How to Fix the Fiscal Crisis in Brazil's States

By Carlos Mulas-Granados

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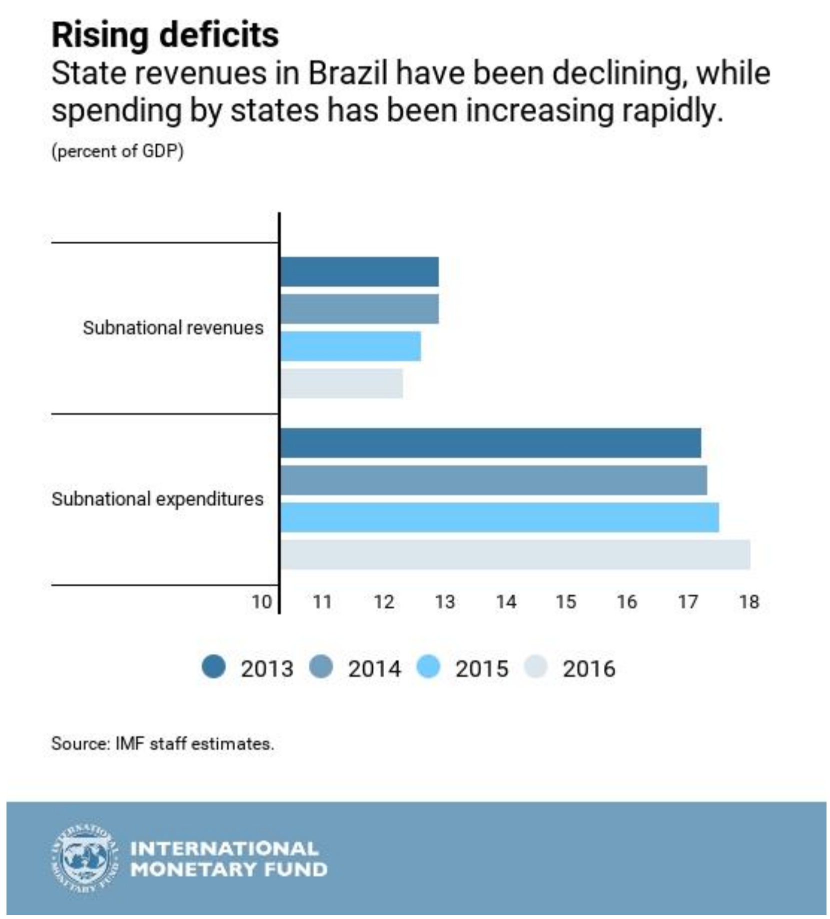
After six years of subsidizing bus and metro fares for the poor in Rio de Janeiro, the reduced fare program was suspended last December. The reason: no meaningful plan by the state of Rio de Janeiro to pay R$10 million in overdue bills from the single-ticket riders' subsidy program in 2016. The suspension impacted 5.3 million people from 20 municipalities who use the card on a daily basis. But thanks to a last minute agreement between the transport concessionaries and the state's promise to liquidate all pending debts, the reduced fares were reinstated in early January.

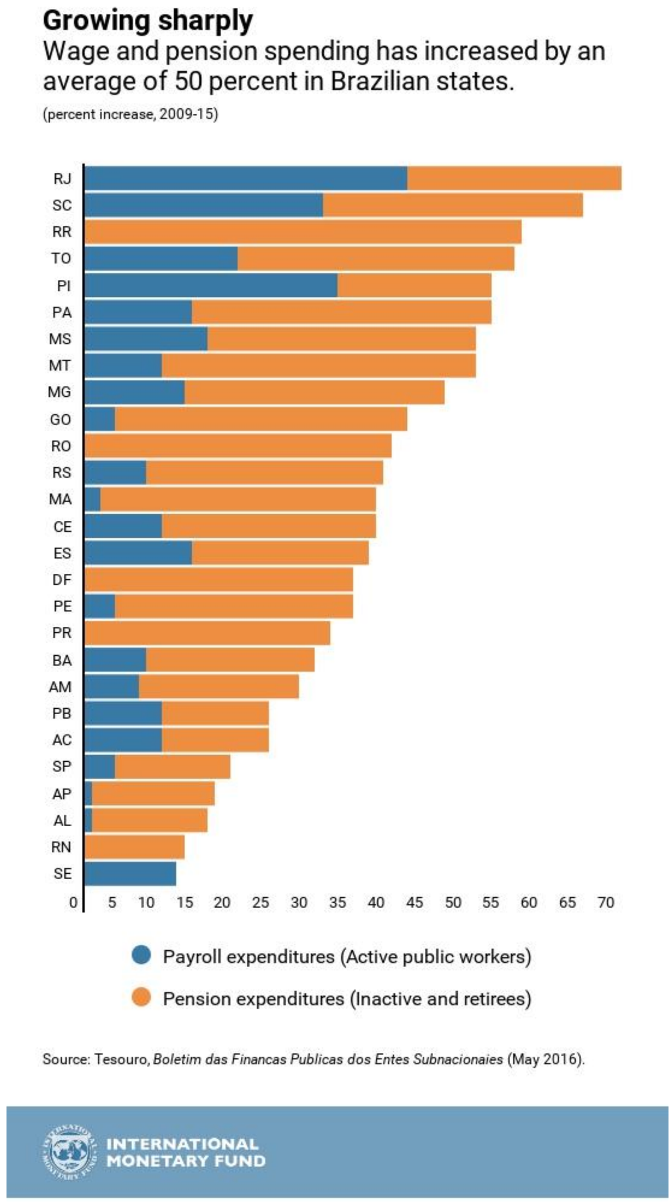
This event is a small example of a much deeper fiscal crisis affecting a growing number of subnational entities in Brazil.

Deeper in the hole

How did this fiscal crisis happen? Toward the end of 2015, the first signs of payment delays emerged. The story was that most states had been adversely affected by the general economic slowdown—falling revenues resulting from the slowdown in growth, compliance problems, and declining commodity prices affecting states such as Rio, which were highly dependent on the oil industry. However, this storyline quickly became more complicated. By mid-2016, it became clear that the most acute fiscal problems had a very large structural element arising from exploding expenditure growth and major rigidities in core entitlement programs, such as the pension program (see chart).



As we show in a recent IMF study, while revenues did collapse, real personnel and retirement spending increased by 50 percent, on average, in the 27 states over 2009-2015 (see chart). In addition to Rio de Janeiro, where that average was 70 percent, the rise in personnel and retirement expenditures was also especially acute in other states, such as Rio Grande do Sul, Santa Catarina, Bahia, and Minas Gerais.



Even a R$50 billion multi-year plan to extend the maturities of states' debts didn't fix the problem. While the debt rescheduling alleviated fiscal tensions in most states, it was insufficient for those states that were in the most difficult situations. As of now, Rio de Janeiro, Rio Grande do Sul, and Minas Gerais have declared a "state of calamity."

Clearly, a number of states did not adhere to the fiscal rule, with several already breaching the limit of personnel expenditures to current net revenues established by the Fiscal Responsibility Law (according to National Treasury data). But how was this increase in personnel expenditures possible? Until 2014, states tax bases remained buoyant, and many states were in addition able to borrow for capital projects, which indirectly relaxed their budget constraints. So when the Ministry of Finance limited new credit operations by regions, and revenues fell as a result of the recession, many subnational entities found themselves short of cash. Running out of options, many states resorted to stop-gap solutions (for example, by using the funds deposited by parties involved in court litigations, the so-called "judicial deposits"), and those in worst shape accumulated arrears on their wage bill payments.

Faced with rigid personnel spending obligations and debt repayment plans, the majority of states have cut their investment expenditures by more than half compared to the years before the strong recession hit, thus undermining their future growth prospects.

Learning from others

Major fiscal reforms are needed to solve the subnational crisis in Brazil, including core changes to the subnational sales tax and putting an end to the structural growth of wage and pension spending. But no single solution works for all states. For example, states like Pará, Tocantins, Amapá, Espirito Santo, Rondonia, and Roraima are still in very good fiscal shape. Therefore, any solution should avoid moral hazard by rewarding good fiscal performers with more financing and prospects for fiscal autonomy, and encouraging bad performers to correct their policies.

The successful resolution of similar crises in other countries can offer some useful insights for Brazil. Over the past three decades, subnational fiscal crises have occurred in many countries, as diverse as Argentina, South Africa, India, Mexico, Spain, Australia, Germany, and the United States. Several common elements emerged across these case studies on subnational crisis resolution. For example, crisis resolution in those countries tended to be more successful when subnational governments took on the burden of solving their own fiscal vulnerabilities, facilitated by federal government financing and effective conditionality. More permanent solutions also required the introduction of crisis prevention mechanisms (including state bankruptcy laws and future resolution frameworks) and a minimum degree of future risk sharing between the different parts of the federation (for example, through a common social security system or through a common deposit insurance for the financial sector).

Coming back to Brazil, the federal government has been proposing a Fiscal Recovery Regime for those states in most dire conditions. This regime, which would be voluntary, would combine some form of central support with strong fiscal reform programs in the states involved. Its introduction, however, has been difficult as many stakeholders have to be brought into agreement.

But a solution to the fiscal crisis of the states is necessary for Brazil's recovery. Brazil's federalism binds municipalities, states, and the federation. In areas such as health and education, the federal government and the states have overlapping responsibilities. In other areas, such as social spending, for instance, the responsibility lies at the federal level almost exclusively, while the states administer almost 80 percent of spending on security. The current subnational fiscal crisis therefore requires a cooperative solution between the different levels of government.

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