

The International Policy Centre for Inclusive Growth is jointly supported by the United Nations Development Programme and the Government of Brazil.

Fiscal Conditions of Brazil's Public Sector: an Analysis of the States in the North and Northeast Regions and Funding for Rural Development

*by Rodrigo Octávio Orair (Ipea/IPC-IG); Sergio Wulf Gobetti (Ipea)
and André Amorim Alencar, Consultant*

Brazil is a continent-sized country and a federal republic, comprising 27 state units (including the Federal District, where the capital, Brasília, is located) and more than 5,500 municipalities with ample tax autonomy and active participation in duties usually befalling public administration, such as the provision of health and education services, public safety and various types of infrastructure. As such, Brazil's fiscal policy encompasses all three levels of the government, which jointly collect and share tax revenues and define the constitutional duties to be performed by each, as well as ways to fund them—through borrowing, for example. In the process of federal coordination, however, the central government plays a key role and holds greater power than the other levels, so that the policies outlined at the central level—beyond the national macroeconomic environment—greatly influence the room to manoeuvre for states and municipalities, in practice restricting their effective autonomy.

Thus, an analysis of the alternatives for expanding the funding of states and municipalities requires, first and foremost, an understanding of the fiscal constraints that have long characterised the work of government units. This puts the meaning and the scope of the current financial and economic crisis into (temporal and spatial) context, as well as its possible repercussions for the policies put in place over the past decade. It is especially important to assess the extent to which this broader fiscal space—opened between 2008 and 2011 and enabling higher debt levels by states and municipalities—will be affected in the medium and long terms.

The analysis in this study shows that the current condition of Brazil's public sector is far less fragile than in previous periods of international turmoil, such as in the debt crisis of the 1980s or the exchange rate crises of emerging countries in the late 1990s. Net debt was greatly reduced and became less vulnerable to external shocks after 2003, due to the de-indexation of the debt against the US dollar and the accumulation of foreign exchange reserves, which turned the country into a net foreign creditor.

The lower financial vulnerability of the public sector, combined with faster economic growth, enabled sufficient headroom for a shift in fiscal policy as of 2006, giving rise to a period marked by fiscal expansion characterised by tax cuts and (initially) increasing public investments (Schettini et al. 2011). This shift resulted in an easing of the central government's restrictions on state and municipal debts and in lower primary balances across all three levels of the government (federal, state and municipal)—evolving from a surplus of over 3 per cent of Gross Domestic Product (GDP) to a deficit of 0.59 per cent of GDP in 2014—the first deficit since the introduction of the fiscal targets system in 1999.¹

As of 2006, the gradual lowering of the primary balance did not prevent the public sector's net debt from continuing its decline, eventually reaching 31.5 per cent of GDP in 2013 (compared to 58.9 per cent of GDP at end of 2002). It was only in 2014—during a strong economic downturn and a sharp drop in the primary balance (from a surplus to a deficit)—that the debt level rose again to 34.1 per cent of GDP, which, in historical terms, is quite low and similar to the levels seen in the early 1990s. The problem is the cost of stabilising the debt—that is, the primary surplus required to prevent it from rising relative to GDP—which has become exceedingly high in recent years, due to another factor related to debt composition: the simultaneous accumulation of assets and liabilities by the public sector and the interest rate differential between them.

As such, Brazil's debt was reduced in net terms, but in gross terms it has increased due to the accumulation of low-profitability assets (foreign exchange reserves and loans from the Brazilian Development Bank (BNDES)—i.e. loans at subsidised interest rates to encourage private investment mostly related to long-term projects by big corporations) and the incurrence of more expensive debt (mortgage bonds and repurchase agreements held by the Central Bank). This explains the public sector's high net nominal interest rate (the difference between interest paid and interest received), especially after the Central Bank increased interest rates once again to try to curb inflation, despite the strong economic slowdown.

Thus, both the nominal deficit and the debt level have increased as a result of a combination of decreasing primary balances and increasing interest rates (explained, as mentioned earlier, by the official interest rate and its difference from the rates earned on assets). The Brazilian government's response to this challenge was a fiscal adjustment (starting in 2015), which interrupted the period of greater fiscal flexibility to reclaim the credibility of economic agents in the sustainability of public finances and, through non-Keynesian expectation channels, endeavour to resume growth and achieve fiscal balance. At least in the medium term, this type of policy will comprise severe restrictions imposed by the federal government when authorising new loans to states and municipalities, greater control of expenditures (and investment cuts), as well as a review of a number of tax exemptions and subsidies put in place during the preceding period.

This study also shows how the debt levels of regional authorities have been affected, regarding debt level and composition, by the guidelines established by the central government and the evolving macroeconomic landscape. Since 1997, large states and municipalities have become debtors to the federal government, through an agreement under which the central government took over the debt securities of these entities, which, in turn, found themselves unable to continue issuing public bonds and were forced to channel a portion of their revenues to settling their debts with the National Treasury (adjusted by the General Price Index (GPI)² plus a real interest rate of 6 per cent to 9 per cent per year). This process of institutionally restricting debt ended in 2000, with the enactment of a fiscal responsibility law that set limits on public debt and prohibited the usual ways to finance deficits through public banks, among other measures aimed at preventing a repeat of the severe fiscal imbalance of the 1990s.

In addition to these specific and individual controls for separate subnational entities, the central government also started controlling the overall volume of credit via resolutions by the National Monetary Council, which restricted borrowing even by states and municipalities with little or no debt. With these institutional restrictions, the net debt of states and municipalities dropped 6.3 percentage points (p.p.) of GDP between 2002 and 2008, reaching 13.4 per cent of GDP in 2008. However, it is important to highlight two other factors that favoured the reduction in state and municipal debt during this period: the acceleration of economic growth, which boosted state revenues, currency appreciation trends and inflation control and favourably influenced the index used to adjust the debt renegotiated with the federal government (the Índice Geral de Preços Disponibilidade Interna (IGP-DI), a price index sensitive to the exchange rate).

This context has changed since 2008, not only due to the deterioration of the macroeconomic landscape as a whole but mainly to newly contracted loans from banks and abroad, approved by the federal government. Between 2008 and 2014, the renegotiated debt maintained its downward trend, dropping 4.2 p.p. of GDP and initially surpassing newly contracted loans. The downward trend in net debt would only cease in 2011, when new loans began to offset or even exceed the acquittance of commitments with the federal government. The net debt of regional entities—which had decreased by 2.5 p.p. between

2008 and 2011 (to 10.8 per cent of GDP)—grew more stable between 2011 and 2013 and rose to 11.6 per cent of GDP in 2014. This level of debt may be considered relatively low by historical standards and harks back to the levels observed prior to the debt increase of the late 1990s.

As such, the rising levels of bank and external debt of regional governments should be seen more as a change in debt composition than as an upward trend of indebtedness. Still, it is a very significant phenomenon: at the state level, which focused on taking out new loans, the banking and external debt rose from BRL23.3 billion to BRL160.0 billion between 2008 and 2014; its share of total debt increased from 6 per cent to 26 per cent, taking over from the (declining) debt with the federal government. This phenomenon was more intense in the North and Northeast regions of the country, where the share of bank and external debt has become most prevalent (79 per cent of the debt in the North and 66 per cent in the Northeast); the debt with the federal government has become secondary.

A breakdown by creditor institution shows that this phenomenon was driven primarily by loans taken by the states from public banks (BNDES, Banco do Brasil (BB) and Caixa Econômica Federal (CEF)) and multilateral organisations (the International Bank for Reconstruction and Development (IBRD) and the Inter-American Development Bank (IDB)). Although a portion of the loans has been used to restructure liabilities—replacing the debt contracted with the federal government by loans borrowed more 'cheaply'—the funds were used mostly for urban infrastructure projects and new federal government programmes to support investments. Credit operations were also destined for other purposes, such as increased funding for rural development, which increased (alongside other debt), while its share of the total remained relatively stable (net of the debt with the federal government).

Specific rural development projects are funded in full by the IBRD and the United Nations International Fund for Agricultural Development (IFAD)—the latter focusing on the Northeast. In the broader concept that includes projects to combat rural poverty and promote sustainable and/or environmental development, multilateral organisations are also major funders (IBRD and IDB); the main funding destinations are the North and Northeast regions of the country. On average, about 86 per cent of the credit operations for rural development funding projects take place in the North/Northeast; these operations have increased in volume from BRL1.9 billion in 2011 to BRL6.3 billion in 2013.

The assessment of indicators on the degree of indebtedness and payback capacity, as well as the credit risk rating assigned in accordance with the methodology developed by the National Treasury, show that the fiscal condition of most states in the North and Northeast regions is not a concern. Such a statement should be taken with a grain of salt, however, because the debt level ceased to improve in 2011, and payment capacity started deteriorating in many states as of 2013; all states saw a severe deterioration of their fiscal results, with unfavourable prospects for the near future. The indicators are likely to evolve unfavourably, as they begin to reflect the more recent trends of fiscal deterioration. This does not point to an explosion of indebtedness, partly

because the fiscal adjustments carried out by the federal government will involve tightening control over new loans and because the accumulated debt to the federal government should benefit from the restructuring measures (a retroactive review of the price index used to correct the debt) recently approved by the Congress and set to come into effect in 2016.

The influence of these factors should prevent the debt level from becoming unsustainable, despite widespread fiscal deterioration. However, the most alarming aspect from a fiscal perspective concerns the deterioration of the general government's (federal, state and municipal) primary balance, amounting to 3.9 p.p. of GDP between 2008 and 2014; during this period, the significant 3.33 per cent surplus became a 0.59 per cent deficit. In the statistics regionalised 'above the line' (released by the Central Bank), the deterioration of the primary balance occurred throughout all state governments in the country, totalling 1.5 p.p. of GDP in the same period; the 1.3 per cent surplus became a 0.2 per cent deficit.

A breakdown of these primary balances by their main components shows that the deterioration of primary balances (as a share of GDP) is due almost entirely to increased expenditures. Revenues remained relatively stable even under tax exemption policies at the federal level. The fiscal easing process, which started in 2006, did not translate into a significant worsening of fiscal results during most of the period, because revenues were driven by high GDP growth rates and an increase in the degree of labour market and enterprise formalisation. However, from 2011 onwards, maintaining the growing pace of expenditures in a landscape with lower economic growth and revenue levels led to a rapid deterioration of fiscal results.

An analysis of individual states corroborates these findings by showing that the most common pattern of fiscal behaviour in the North/Northeast was the combined accelerated growth of primary spending—persistently above GDP—and a deceleration in the growth rate of primary revenues. In the states of the North and Northeast regions, the slowdown in primary revenue was attributed to different causes than in other regions of the country. There was a closer relationship with the slowdown in transfers from the Federal Government, not only because of the greater degree of budget dependence on transfers but also due to better tax collection and economic performance in those regions (with a few exceptions). As such, the deceleration in primary revenue growth in the North/Northeast mainly reflects the indirect impacts of the economic downturn and fiscal easing (tax cuts) on federal revenues shared with regional governments. This is different from the South and Southeast regions, where the direct impact on their own tax collection was more pronounced, due to their lower dependence on transfers and the worse economic performance that prevailed in the states in those regions.

On the other hand, an analysis of expenses shows that their growth is due to several causes at the federal and regional levels. At the federal level, the growth was mainly due to spending on social benefits, subsidies and funding. At the regional level (both in states and municipalities), the main cause of increased spending was personnel expenses.

Personnel expenses increased in nearly all state governments in the country and are the main reason for the large increase in primary expenditure. Additionally, costing expenditures can be considered a secondary determinant and more restricted to certain states. The behaviour of costing expenditures accounts less for the high level of growth and more for the differences among the states: states that exerted tighter control over their costing expenditures showed lower growth rates in primary expenditures, and vice versa.

Paradoxically, public investments—the main targets of fiscal easing and the main destination of new loans contracted by states and municipalities—remained relatively stable between 2008 and 2010, bringing the prevailing trend of expansion to a halt when the downturn in primary balance first began. This occurred at the federal, state and municipal levels. Evidence suggests that state governments substituted funding sources, thereby releasing funds (previously committed to investments) to pay for personnel and, in many cases, maintenance instead.

This channelling of the fiscal space towards current expenses is alarming because investment expenditures have a greater capacity to stimulate economic growth. On the other hand, the general trend of increased current expenditure reflects, largely, pressures of a more structural nature on state budgets. These include redistributive pressures for the expansion of basic social services (health and education), the impacts of the minimum wage appreciation policy on payrolls and demographic pressures on social insurance benefits. In many cases, these pressures are exogenous to the tax authorities; they are the main vectors behind the expansion of public spending and curtail fiscal adjustments on the expenditure side.

On the revenue side, authorities also face difficulties in expanding in the current environment—characterised by low economic growth and limited collection of the main tax (*Imposto Sobre Circulação de Mercadorias e Prestação de Serviços*—ICMS, the state value-added tax)—and the erosion of their tax bases over a long fiscal war. In parallel to the fiscal adjustments at the federal level, 2015 saw the introduction of new restrictions on voluntary transfers to subnational governments, which can be partially offset by reviewing tax exemptions involving revenue shared with states and municipalities. Under this framework, there is little room for effective fiscal adjustment in the short or medium term; the development of tax results will depend mainly on the perpetuation (or reversal) of the current depressed state of Brazil's economy.

This depressed situation signals that primary deficits may be unavoidable for state governments in the coming years. Some states face enormous difficulties in making their payments on time; such is the case of Rio Grande do Sul, where the state government has been delaying wage payments to civil servants (or, in some cases, paying them in instalments) while trying to pass a package of tax increases. In most states of the North and Northeast regions the situation is not as dire, either because they are younger states (some originating from former federal territories) or because the demographic pressure on them is not as great (shorter longevity); these factors influence spending on retirement pensions. ■

References:

Giavazzi, Francesco, and Marco Pagano. 1990. "Can severe fiscal contractions be expansionary? Tales of two small European countries." *NBER Working Paper 3372*. Cambridge, MA: National Bureau of Economic Research.

Schettini, B.P., R.R. Gouvêa, R.O. Orair, and S.W. Gobetti. 2011. "Resultado estrutural e impulso fiscal: uma aplicação para as administrações públicas no Brasil – 1997-2010." *Pesquisa e Planejamento Econômico* 41, 2, August.

Notes:

1. Unlike the fiscal contraction between 1999 and 2005 characterised by increasing tax burden, low levels of public investments, tight fiscal targets and restrictions on new loans from states and municipalities.

2. The GPI is a weighted mean of the consumer price index, the construction cost index and the producer price index.

This Executive Summary is a partnership between the IPC-IG and the International Fund for Agricultural Development (IFAD).

The views expressed in this brief are the authors' and not necessarily those of the Government of Brazil or the United Nations Development Programme.



Empowered lives.
Resilient nations.



Ministry of
Planning



International Policy Centre for Inclusive Growth – United Nations Development Programme

SBS, Quadra 1, Bloco J, Ed. BNDES, 13º andar – 70076-900, Brasília, DF - Brazil ▪ ipc@ipc-undp.org ▪ www.ipc-undp.org