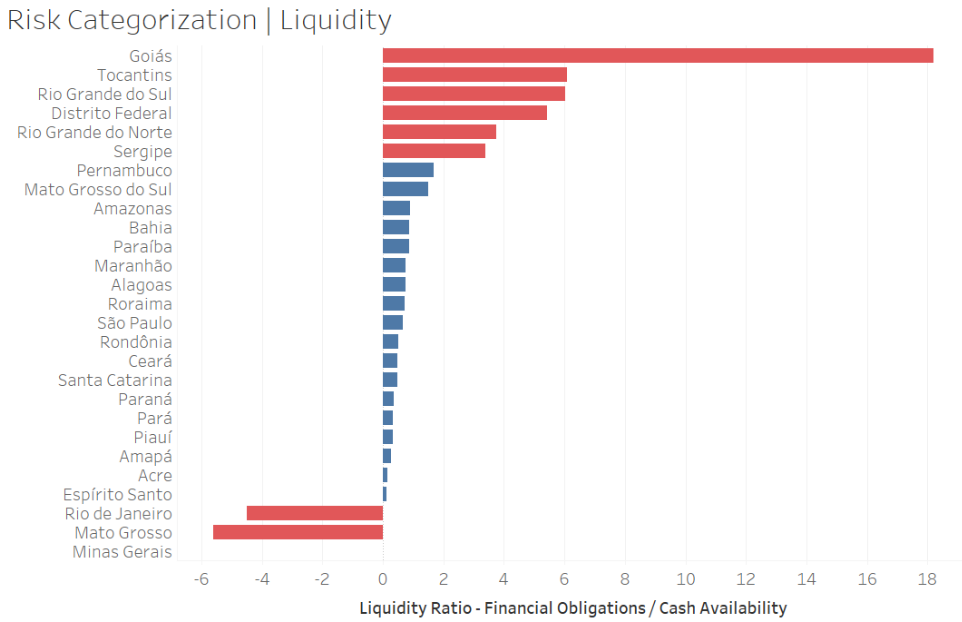
Indicator 2: Current Savings



Risk Categorization based on Current Savings (Current Expenses / Adjusted Current Revenue) | Source: http://www.tesouro.fazenda.gov.br/documents/10180/0/Boletim+de+fina%C3%A7as+dos+entes+subnacionais+vers%C3%A3o+final+2/635d1169-777c-46bf-9e98-dab987e9f6f7

This indicator provides an important dimension to the analysis of the fiscal position of states. Looking at a state's current expenses against its adjusted current revenue points to its capacity to cover short-term expenditures with the income generated over the same period. The high-risk category for this indicator was defined as all ratios in excess of 100%. This, in turn, would indicate a state's inability to cover its short-term expenses with its adjusted revenues from the same period. Four states fell into this band, namely Rio de Janeiro, Minas Gerais, Mato Grosso do Sul, and Rio Grande do Sul.

Indicator 3: Liquidity Ratio

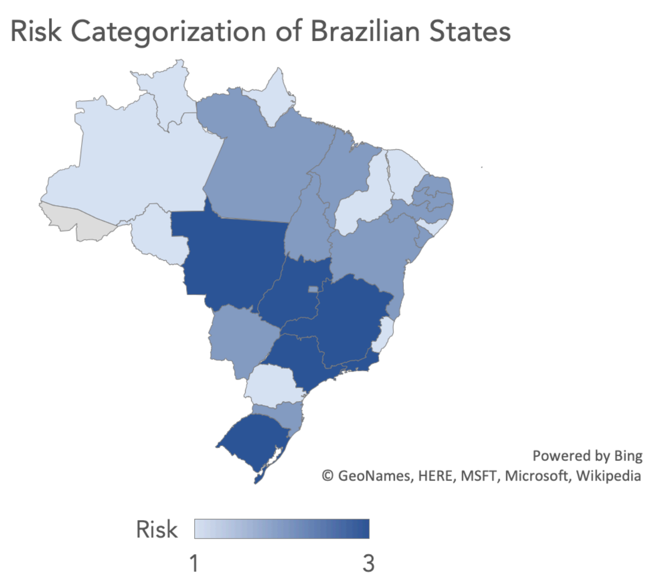


Risk Categorization based on Liquidity Ratio (Financial Obligation / Cash Availability) | Source: http://www.tesouro.fazenda.gov.br/documents/10180/0/Boletim+de+fina%C3%A7as+dos+entes+subnacionais+vers%C3%A3o+final+2/635d1169-777c-46bf-9e98-dab987e9f6f7

The final indicator used to evaluate the fiscal position of states was a liquidity ratio that relativized each state's financial obligations to its available cash. This is a revealing metric as it highlights how cash-poor many of Brazil's major states are, while reinforcing the severity of the issue of stymied revenue generation. According to liquidity ratio, Rio de Janeiro, Mato Grosse, Minas Gerais, Goias, Tocantins, and Rio Grande do Sul are the most high-risk states.

Consolidating the insights from the fiscal metrics highlighted above brings six high-risk states to the forefront: Goiás, Minas Gerais, Mato Grosso, Rio de Janeiro, Rio Grande do Sul, and São Paulo (level 3 risk in the map provided).

The following will provide an impact analysis of the consolidated high-risk category, as well as a deep dive into the case of Rio de Janeiro.

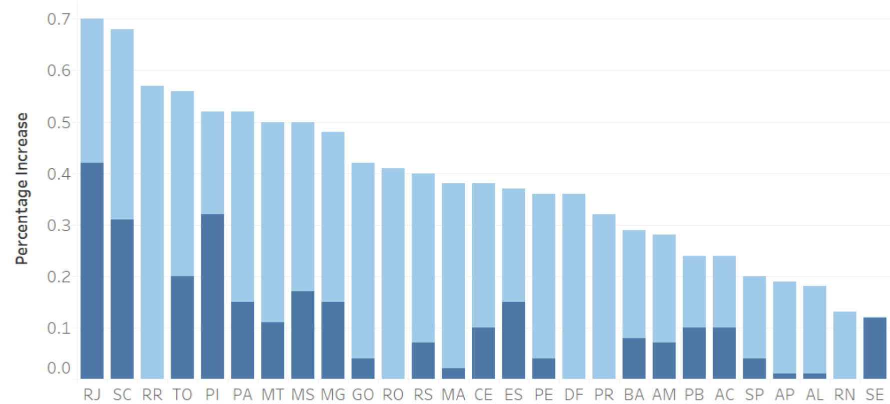


Analysis of High-Risk States

The six high-risk states in Brazil account for more than 40% of the nation's population, as well as ~62.8% of the country's GDP. Collectively, they have outstanding debt obligations of more than R$630 billion, of which the vast majority is owed to the federal government, federal banks, or external creditors. These states share a number of similar structural impediments to achieving financial stability and fiscal insolvency in any, or all, of these states could be hugely detrimental to Brazil.

All 6 states face significant social security deficits – although those of Rio de Janeiro, Sao Paulo, and Minas Gerais are most severe. Together, the six states are accountable for almost 69% of the consolidated state Social Security costs, and 73.4% of the deficit that arises as a result of the social security service. What's more, aside from Sao Paolo and Goiás, each of the six high risk states currently lie above the 60% limit on personnel expenditures to net current revenues, stipulated by the Fiscal Responsibility Law. This is an issue that has become increasingly exacerbated over the past decade and, due to the need for constitutional amendments for many of the structural issues facing the states, threatens to persist going forward.

Real Growth in Payroll and Pension Expenditures by State (2009-2015)



Pension Expenditures and Payroll Expenditures for each State | Source: IMF Country Report No. 16/349

Measure Names
- Pension Expenditures
- Payroll Expenditures

Taxes represent the primary source of income for Brazilian states. Almost 60% of the revenues of the 10 largest debtors (D-10) is derived from taxes. Of these, the ICMS – equivalent to an origin-based VAT – is the largest contributor at 75%. States, especially the D-10, have suffered under falling ICMS revenues, which decreased from 5.4% to 4.6% of GDP from 2005 to 2015. Tax-based competition between states that have the autonomy to independently set their ICMS rates has added to this decline, as many are stuck in a race-to-the-bottom dynamic as they look to entice investments. Many countries would combat declining revenue streams by reducing expenditures. However, states face considerable fiscal rigidity.

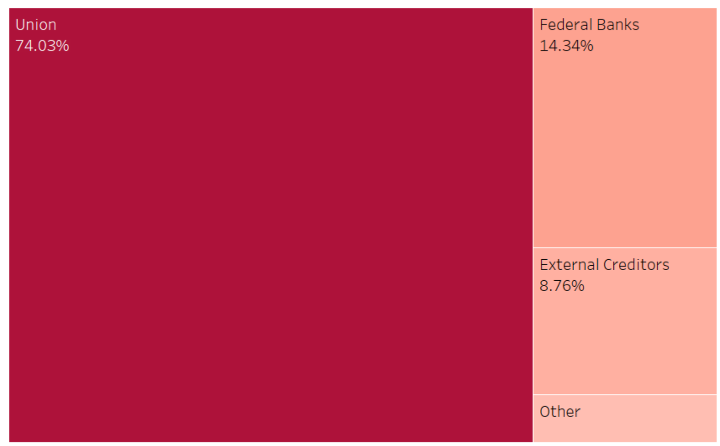
The impact on the Brazilian economy of "fiscal calamity" for any, or all, of the high-risk states, could be severe and pervasive. In 2017, the six high risk states accounted for close to 89% of total state debt owed to the federal government – close to R$480.59 Billion. What's more, the federal government has guaranteed approximately 50% of the debt. In addition, the states currently have outstanding obligations to federal banks that amount to more than R$54.7 billion, which is close to 54% of the exposure the banks have towards tier 2 subnational debt. State bankruptcy would not only likely damage these institutions, but the impacts would likely ripple through society as well.

Rio de Janeiro

Rio de Janeiro has the nation's second largest subnational economy, accounting for more than 10% of Brazil's economic output. Despite being the federation's smallest state, Rio is home to almost 17 million people, making it the country's most densely populated state. As such, fiscal collapse in Rio would not only be economically, but also socially, devastating.

According to the most recent data, Rio has a debt burden of more than R$134.83 billion, 74% of which is owed to the federal government. Federal banks and external creditors, in turn, make up a smaller – but not insignificant – portion of the state debt.

Breakdown of Rio de Janeiro's State Debt



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Rio de Janeiro has been chronically fiscally mismanaged. From 2016 to 2017, the state's DCL/RCL ratio increased by ~20% to 288.46%. As such, the federal government suspended payments of debts refinanced and guaranteed by the government in accordance with the Tax Recovery Regime (RRF). In the same year, more than 16% of Rio's revenues were generated through credit operation, corollary to assuming more debt. These developments can be boiled down to a number of primary factors.

Firstly, Rio has an incredibly bloated civil service. In fact, in 2017, personnel payments accounted for more than 70% of net current income. This is considerably over the constitutionally mandated PAF limit of 60%. This has been a pervasive issue for Rio over the past decade. From 2011 to 2017, the real increase of personnel expenditures amounted to more than 100% – the median for all states was 27.19%. As such, personnel expenses accounted for ~65% of the state's total primary budget

Secondly, Rio is burdened by Brazil's constitutionally-mandated vertical and horizontal transfers. The median proportion of revenues received from transfers among all states lies at 33.29%. Rio received approximately 10% in 2017, which doesn't include the transfers made from Rio to municipalities. When these are taken into account, the picture becomes bleaker.

Finally, Rio de Janeiro adopted a number of unpopular policies over the past 5 years, including raising taxes and increasing the income of state employees, while simultaneously demanding renegotiations of the state debt with the federal government. As such, the state government has continued to expand the limits of state expenditures without generating new sources of revenue.

Section 3: Municipalities

As outlined, Brazil's 5,570 municipalities hold the status of federal entities, with constitutional autonomy; municipalities are charged with the organization of local public services, enacting and collecting taxes, and personal administration, among others. The autonomy and fiscal rigidity have meant municipalities, like states, have found themselves in increasingly burdensome fiscal situations. Much like the states, municipalities were authorized to take on new debt to finance expenditures during periods of economic downturn.

The breakdown of creditors of municipalities can be visualized in the attached figure.

The largest creditor comes in the form of the Union – meaning transfers from either state or federal levels. This is part of what makes the worsening fiscal situation so pervasive; the federal government is a major financer of state and municipality debt, and there exists a moral hazard amongst subnational governments and little incentive to right their fiscal situations with the knowledge that the federal government has bailed them out in the past.

Across all levels of Brazilian government, foreign or foreign-linked debt owed to foreign creditors is predominantly denominated in US dollars. The real's value relative to the dollar becomes increasingly important when examining levels of external debt at the subnational level. Much the external debt that is sourced from the World Bank or regional development banks is denominated in US dollars, which becomes increasingly tenuous when revenues are not being earned in US dollars and the real continues to trade around 4:1 vis-à-vis the dollar.

Municipalities, especially the state capitals of São Paulo, Rio de Janeiro, and Florianópolis, are particularly indebted, and add a layer of complexity to the subnational debt situation and the nature of Brazil's federalism. The nearly 5,800 subnational governments, comprised of states and municipalities, and their varying levels of indebtedness requires the federal government to remedy its own fiscal situation in order to be prepared for potential contagion scenarios.

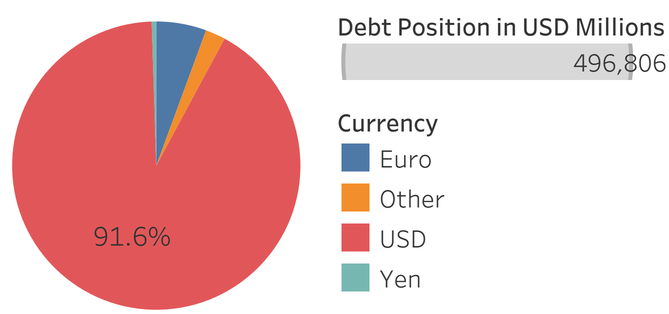
Creditors to Municipalities

External Creditors	
World Bank	5,041
Inter-American Developm..	4,211
Development Bank of Lati..	1,177
Other Creditors	577

Internal Creditors	
Union	44,203
CEF	15,027
Brazil Development Bank ..	5,994
Banco do Brasil	3,161
Other	859

Millions of Reais, Source: Boletim de Finanças dos Entes Subnacionais 2018

Breakdown of Gross External Debt Position



Total Foreign Currency and Foreign-Currency-Linked Debt Position of Brazil | Source: World Bank

Section 4:
Pension & Other Reforms

President Bolsonaro ran on a platform of pro-market and economically liberal policies, such as privatization, deregulation, and fiscal discipline. Three major pieces to the economic vision of the Bolsonaro, which boasts Paulo Guedes at the helm, are pension reform, simplification of the tax code, and privatization. Each of the reforms aims to right the fiscal ship by either reducing spending, ensuring greater tax revenue capture and a more pro-business environment, or raising capital for the government. Brazil's ballooning debt, at each level of government, has instilled a degree of urgency in the economic reforms, namely that of social security.

Pension Reform

Social security reform – highlighted in previous reports of this series – is billed as the headliner amongst the list of broader economic reforms proposed by Bolsonaro and Guedes. Pension spending in Brazil accounted for roughly 44% of federal spending in 2018, and is considered one of the most generous systems in the world, allowing workers to retire at 55 and earn upwards of 70% of their salary. The necessity for reform is apparent given the priority of social security spending at both the federal and subnational levels; the system is enshrined in the constitution and requires a constitutional amendment in order to make changes to the program.

Officially, the constitutional amendment regarding social security (PEC 6/19) has been submitted to Congress and is currently in its first of multiple committee stages with the Constitution and Justice Commission, with debate to begin April 15th, and a vote to come as early as April 16th. The current proposal aims to save one trillion reais over the next 10 years; despite the potential for small cuts to various aspects of the proposal, Guedes remains confident that the government will secure the intended savings. Other estimates have potential savings at 60-70% of Guedes' one trillion reais target after lawmakers dilute the proposal. Amongst citizens, opinion of the proposed reforms to the social security system is virtually split down the middle, with half of Brazilians supporting the proposal.

An issue that has sewn anxiety amongst lawmakers and investors alike is the, to date, unwillingness of Bolsonaro or Guedes to engage with politicians of other parties in order to build political bridges within Brazil's complex and fractured Congress to ensure the success of the reform package.

Complicating matters further for the government are the recent allegations from federal prosecutors, as part of Operation Car Wash, that House Speaker Rodrigo Maia had taken bribes from a major engineering firm. This comes weeks after Bolsonaro and Maia engaged in a public spat over social security reform. Political infighting and corruption probes only stand to roil markets and threaten the overall success of the proposed reforms.

Privatization and Tax Reform

The government has stressed its desire to privatize numerous state assets, with Guedes stating "[the government is] selling everything", and overhaul the tax code to ease the cost of doing business and tackle revenues lost to inefficiencies and corruption. To date, the privatization process has raised US$12 billion, more than half of the US$20 billion forecast. Privatization proceeds will provide needed revenues for the government but will be short-lived compared to the sustained solutions that pension and tax reform could provide. Details of any tax reform are scarce, with such a complex reform process likely only to be proposed after an outcome with social security is realized.

Privatizations at the state level could provide respite from a worsening fiscal situation. The governor of Minais Gerais stated that privatization efforts could raise up to 9 billion reais, which could drastically help finance the state's 12 billion reais deficit.

As highlighted, the strain placed on the federal government by the fiscal situations of both states and municipalities has become an issue that can no longer be ignored by those in Brasília. Failure to achieve significant savings via pension and other reforms would place the federal government and, by extension, states and municipalities in an increasingly precarious financial situation.