The George Washington University
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Washington, DC

Subnational public debt in Brazil: Some regulation issues

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Minerva Program, Fall 1999

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Abstract

This monograph tries to show that the explosive growth of subnational debt in Brazil in the last two decades is due to a series of institutional failures, some of them originating in the Constitution of 1988, some of a more structural nature (especially the relations among different levels of government). Together, they conspired to create a soft budget constraint to those levels of government. It's important to note that, given these institutional failures, the existing comprehensive regulation on subnational debt issues was unable to prevent the undesirable outcomes, and therefore legislative reforms and continuing political commitment to fiscal balance are needed. In the conclusion there is a brief presentation of proposals focused on what are thought to be the main failures of our debt control system.

1 – Introduction [1]

The Brazilian federation comprises the Union, 26 states plus the Federal District and more than 5.000 municipalities. Indebtedness of states and municipalities (especially the former and the biggest capital cities) has increased markedly in the last two decades, in many cases reaching a point where serious fiscal adjustment is needed before those public entities can again be considered financially sound. In one of the states (Alagoas) there had to be a near federal intervention in 1996 after six months of delayed payments to civil servants and civil unrest. Considering all states and municipalities (companies excluded), net debt [2] has risen continuously, from 5.8% of GDP in 1989 to 15.7% of GDP in July 1999, that is, roughly 10 points of GDP. Federal net debt, it is fair to say, rose about the same amount (from 19.9 % in 1989 to 30.6% in July 1999).

Gross debt of states and municipalities reached R$ 227 billion last July, or 22.7% of GDP. The next tables show the ratio of debts to net revenues for states and the majority of capitals, an indicator related to solvency [3].

[1] I wish to thank Otávio Ribeiro Damaso, who helped me with this monograph in many ways, and Prof. William C. Handorf for his comments on a draft version.
[2] Debts minus financial assets.
[3] We take state net revenues such as defined by Federal Senate (Res. 78/98): almost all capital revenues are excluded, as well as constitution mandated transfers to municipalities, with some other minor adjustments. Net revenues data are not available on a regular basis for most municipalities.

Ratio debt/net revenues in 1998
States *

R$ million

State	Total debt	Net Revenues	Debt/ net revenues
Rio de Janeiro	21,540	6,051	**3.56**
Goiás	6,256	1,778	**3.52**
Mato Grosso do Sul	2,241	726	**3.08**
Minas Gerais	18,608	6,591	**2.82**
Alagoas	2,131	757	**2.82**
Piauí	1,394	524	**2.66**
Maranhão	2,452	1,007	**2.43**
Santa Catarina	4,843	2,081	**2.33**
São Paulo	52,876	25,205	**2.10**
Rio Grande do Sul	9,777	5,056	**1.93**
Bahia	6,534	3,393	**1.93**
Pernambuco	3,454	2,131	**1.62**
Paraíba	1,435	957	**1.50**
Ceará	2,218	1,977	**1.12**
Sergipe	781	830	0.94
Espírito Santo	1,221	1,552	0.79
Paraná	2,589	3,682	0.70
Tocantins	309	539	0.57
Rio Grande do Norte	588	1,067	0.55
Distrito Federal	983	1,994	0.49
Total	142,232	67,898	2.09

Source: BACEN/DEDIP and state governments
Note: * excludes agencies and companies

Ratio debt/net revenues in 1998
State capitals *

R$ million

State	Total debt	Net Revenues	Debt/ net revenues
São Paulo (SP)	9,944	5,523	**1.80**
Rio de Janeiro (RJ)	2,998	2,648	**1.13**
Maceió (AL)	161	144	**1.12**
Aracaju (SE)	73	106	0.70
Belo Horizonte (MG)	380	815	0.47
Campo Grande (MS)	78	175	0.45
Recife (PE)	175	443	0.39
Goiânia (GO)	96	290	0.33
Natal (RN)	48	156	0.31
Curitiba (PR)	189	644	0.29
São Luís (MA)	45	164	0.27
Fortaleza (CE)	114	525	0.22
Teresina (PI)	32	152	0.21
Vitória (ES)	35	199	0.18
Florianópolis (SC)	21	131	0.16
Porto Alegre (RS)	51	536	0.09
Total	14,440	12,650	1.14

Source: BACEN/DEDIP and municipal governments
Note: * excludes agencies and companies

Not only are those ratios very high for the majority of the states and for the city of São Paulo, they are still increasing, as we can see in the table below, which shows states and municipalities still run primary deficits [4], as well as nominal deficits. Deterioration of primary balances was acute in 1992 and 1995, while nominal results improved substantially after 1995 due to stabilization process and the consequent fall in nominal interest rates. Meanwhile, unlike local governments, the federal government has managed to produce primary surpluses, though not operational and nominal surpluses.

States and municipalities borrowing requirements *

% GDP

Year	Primary Result	Nominal Result
1991	-1,33	8,34
1992	-0,35	15,96
1993	-0,55	24,77
1994	-0,88	19,34
1995	0,17	3,56
1996	0,55	2,72
1997	0,72	3,02
1998	0,21	2,04

Source: BACEN/DEPEC
Notes: (+) Deficit (-) Surplus
* Excludes companies

The data presented here seriously underrepresents the debts, since they only consider the so-called financial debts, and exclude actuarial debts, court judgements ("precatórios") not yet included in annual budgets and payment arrears (including overdue court judgements). As to actuarial debts to their employees, states and municipalities weren't even required to measure them, since they used a pay-as-you-go social security system and financed any cash deficits with general treasury revenues.

[4] From now on states and municipalities will be called local or subnational governments. Primary result is

In the last two decades, there have been three major subnational debt crises. The first one took place after the international debt crisis of the 1980's. Foreign exchange constraints forced the states to default on their foreign debts, even when they had the resources in local currencies to service them. The federal government had guaranteed most of that debt (the part owed to multilateral agencies) so they automatically became a federal liability. In 1989 the Union agreed with the states to transform the outstanding stock of federally guaranteed external debt into a long-term debt to the federal Treasury (Law 7.976/89).

The second crisis concerned debt owed by the states and municipalities to federal financial institutions (mainly Caixa Econômica Federal – CEF). Due to the complex political relations between the Union and local governments [5], those were the debts more liable to be defaulted on. That crisis was resolved again by a federal government sponsored bailout (Law 8.727/93). Bond debts, though, continued to be rolled over at high interest rates.

The third and biggest crisis was precipitated by the success of the Real Plan in rapidly reducing inflation rates in 1994. Annual inflation fell from 929% in 1994 to 22% in 1995 and 9% in 1996, so removing the one mechanism of adjustment used by local governments so far: reduction of real salaries, pensions and other less than perfectly indexed expenses through inflation. At the same time, the Real Plan relied on a tight monetary policy (required to maintain the exchange rate anchor and to counterbalance

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defined as the difference between non-financial revenues and non-financial expenditures.
[5] See section 2.2.

the perceived threats to attain a consistently sound fiscal policy), additionally hurting local finances through increased debt service. Real annual interest rates on bonds were 22% in 1994 and 25% in 1995.

States began to resort more heavily to short term bank loans (less than one year, the so-called Operações de Antecipação de Receita Orçamentária - AROs) and even to payment arrears. Some states and municipalities forged court judgements lists so they could issue bonds [6], using the proceeds to pay for other expenses. That eventually brought about parliamentary investigations (CPI dos precatórios) which resulted in stricter Senate regulations but failed to punish those responsible for the frauds. States also took advantage of a loophole in regulations, using special purpose companies (previously not subjected to Senate control) to issue bonds which in the end were backed by tax revenues.

After some transitional agreements (bond exchanges with Central Bank and Voto CMN 162/95) and prolonged negotiations, the federal government assumed states bond debts and other short term debts (Law 9.496/97) and refinanced them. At the same time, the Union offered the States long term loans to privatize, liquidate or transform their banks (which faced huge losses over the years, in many cases resulting in negative net worth) into non-financial institutions.

[6] Constitutional amendment n. 3 prevented states and municipalities from issuing bonds for any other purpose than rolling over maturing bonds and paying for court judgements.

Originally local governments borrowed from a wide variety of sources, including bond issues, loans from federal banks (especially CEF and BNDES) loans from foreign private lenders and multilateral institutions. There were also several (if illegal) financial arrangements with banks owned by the states themselves that resulted in the states being one of their biggest clients. The most conspicuous case is that of the Bank of the State of São Paulo – BANESPA. After the repeated federal bailouts, though, most of the debt is now owed either directly to federal government or to its financial institutions (92% as of last July). That percentage will even increase after the proposed federal government restructuring of municipalities debts (MP 1891/99).

2 – Theoretical issues on public debt and their application to the Brazilian case

2.1 – Why governments (over)contract debts

According to conventional economic theory and policy, governments may justifiably run deficits and, consequently, contract debts, for a variety of reasons: countercyclical policies, intergeneration fairness (future generations should help pay for capital expenditures which will produce returns over many years) and tax smoothing (to reduce the distortionary effect of taxes) [7].

Notwithstanding, public choice literature also offers some reasons why governments may and often do resort too much to borrowing, without due regard to budget constraints or to market signals. Buchanan argues that politicians have an

incentive to raise debts since future generations, which will pay for those debts, can neither express their opinions nor vote [8]. Alesina and Tabellini [9], by the same token, affirm democratic governments have a short run horizon, which lasts only until the next election. If they feel they have little chance of being reelected, they will probably run deficits, which will be paid by their successors. The new government will have less room to implement whatever policy it favors for it will have to service the debt. So political polarization is associated with higher debt levels. Governments in general also have no adequate incentives to make reasonable, sound investments. Regardless of the rate of return on those investments, they will fulfil some of the voters needs and create employment in the short run, that is, during their terms. Furthermore, it's common to have investments that benefit specific groups (so there is an identifiable political demand for them) yet they are financed through general taxes, or, even better, through public debt or inflation, so their costs are spread throughout the population.

The application of those theoretical arguments to the Brazilian case is straightforward. One other argument is more specific, as it's based on a strong characteristic of Brazilian economy, namely income concentration. The model was proposed by Cukierman and Meltzer [10], and requires the current generation to have poor and rich agents. For the rich ones, the Ricardian equivalence is valid, so they are

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[7] See Elmendorf and Mankiw (1998)
[8] Apud Fecury 1998 pg. 7-8. The argument of Ricardian equivalence seems to contradict Buchanan's reasoning, but since people may be less than perfectly altruistic towards future generations and since information and credit markets are less than perfect, individuals might still prefer an increase in expenditures without equal increase in taxes.
[9] Apud Mendes (1996) pg. 18
[10] Apud Rigolon and Giambiagi (1998) pg. 5. The original article is: Cukierman, Alex and Meltzer, Allan H. (1989). "A political theory of government debt and deficits in a Neo-Ricardian framework". American Economic Review, v. 79, n. 4, September, pg. 713-732.

indifferent to the fiscal policy stance (since they can compensate for any change in taxes or current deficits by adjusting the amount of inheritance they leave for the next generation). Poor agents, on the contrary, favor public deficits, which enable them to borrow indirectly from future generations. As one of the groups is indifferent to public debt and the other prefers a positive public debt, society as a whole will choose the latter.

The model doesn't prevent *per se* the possibility that the government chooses the stock of public debt that makes marginal benefits from debts (intertemporal reallocation of consumption for poor agents) equal to marginal costs (higher interest rates, crowding out, possibly higher expected levels of inflation). In that sense some level of public debt will maximize social well being, but, given the other factors above mentioned and the difficulties arising from a federative system, debt levels may explode instead, as they have in Brazilian states and part of the municipalities. The next section deals with the kind of problems the adoption of a federative system may cause to attain and maintain fiscal balance and how they manifest themselves in Brazil.

2.2 – Fiscal federalism

The literature on fiscal federalism stresses that local governments have better knowledge of the utility function of voters/tax payers, so they can allocate resources more efficiently than could the federal government or a unitary state. On the other hand, regional redistribution of income, for obvious reasons, should be conducted by the federal government. The same applies to macroeconomic management, since the

spillover effects of stability in each local government would generate an incentive for all others to be free riders.

Such a distribution of functions cannot be perfectly realized in practice, if the subnational share of overall government revenues and expenditures is beyond a certain size, as is often the case. This fact in itself limits the control of federal government over fiscal policy.

The Brazilian Constitution of 1988 embodies a reaction to the extreme centralism that characterized the authoritarian governments since 1964. It severely restricts central government intervention in the affairs of the states, even in case of near-bankruptcy. As it comes to the distribution of revenues and expenditures, subnational governments were granted more taxing powers and tax transfers from the federal government. While the federal share of tax revenues, net of transfers, dropped from 61% to 52% between 1987 and 1992, the states' share increased from 28% to 31% and municipal share had the biggest increase (12% to 17%). Many municipalities were created only to take advantage of the automatic revenue-sharing mechanisms. The Union, the states (especially the ones with biggest populations) and municipalities located in metropolitan regions lost net revenues [11]. From 1994 on, a constitutional amendment authorized the federal government to reduce sharing of income and industrialized products taxes by 20% (the so-called FSE, later FEF).

[11] Mendes (1996) pg. 21.

Expenditure assignments were not as clearly defined, since the constitution envisages concurrent responsibilities for most expenditure items. What decentralization of expenditures there was can be attributed to fiscal problems at the federal level (derived in part from the redistribution of revenues aforementioned), so that process of decentralization was laden with inefficiency.

That lack of clarity both in expenditure assignments and in the responsibilities of federal government vis-à-vis local governments is one of the factors that reduce local governments accountability. It also allow mayors and governors to continue behaving much as they did during dictatorship, that is, resorting to federal government for each and every problem they face. Central government is held responsible for undertaking a number of tasks: to increase or at least maintain direct transfers to the other levels of government regardless of economic environment; to conduct monetary policy in a way that doesn't hurt the interests of highly indebted States; to provide them with subsidized credit (through federal financial institutions); and, when all else fails, to bail subnational governments out when they are in the verge of or have already defaulted on their debts.

Besides that, Constitution assigns to Federal Senate the control of subnational debts. In fact, each loan or bond issue must receive prior approval from Senate. This kind of detailed yet ineffective control of subnational finances also makes it difficult for federal government to distance itself from occasional subnational defaults. Another instance of such interference is that multilateral financial institutions require federal government to guarantee their loans to local governments.

Weak party discipline, too, helps explain the fact that sitting state governors are usually able to lead the other politicians of the same state to satisfy regional demands. For a large number of representatives and senators, national politics is a secondary concern, left for the president, who, in order to implement his programs, must build coalitions that not only involve several parties, but also satisfy regional demands [12]. It follows, for example, that the strong need for constitutional reforms in the last five years (on privatization, administrative issues, social security, tax system and political reform) imposed such a heavy political burden on federal executive that it could not stand the pressures from local governments, so postponing any significant changes in its relations with them.

As it comes to debt control by the Senate, Dillinger and Webb (1998, pg. 12) present a very significant feature of our politics: three quarters of the senators are former or future governors. Consequently their links to the states are not only the institutional ones, but there is also a strong element of personal interest.

It's noteworthy that our states differ considerably as to the size of their respective economies. Big states, highly indebted, like São Paulo, threatened to cause problems for the whole financial system if they defaulted, and then the federal government was almost forced to bail them out. That reasoning led big states and their lenders to take financial risks well beyond their capacity to absorb negative shocks (Dillinger and Webb 1998, pg. 36). Given that and the equal political status among states, smaller states too were willing to raise more debts, rather than going through painful fiscal adjustment.

[12] See Dillinger and Webb (1998) pg. 11.

3 – Debt control

Craig and Ter-Minassian (1998) group country approaches to the control of subnational borrowing into four "stylized" categories, as follows:

- Sole or primary reliance on market discipline;
- Cooperation by different levels of government in the design and implementation of debt controls;
- Rules-based controls; and
- Administrative controls.

The pure market approach is quite rare, and it's almost only used in countries with well-developed and relatively transparent financial systems. The cooperative form of control is even rarer, as it requires a degree of coordination difficult to achieve. Control by rules is much more widespread, and it has the advantage of transparency and perceived fairness, though it's not as flexible to respond to business cycle or external shocks as market discipline. Finally, direct control is the least flexible of them, which usually means it causes the most distortion. It may take the forms of annual limits on the overall debt of individual local jurisdictions, authorization of individual borrowing operations, and/or centralization of all government borrowing, with on-lending to subnational governments. Examples of countries that resorted to this kind of control are the United Kingdom (until 1988), Japan, France, Spain and India.

In practice, almost all countries utilize a mix of the different approaches. In the Brazilian case, administrative controls are extensively and increasingly used, together with rules-based controls. It's useful to examine why the other forms of control were deemed less effective for Brazil. In historical circumstances like ours, where decentralization is still a developing, highly controversial process, it's easy to see it's not yet feasible to implement a cooperative approach. As to the preferred alternative of market control, we describe in the next section the obstacles to its implementation.

3.1 – Conditions for market discipline

Lane (1993) [13] suggested that four conditions must be met so that financial markets alone can prevent borrowers (in this case, local governments) from taking on too much debt. The next four subsections are used to describe them and to show Brazilian local governments fulfill none of them.

3.1.1 – No captive markets

Markets should be free and open, in the sense that no regulation should impose on financial intermediaries an obligation to lend to specific borrowers, or to land money at interest rates other than market rates.

[13] Lane, T., "Market discipline", Staff Papers, IMF, Vol. 40 (March 1993), pp. 53-88, apud Craig, J. and Ter-Minassian, T. (1998).

As pointed out in the introduction, most of the local debt is now owed to federal government, interest rates are heavily subsidized and average maturity is much longer than what local governments could expect to find at market conditions. As there's no real market for local debt, first such a market would have to be created; that is, minimum financial sustainability must be restored, together with institutional barriers to future fiscal imbalances, before private financial intermediaries could resume lending.

One traditional captive source of credit to subnational governments used to be state-owned banks. 25 out of 27 states had their own financial institutions and used them either to finance private projects of public interest (without due regard to their economic return, repayment capability of debtors and guarantees), to finance municipal governments' investments or even to finance the state governments themselves. It must be noted that the latter practice has long been specifically forbidden by legislation (Law 7.492, issued in 1986), but it never ceased. In particular, the capitalization of unpaid interest assures an ever-growing exposure of state-owned banks to those loans. The lack of independence of the Central Bank, responsible for bank supervision, when it comes to liquidating state-owned banks (which is naturally a very sensitive issue in the already complex relations between federal and state governments), helps explain why that situation continued for so long.

After many failed attempts during the 80's to rescue those banks from a state of near-bankruptcy, the federal government set up a program in 1996 (Programa de Incentivo à Redução do Setor Público Estadual na Atividade Bancária - PROES). The Central Bank managed the program, which aimed at privatizing state-owned banks,

whenever possible, and, when this was not an alternative, to liquidate them or to transform them into non-financial institutions (agências de fomento). In these cases, federal government advanced 100% of the necessary resources, to be paid in 30 years. States had also the alternative to keep their financial institutions, in which case they had to provide 50% of the resources needed to recapitalize them. As of July 1999, out of 35 pre-existing institutions, 24 were liquidated, privatized or transferred to federal government for future privatization. There are only three sizable banks left in the hands of the states: Nossa Caixa Nosso Banco – NCNB, Banco do Estado do Rio Grande do Sul – Banrisul and Banco Regional de Desenvolvimento – BRB. In conclusion, it seems the states won't be able to use banks again as a captive source of credit.

3.1.2 – Information disclosure

That requirement for a proper functioning of financial markets means potential lenders should have access to adequate information on the borrower's outstanding debt and repayment capacity.

There are a number of obstacles in the way of having transparent subnational public accounts in Brazil. In the first place, states and municipalities have almost complete autonomy in determining their accounting practices. Standards are set and accounts are audited by different legislative agencies (Tribunais de Contas). There is usually one agency for each state, but some states have one agency for the state government and another for its municipalities, and two state capitals have agencies of their own. There is federal regulation on the subject of public accounts (Law 4.320/64)

but it's too general and too outdated. The federal government itself uses an accounting plan that is different from the one prescribed by that law. In practice, state and municipal accountants have much room for arbitrary procedures. For the same reason accounting criteria change through time, which makes it difficult to follow financial events even as one is interested in only one local government. Furthermore, many small municipalities lack technical staff capable of producing adequate financial statements.

Another difficulty is that few governments present consolidated data for core governmental activities (administração direta) and its agencies and companies (administração indireta). Neither they evaluate their respective social security systems actuarial debts. One last, but not unimportant, problem for transparency until the middle of the 90's was high inflation, which significantly distorted financial data.

3.1.3 – No bailouts

For market discipline to work there should be no perceived chance of bailout of the lenders in the case of impending default. Repeated bailouts (and, what is particularly important, the consequent expectation that subnational governments will always be rescued regardless of costs) were perhaps the most important single cause for the perceived soft budget constraint of local governments and especially of states in the last two decades.

The existence of a soft budget constraint creates an incentive (moral hazard) for the states not to focus on fiscal adjustment efforts and to incur in excessive debts. On

the other hand, they had an incentive to devote political will to a bargaining process with the federal government.

Federal bailouts of states
1987-1999

Legal rules	Measures	Characteristics
Law 7.614/87	Line of credit from National Treasury (through Banco do Brasil) to states and municipalities	
Law 7.976/89	Assumption and rescheduling of states external debt	RS$ 10.5 billion * Long term – 20 years to maturity Grace period – 5 years Interest rate – the same rate paid by the federal government to its foreign creditors
Law 8.727/93	Assumption and rescheduling of states and municipalities debts (including companies) owed to federal financial institutions	RS$ 39.4 billion * Long term – 20 years to maturity Interest rate based on the original contracts No grace period Service of this debt, plus that resulting from Law 7.976 and some other debts were limited to 11% of net revenues (9% in 1994) Federal constitutional transfers were used as pledges
Res. CMN 2.081/94	Exchange of state bonds (LFTE) for Central Bank bonds (LBC) (1994-1998)	R$ 30.6 billion * States kept financing their deficits by using LBCs as collateral in overnight operations, which cost less than operations using their own bonds as collateral

(cont.)

Legal rules	Measures	Characteristics
Voto CMN 162/95 and others	Line of credit from Caixa Econômica Federal for the states to pay off debts in arrears, to consolidate short-term bank loans (ARO) and to finance programs to reduce personnel	R$ 2.2 billion * Medium term – between 18 and 36 months States were required to follow a program of fiscal adjustment Federal constitutional transfers and state taxes were used as pledges
Law 9.496/97	Assumption and rescheduling of existing bonds, debt contracted under Voto 162/95 and other debts contracted up to December 1994.	R$ 89 billion Front loaded amortization of part of the debt (through privatization or transfer of assets to federal government). In the case of São Paulo, it represented 12.5% of the amount refinanced. Direct subsidy corresponding to interest rate differentials. In the case of São Paulo, it represented 7.5% of the amount refinanced. Long term – 30 years to maturity Interest rate – IGP- M plus 6% p.a. Service of all debts owed to the federal government, external debt and some other debts were limited to 11.5%, 13% and 15% of net revenues, depending on the state (the caps for 1998 and 1999 were lower than those) Federal constitutional transfers and state taxes were used as pledges. Fiscal adjustment programs were signed with each state, and non-compliance with the programs goals were to be punished with higher interest rates and a bigger ceiling on debt service.

Source: Rangel 1999
Note: * valued at prices of December 1998

Alongside with that, there were several programs during the 80's and 90's aimed at the state-owned banks (PAC, PROREF, special credit lines, Resolução CMN 1748/90, direct interventions and liquidations), all conducted by the Central Bank. They represent an indirect bailout of the states, since the state-owned banks problems, as explained in the introduction to this monograph, derive from their relations with the states. The cost of those programs and interventions exceeds R$ 30 billion. The ongoing program of extinction/privatization of state-owned banks (PROES) can also be considered a bailout, with the *proviso* that it attacks one important cause of the states soft budget constraints.

Rigolon and Giambiagi (1998) take a positive view of the last three debt restructuring operations, in that they created a control mechanism of subnational finances, namely the seizure of state revenues (constitutional transfers and taxes) in the case of default. At the same time, the process was accompanied by a strengthening of normative constraints on additional credit operations, which we'll consider in section 4.

It's worth commenting on the last federal rescue operation (Law 9.496/97). All states signed contracts, but for two economically small states (Tocantins and Amapá) and the Federal District didn't sign a contract either. The explicit upfront subsidy plus the implicit subsidy coming from the difference between the interest rate the federal government faces and the rate it requires from the states during the next 30 years have been estimated at between R$ 32 billion and R$ 46 billion

[14]. Such a huge subsidy also sends the states the wrong signals as to the necessary fiscal adjustment. The same point can be made about the cap on debt-service payments based on annual revenues, since measures aimed at increasing their revenues will also increase payments to the federal government. On the contrary, any factor that adversely affects state revenues imply an automatic rescheduling of service in excess of this cap.

Another important point is that the 1997-98 debt restructuring agreements require the states to follow detailed middle term adjustment programs that include expenditure cuts, increased tax collection and privatization, so that the ratios of debts to projected revenues are reduced to a maximum of 100% within an agreed period, ranging from 6 to 19 years. States are also forbidden to issue bonds and to take short term bank loans - AROs. As to privatization, states should sell assets equivalent to 20% of the refinanced debt and use the proceeds to amortize the debt. That was the only prior condition, and an important one at that, to refinance the debt. All other conditions, especially the commitment to adjustment programs, can only be verified after the actual debt restructuring. That characteristic of the agreements, when coupled with the complex political relations between federal and state governments prevents the central government from really enforcing the agreements reached.

Therefore it comes as no surprise that many states (especially those ruled by opposition parties) challenge the terms of the contracts they signed. This

[14] Rigolon and Giambiagi (1998) pg. 14. The interval refers to present values, at 1997 prices.

movement, if the federal government can't avoid it, will likely result in more concessions and considerable loosening of fiscal discipline. Alagoas, one of the most indebted states, and Minas Gerais, also highly indebted, declared moratorium in the beginning of 1999, right after the gubernatorial elections. So far the federal government has been able to retain federal transfers destined to Alagoas and Minas Gerais to service the debt.

The state of Rio Grande do Sul sued the Union on the grounds that the financial conditions of the refinancing were too harsh and that federal transfers can't be withheld even in the case of default. The state of Rio de Janeiro lost interest in the contract it had already signed and engaged in new negotiations to get better financial conditions on the restructuring deal, including an advance on oil royalties which the federal government would pay to the state over the next 15 years. The governor has announced last October that an agreement has been reached, but so far no new contract was signed.

One reason why the restructuring agreements were so unsatisfactory from the point of view of the federal government is that negotiations were conducted separately with each state, beginning with the most indebted ones. The President, instead of Congress, established rules through provisory measures (Medidas Provisórias). Prolonged negotiations allowed many states to extract additional concessions from the federal government. Then, as provisory measures can be changed every month depending only on the will of the

President, those concessions were included in them and so extended to all states [15].

Finally, one must mention that a restructuring of municipalities' debts is under way, regulated by Provisory Measure 1.891, edited last January. It includes bond and contractual debts with financial institutions, both internal and foreign. Its financial conditions are basically the same the states were offered: 30 year loans, 9% p.a. interest rates, constitutional transfers and tax revenues required as pledges, cap on debt-service payments equivalent to 13% of annual net revenues etc.

3.1.4 – Responsiveness to market signals

The last condition for market discipline alone to function well is that borrowers should be able to respond to market signals before reaching the point of exclusion from new borrowing. That means increases in interest rates should be interpreted by the borrower as a signal to start adjustment measures, so curtailing the debt upward trend.

This clearly wasn't the case for the states and many municipalities, mainly because of the repeated bailouts. Increasing interest rates only made the debts grow faster, since interests were usually not paid, but capitalized. That was particularly true in the case of bond debt. Another important factor that prevented

[15] That point was suggested to the author by João do Carmo Oliveira.

an adequate response was constitutional regulation forbidding salary reduction in nominal terms and dismissal of redundant civil servants. A constitutional amendment approved in 1998 overruled the latter constraint.

On the contrary, civil servants previously entitled to receive benefits from general (federal) social security system after thirty-five years of employment (less for women and teachers) were compulsorily transferred to the states' social security systems [16], without any compensation to the states. Additionally, in the last five years there was a wave of early retirements (allowed by legislation with pensions proportional to period in service) for fear that the constitutional amendments then being discussed in Congress would restrict their privileges.

Given that none of the conditions for market discipline are met in the case under study, direct control of subnational debt has been increasingly used. In the next section, we turn to the specifics of subnational debt regulations in Brazil.

4 - Subnational debt control in Brazil

There are mainly two kinds of regulation of subnational debt in Brazil: one is Federal Senate's ex-ante control and the other one is a credit ceiling imposed on loans from financial institutions to the public sector, which is carried out by National Monetary Council (CMN). Additionally, there's the Constitutional

[16] With a pension equal to their exit salary, plus any subsequent increases granted to their previous position.

Amendment n. 3, edited in 1993, which allows issuance of bonds only to refinance preexisting bonds at maturity or when its proceeds are used to pay for court judgements. The legal effects of this amendment will expire at the end of 1999. A fourth and more limited form of control is the concession of federal guarantee for external loans. The Ministry of Finance sets rules (based on the capacity of repayment) that guide the decision as to whether to offer local governments such guarantees.

The law that regulated the last renegotiation of state debts (Law 9.496/97) created additional constraints for the states, especially the need to reduce the ratio debt/net revenues to 100% according to a preestablished schedule and the ban on new bond issues.

Both Senate and CMN regulations have changed over the years, and I will cover here only the current regulations, that is, Senate Resolution 78/98 and CMN Resolution 2.653/99.

Senate Resolution 78/98 is binding on States, the Federal District and Municipalities, but not on state and municipality-owned companies, hence providing an opportunity to shift debt to these companies. Basically the resolution requires that each credit operation be subject to prior approval by Senate, or by the Central Bank on its behalf, and sets the conditions for the authorization. In any case, the application for a loan is submitted to the Central Bank, and then

examined, approved, rejected or, in the case of bond issues or external loans, sent to Senate.

The main conditions for approval of a loan or bond issue are:

- New borrowing in any particular year should not exceed budgeted capital expenditures for that same year (golden rule);
- New borrowing in any particular year should not exceed 18% of net revenues [17];
- Maximum annual projected debt service should not exceed 13% of net revenues;
- The ratio total debt/net revenues should not exceed 200% if the application is submitted in 1998, 190% if in 1999, and so forth. From 2008 on, the maximum ratio allowable is 100%. The introduction of this requirement represents a considerable improvement over previous resolutions, since that ratio is more directly related to solvency;
- The primary result of the 12 months before application must be non-negative; and
- The applicant cannot be in default.

There are also other limits for specific kinds of loans. Outstanding ARO loans can't exceed 8% of net revenues, and at least 5% of the bonds must be redeemed at maturity. The latter constraint is not relevant anymore since states

[17] Net revenues are measured in the 12 month period before the application.

(with the exception of Rio de Janeiro) have no more bonds outstanding and a few municipalities which issued bonds will soon exchange them for long term loans from federal government. The stock of guarantees to credits contracted by third parties (contingent liabilities) is limited to 25% of net revenues and subject to the same process of approval as loans.

The resolution includes additional restrictions to states that participated in the last renegotiation. Approval of further loans is dependent on the agreements signed allowing states to do so.

In the case any of the quantitative limits (and some other conditions) are not met the loan is rejected by the Central Bank and does not go to Senate, that is, the states and municipalities cannot appeal to political reasons to circumvent the rules. This is an essential feature introduced by Resolution 78/98, since, as explained in section 2.2, the Senate is traditionally very lenient towards loan applications. One report from Senate [18] acknowledges that in 1995, 49 out of 50 applications were approved and in 1996, 83 out of 97 were approved (13 were under examination at the time of the survey and 1 had been dropped by the applicant).

However, the provisions of Resolution 78/98 have been overruled in some cases by other resolutions. It happened in the case of the last rescheduling of state debts and of the loans to privatize/extinguish state-owned banks. Both

could be defended on the grounds that they were once and for all measures and, furthermore, that they were necessary to create the conditions for enduring fiscal adjustment. Less justified were the exceptions granted to states so they could receive loans from federal government to compensate for federally mandated state transfers to municipalities related to education expenditures (FUNDEF).

Specifically as to the limitation of all borrowing to investment purposes (golden rule), the way it is done in the Resolution is quite ineffective, since our budget expenditures are not mandatory. That means investment expenditures can be overestimated in the budget so that current expenditures can be financed out of borrowing. Furthermore, no evaluation is made of the economic and social return of the proposed investment projects. The requirement of a positive primary result, on its turn, is not a very adequate indicator of solvency: for highly indebted governments it's simply not enough to achieve primary balance, particularly when interest rates are high. On the other hand, governments with very small debt/revenues ratios can incur in primary deficits without having solvency problems, as long as the long term returns on investment projects are higher than interest rates.

The Resolution 78/98 itself houses an exception to its own quantitative limits: loans from either multilateral institutions or federal banks which seek to improve either tax collection or financial and property management of local governments are exempt from those limits.

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[18] Senado Federal (1997), Relatório Final da CPI dos Precatórios, apud Fecury (1998), pg. 35-36.

National Monetary Council, composed by the Ministers of Finance and Planning, and the President of the Central Bank carries out the second form of subnational debt control. This control, exerted at least since 1988, is directed at the supply of credit granted by the national financial system to the public sector, including the federal government (except purchase of federal bonds) and companies of all levels of government.

The regulation changed substantially over the years, but one common feature is that all resolutions allowed a certain number of loans and other credit operations to occur regardless of the credit ceiling [19]. Basically those exceptions involved loans from federal banks, which are accountable to the Ministers of Finance and Planning. This is another instance of an inadequate institutional setting, in which regulatory and executive concerns are mixed and efficiency reduced. In November 1997 CMN issued Resolution 2.444, which considerably tightened credit limits and revoked previous exceptions. One month later CMN issued Resolution 2.461, reintroducing many exceptions. Later resolutions gradually limited the exceptions, until Resolution 2.563, issued in September 1999, took a different approach.

It dropped the traditional limit to the stock of operations of financial institutions with the public sector (based on past stock on a particular date),

[19] The so-called "operações extra-limite".

revoked almost all exceptions and established three kinds of limits to the operations:

- Stock of credit operations of each financial institution with public sector should not exceed 45% of adjusted net worth. That prerequisite aims at reducing excessive concentration of the supply of credit to public sector in federal banks. Banks whose loans now exceed this limit can keep them, as long as the ratio between loans to public sector and net worth doesn't increase. It seems to be the case that net worth growth for these banks is smaller than the relevant interest rate, so at least part of the interest will have to be paid. Though the limit is still quite high considering the risk of default, it helps reduce state and municipal pressures on federal banks for more financing.
- Each borrower (or its controller, in the case of companies) should comply with the quantitative limits of Senate Resolution 78/98. Apparently meaningless, because it duplicates the criteria used by Senate for each loan, this measure makes sure that an unsuitable loan will not be approved, even if the borrower manages to get special treatment from Senate.
- New loans are limited to R$ 600 million from now on. The setting of a fixed amount as a limit amounts to an implicit assumption that the resolution will be somewhat short-lived.

It's too early to reach a conclusion regarding the effectiveness of the last change in regulation of credit supply to the public sector, but it certainly represents one more step in a trend towards more strict controls.

5 – Conclusions and suggestions

The persistent imbalances in many subnational government accounts in Brazil and consequent overindebtedness have little to do with flaws in debt regulation *strictu senso.* On the contrary, those regulations have improved over time, much as a reaction, if late, to sharp increase in debts. On the other hand, interpretation of the regulations, as well as its enforcement, have been invariantly too lenient.

Another important problem is the series of bailouts of local debts, which were a major factor in creating a soft budget constraint. All those problems seem to arise from an inadequate relationship between federal and local governments in a context of fiscal decentralization after the dictatorship period [20].

Present overindebtedness, coupled with the fact that by far the biggest creditor of states is the federal government (and municipalities will soon follow that trend), doesn't make it easier for the federal government to put in place additional constraints. Yet those constraints are necessary, for the conditions for sole reliance on market discipline are not currently present.

[20] This interpretation of the facts contrasts to the one given by Rangel (1998 pg. 32). He says the federal government has a recognition lag as it refers to local debts, so it takes it too long to reinforce local budget constraints, and when it does occur it's not enough to make up for

This diagnostic justifies two courses of action: one, we must recreate the conditions for market discipline; and two, current administrative controls and its implementation should be further improved, mimicking market discipline that is not yet available. In some cases, the same measure serves both purposes.

Although this monograph focuses on debt control issues, the proposals advanced below should be discussed in a broader context, that takes into account factors (both economic and institutional) affecting revenues and expenses of states and municipalities, the demand for services they must provide, regional imbalances etc. Anyway, as far as I know, those proposals are not inconsistent with other necessary reforms concerning those issues.

First and foremost, there need to be a firm commitment, on the part of the federal government, to the terms of the agreements made under Law 9.496/97, together with a firm refusal to engage in further bailouts. Given the long history of bailouts, this policy must be followed for a long time before markets realize they will have to bear risks when they lend to local governments and the latter will take equally long to internalize the need for sound financial management. Preferably this would have to be done through a constitutional amendment to make it credible.

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increased debt service. I tend to think this lag, though existent, is due to the problem of federalism, and not a separate cause of excessive debt in itself.

Second, the supply of credit to local governments must be less concentrated. The Resolution CMN 2.653/99 takes one step in that direction, but it's still not enough. In particular, National Treasury loans could be transformed into (possibly shorter) securities and sold in the market, as long as the commitment to non-bailout is in place [21]. Pension funds could be interested in buying longer term securities. Another possibility is for federal banks to encourage private banks to buy from them local government loans, at the same time providing liquidity to buyers.

Third, local government's social security systems need reforming, along the lines set up by a constitutional amendment on social security approved last year. Otherwise, the growing amount of pensions to be paid over the next ten years and, in some cases, less than that, will require such a reduction in other expenditures as to make fiscal adjustment politically impossible. By the same token, states and municipalities will have to reduce their personnel, taking advantage of the constitutional amendment on administrative reform. Before that, it was virtually impossible to fire public servants.

Fourth, it is necessary to adopt the broadest possible concept of debt. The most conspicuous case of an overlooked debt is the actuarial debt, whose amount is unknown. What we do know is that it is large relative to the other debts and relative to the capacity of payment of local governments. Two other kinds of

[21] Mendes (1998) presents a similar suggestion, by which all loans would be gradually registered in the same institution as state bonds (CETIP) so they would have standard characteristics and

debt are not considered in Senate regulations: arrears to suppliers and public servants ("restos a pagar") and court judgements ("precatórios"). Sale and leaseback arrangements are possibly another kind of liability that should be considered.

Fifth, there is a constitutional provision (CF art. 52 – VI) that allows the President to propose an overall limit to debts of the union, states, the federal district and municipalities, and Senate has the power to approve those limits. That provision has never been used, and it might well constitute a very useful coordination tool. As mentioned in section 2.2, senators usually approve the loans that are of the interest of each other. However, it would be difficult to oppose a global ceiling on annual borrowings which, first, could be easily related to the overall goals of financial stability, second, does not amount to rejecting any particular loan, and third, would have a counterpart in a ceiling for the federal government itself. This mechanism could prevent the collusive behavior among senators and, incidentally, produce a better allocation of resources [22].

Sixth, standard rules for public accounting are necessary to reduce the cost of collecting comparable information and making it available to the general public. In practical terms, it possibly requires that states and municipalities all adopt the same financial management computerized systems. In this case, the obvious choice would be the system used by the federal government (SIAFI),

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could be traded more easily.

which, with relatively minor rearrangement (SIAFEM) is already used by many states and some municipalities. The federal government, with support from BIRD, has already begun a program of technical and financial assistance to the states with that end. Still, in order to achieve the necessary standardization of procedures, federal government should assume regulatory powers on accounting principles and practices. Along the same line of increasing transparency, debt control should focus on a small number of simple, significant indicators, that could be readily understood and accompanied by the media and public opinion. Another possible way to do it would be to help create independent rating agencies in order to disseminate objective information about credit risks more efficiently [23].

[22] Mendes (1998, pg. 40) originally presented that proposal,. adding that general rules governing subnational debt should be set up in the law, instead of in Senate resolutions.
[23] This measure is recommended by Peterson (1997, pg. 37), based on the experience of Korea, India, Thailand, South Africa and Chile.

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