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Economic Watch

Brazil

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Economic Analysis

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The centralization of sub-national debt in the 90's: a key step for stability in Brazil

- **The evolution of sub-national debt in the 90's: an unsustainable path**

  The overall net debt of Brazilian regional governments climbed sharply from 5.8% of GDP (15% of total public sector debt) in 1989 to around 10.0% of GDP (39% of total public sector debt) in 1995. The already fragile situation became unsustainable when inflation declined and interest rates moved up following the implementation of the *Plano Real*. The federal government was, then, forced to intervene.

- **Centralization and legal enforcement: solving the sub-national debt problem**

  In the second half of the 90's the federal government adopted programs to redesign fiscal federalism. It assumed part of sub-national debt and provided resources for regional governments to address their fiscal problems. In return, regional governments legally committed to series of fiscal targets which guaranteed fiscal responsibility and fiscal solvency. The legal framework was then reinforced by the Fiscal Responsibility Law in 2001.

- **The fiscal federal pact: a requisite for fiscal and macroeconomic stability**

  The assumption of sub-national debt and the injection of resources by the federal government generated a significant cost in terms of federal debt. The benefits of the new fiscal federal pact, however, by far exceed the costs: given the right incentives, the management of regional accounts improved substantially and induced a sharp reduction of both sub-national and total public debt. More importantly, the commitment to fiscal solvency became one of the pillars of Brazil's macroeconomic model and allowed the country to grow steadily in the last years.

The evolution of sub-national debt in the 90's: an unsustainable path

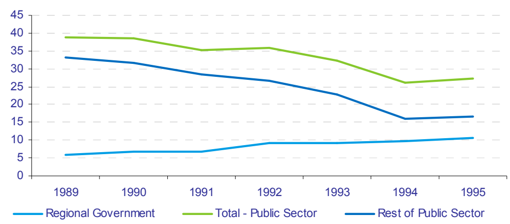
The overall net debt of Brazilian regional governments –including states and municipalities -climbed sharply from 5.8% of GDP in 1989 to around 10.0% in 1995. The fiscal deterioration in regional governments contrasted with the decline in the debt of central government (from 18.1% of GDP in 1989 to 10.0% in 1995) and of state-owned companies (from 15.0% to 6.8%, at a large extent due to the privatization of many companies). As a direct consequence, the weight of sub-national government debt in total public debt increased from 15.0% in 1989 to practically 39.0% in 1995.

The significant expansion of sub-national government debt was a direct consequence of the continuous generation of primary deficits[1] (which averaged 0.5% of GDP in the 1990-1995 period) and of high interest rate payments (1.1% on average).

The 1988 Constitution had set a federalism model in which an important share of tax revenues were transferred to regional governments from the central government while expenditures remained at a large extent under the responsibility of the central administration. States and municipalities, however, adjusted quickly to this new situation by driving their disbursements up in such a magnitude that their expenditures exceeded their revenues.

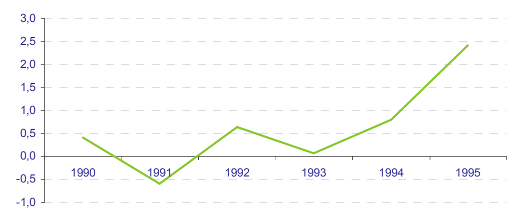
This new federalism, therefore, created several problems for achieving macroeconomic stability as, on one hand, the central government had limited resources to face substantial obligations and, on the other hand, regional governments were given no adequate incentives to adopt fiscally responsible policies.

Chart 1: Net Debt (% GDP)



Source: Giambiagi (1999)

Chart 2: Regional Operational Deficit (= Primary Deficit + Real Interest Rate Expnditures) (% GDP)



Source: Giambiagi (1999)

In such environment, central government efforts to guarantee fiscal solvency were offset by regional governments' lavishness.

Another important fiscal problem was that the relationship between regional government and regional banks was at that moment guided by political rather than economical criteria. Public were commonly used to finance local governments.

The already fragile situation of regional (and national) fiscal accounts was, then, negatively impacted by the implementation of the Plano Real in 1994 as the sharp inflation slowdown and the upward adjustment of interest rate eroded nominal revenues and drove fiscal expenditures up.

The situation became, then, unsustainable as an increasing sub-national debt threatened Brazil's macroeconomic stability and growth outlook.

As a response to this extreme situation, the federal government was forced to adopt strong measures.

[1] The primary fiscal result is defined as the difference between overall revenues and primary expenditures (which exclude interest rate payments).

Centralization and legal enforcement: solving the sub-national debt problem

In 1995, the National Monetary Council (*Conselho Monetário Nacional*, CMN) issued the Resolution 162 and started the construction of a legal framework to solve the sub-national government debt problem and to pursue fiscal solvency.

The Resolution 162/1995 created a program to support states' fiscal adjustment and restructuration. This program offered resources for the states to refinance their debts. In exchange for these resources the states were required to:

- reduce personnel expenses;
- privatize and concede some public services to private sector;
- control state-owned companies;
- fulfill fiscal targets (quarterly primary targets);
- increase revenues, improve tax collection mechanisms, improve expenditure control systems, improve information on fiscal accounts;
- reduce and control sub-national debt.

As the sub-national crisis refrained from receding and governments' debt refrained from moderating[2] a new fiscal program was designed to tackle fiscal problems. This new program was officially established by the Law 9.496 in September of 1997. The new program built on that defined by Resolution 162/1995.

The program set by the Law 9.496 contributed to the reduction of sub-national government debt by conceding an initial subsidy to states and municipalities, by lengthening the term of their debt, and by cutting financing costs.

In return, the federal government was allowed to assume sub-national debt (which included regional bonds and any other debt authorized by the Senate). In addition, states and municipalities committed to series of targets on:

- financial debt as a share of net revenues;
- primary fiscal results;
- public servants expenditures;
- revenue collection;
- privatization and public services concession, and a management reform;
- investment expenditures as a share of net revenues.

25 out of 27 States ended up requiring a *Programa de Reestruturaçao e de Ajuste Fiscal* (Restructuration and Fiscal Adjustment Program). Only the states of Amapá and Tocatins did not do it.

The legal framework to ensure fiscal solvency in Brazil was later on strengthened by the implementation of a Fiscal Responsibility Law, in May of 2000. Among other things, this law consolidated the use of primary surpluses to guide fiscal policy, banned refinancing and debt

[2] At some extent due to the implementation of the Plano Real (meaning lower inflation and higher interest rates), the sub-national debt increased from 10.0% of GDP to around 13.0% in 1997 (and 14.4% in 1998).

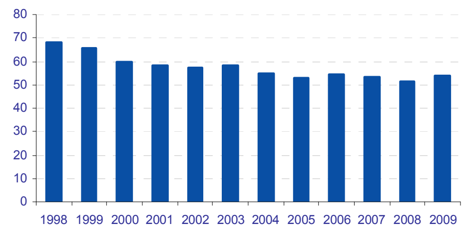
postponement practices, set limits for public servants expenditures (50% of net revenues for the federal government and 60% for states and municipalities), adopted severe penalties for not fulfilling established goals, required an authorization for sub-national governments to get credit loans and to issue bonds, restricted credit operations between sub-national institutions.

The fiscal federal pact: a requisite for fiscal and macroeconomic stability

The assumption of sub-national debt by the federal government and the supply of resources to regional governments had a cost around R$ 300bn between 1994 and 2001 (which represents a yearly cost of 4.1% of the Brazilian GDP from 1994 to 2001 or, from a different perspective, 23% of 2001 GDP). This cost helped to drive federal net debt from 9.6% of GDP in the end of 1993 to 30.2% of GDP by the end of 2001 and overall public sector net debt from 33% to 48% in the same period. The injection of resources into public banks and the recognition and the officialization of previously hidden (out-of-balance) liabilities also were very costly (R$65bn and R$63bn, respectively, from 1994 to 2001) and helped to explain the debt dynamics in the period.

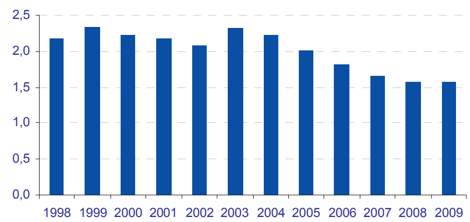
In spite of its high cost, the new federal pact was certainly very positive. It induced a i) reduction of sub-national governments' personnel expenditures from 68% of net revenues in 1998 to 53.9% in 2009 (Chart 3), ii) a decline in the ratio debt /net revenues from 2.2 to 1.6 (Chart 4), iii) a 37% real increase in revenues collected directly by regional governments, which excludes transfers from federal government (Chart 5), iv) an upward trend in investments as a share of net revenues -after an adjustment period- from 2003 onwards (Chart 6), v) significant sales of assets (11% of net revenues in average in the period 1998-2000) at a large extent due to privatizations and concessions to private sector (Chart 7), vi) sharp reduction of the credit funding, from 25.6% of net revenues in 1998 to 4.7% in 2009 (Chart 8), vii) a substantial drop in gross funding expenditures, from 38% of net revenues in 1998 to 12% in 2009 (Chart 9), viii) a very positive evolution in terms of generation of primary results (Chart 10), and a 6.5% real drop of sub-national debt stock (Chart 11).

Chart 3: Regional Governments - Personnel Expenditure / Net Revenues (%)



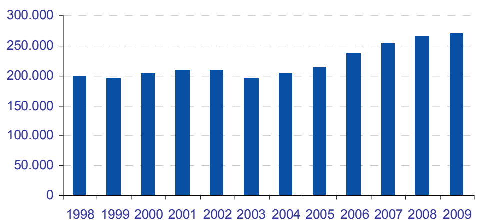
Source: National Treasury

Chart 4: Regional Governments - Debt / Net Revenues Ratio



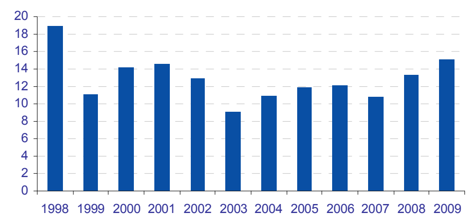
Source:National Treasury

Chart 5: Regional Governments - Revenues (excludes transfers from public institutions) (R$ millions as of 2009)



Source: National Treasury

Chart 6: Regional Governments - Investment / Net Revenues (%)

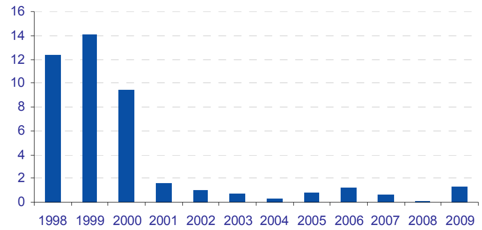


Source: National Treasury

All these improvements / advances are behind the steady decline of both sub-national and overall public sector net debt. As the Chart 12 shows, the debt of states and municipalities dropped from 17.6% of GDP in 2001 to 11.5% in 2011 and the overall debt of the public sector moved down from 52.0% to 36.4% in the same period.

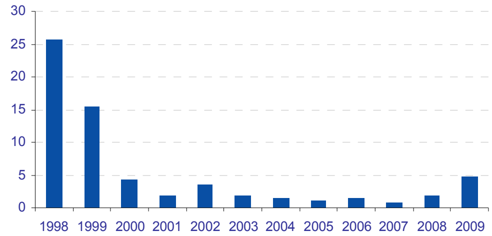
The public sector debt profile also improved significantly as a consequence of the changes introduced during the government of Fernando Henrique Cardoso: the average term of federal bonds increased from 4 months in the end of 1996 to 32 months in the end of 2011, the share of both dollar-denominated and SELIC-linked bonds in total bonds dropped from, respectively, 29% and 53% in 2001 to 0.6% and 32% in 2011 while, on the other hand, the share of fixed interest rate bonds increased from 7.8% to 35% in the same period.

Chart 7: Regional Government - Sales of Assets / Net Revenues (%)



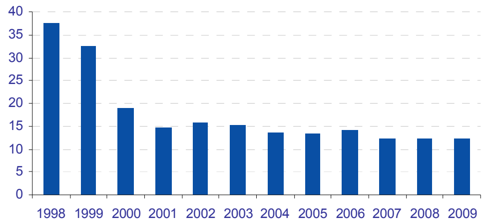
Source: National Treasury

Chart 8: Regional Government - Credit Funding / Net Revenues (%)



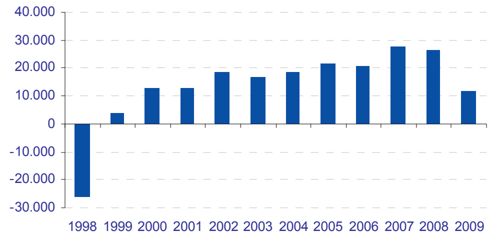
Source: National Treasury

Chart 9: Regional Governments - Gross Funding Expenditures / Net Revenues (%)



Source: National Treasury

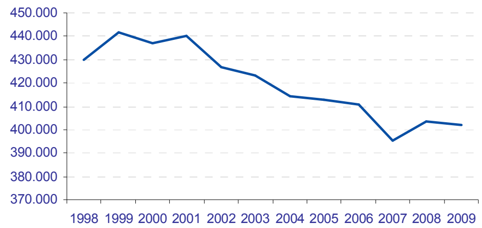
Chart 10: Regional Government - Primary Surplus (R$ millions of 2009)



Source: National Treasury

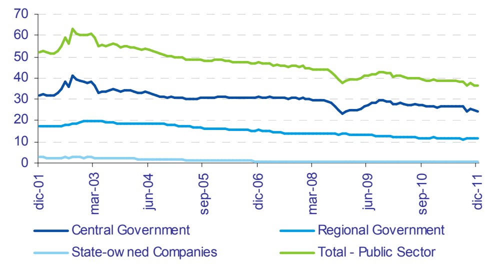
Another clear sign of the progress made in fiscal terms the last years was the recent classification of Brazil' sovereign debt as investment grade by all the main rating agencies.

Chart 11: Regional Governments - Debt Stock (R$ millions of 2009)



Source: National Treasury

Chart 12: Net Debt (% GDP)



Source: Central Bank of Brazil

The commitment to fiscal solvency -evidenced among others by the fiscal federal pact agreed in the end of the 90's and reinforced by the Responsibility Fiscal Law in 2001- is one of the three pillars of the macroeconomic model Brazil has been adopting for more than a decade now (the other two pillars are no-tolerance with inflation and exchange rate flexibility). It is, therefore, a fundamental piece to understand why the country has been able to accelerate GDP growth while keeping inflation under control and reducing interest rates.

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