Intergovernmental Fiscal Issues

How to overcome the States’ fiscal crises
I. Key Sectoral Challenges

Increasing illiquidity and insolvency among State governments

• Subnational governments are in fiscal crisis:
  • Declared “financial calamity”:
    Rio de Janeiro, Rio Grande do Sul, and Minas Gerais
  • Using pension reserves (capitalized funds) to pay for current expenditures
    Minas Gerais, Rio Grande do Norte, Goiás, DF, Sergipe, Paraná
  • Liquidity shortages, running up arrears, struggling to pay salaries
    Almost all states, some large municipalities
I. Key Sectoral Challenges

Structural unsustainability

• Increase of rigid current expenditures is eroding fiscal space and room for adjustment

Figure 1: Current Primary Spending vs. Investment 2010-2017 (States average, % of current revenue)

Figure 2: Rigidity index 2017 (Current spending and debt service as % of net-revenue)

Note: The definition of rigid expenditures is an approximation based on available data and likely overestimates.
I. Key Sectoral Challenges

Existing rules are part of the problem

• Pro-cyclical expansion rules:
  - Minimum spending linked to tax revenues; and
  - FRL indicators (debt, personnel spending limit) defined as % of net-current revenue.

• Federal mandates:
  - Rigid statute for civil servants employment (difficult to dismiss, and reduce payroll when needed);
  - Minimum wage and teachers’ salary floor; and
  - Overgenerous pension entitlements.

• Moral hazard problem:
  - States expect (and receive) federal bailouts. This reduces incentives for economic reforms; and
  - The lack of federal instruments for liquidity injection reduces financial support from the federal government in cases of bankruptcy and debt restructuring thus creating adverse incentives.
I. Key Sectoral Challenges

The pensions time bomb

• States are largely unaware of the severity of the upcoming crisis of their pension system:
  • Official pension subnational RPPS projections do not reflect the future deficit projections;
  • Estimates by the World Bank using data from states show that the subnational RPPS will face a rapid increase in liabilities over the next 20 years;
  • Deficits will absorb as much as 30 percent of NCR in many states.

• Determinants of subnational pensions:
  • Wage policy for active civil servants has immediate impact on pension liabilities;
  • Adding to this, some states offer special bonuses to civil servants.

Figure 4: Pension deficits: World Bank Projections in 4 States

% de RCL


Bahia
Sao Paulo
Rio de Janeiro (excl. royalties)
Mato Grosso
I. Key Sectoral Challenges

The subnational fiscal time bomb

• A simple fiscal forecasting framework projects more insolvencies* going forward:
  • 10 States projected to be insolvent by 2021 in baseline scenario (moderate recovery); and
  • 17 States projected to be insolvent in adverse scenario (renewed recession).

* Insolvency defined as open financing needs even after 3 years of successive fiscal adjustments.
II. Policy Recommendations

What has been tried so far?

• Short-term Federal debt rescheduling (LC 156)
  • States can reduce their repayment of federal debt for 18 months (January 2017-June 2018).
  • Commit to spending limit (current spending flat in real terms) for 2 years. In practice many states have not managed to limit their spending, and might loose the benefit (ex-post)
  • Short-term debt relief, no structural changes

• “Fiscal Recuperation Regime” (LC 159)
  • Additional debt relief for states in fiscal crisis (so far applied only to Rio de Janeiro State)
  • Fiscal adjustment and reform (incl. privatizations) demanded, but very little adjustment actually achieved in the case of RJ State
  • No instrument to support or incentivize States with low debt
II. Policy Recommendations

What has worked elsewhere?

• Argentina (1993): Pension bailout as part of the renegotiation of the revenue sharing agreement.
  • + Similar tradeoff exists in Brazil
  • - Did not address some structural problems

• Colombia (1999): Administrative insolvency framework with designated legal arrangements
  • + Designed to minimize the need of judicial interference (a problem in Brazil)
  • - Strong central government (applicable to Brazil?)

• Spain (2011): Federal liquidity injection combined with fiscal adjustment and tight controls
  • + Liquidity injection likely needed and possible in Brazil
  • - How to enforce adjustment and reduce moral hazard?
II. Policy Recommendations

What is needed in Brazil?

1. A new instrument to address the current crisis:
   - Fund to provide liquidity injection and prevent state bankruptcies; and
   - A mechanism to incentivize fiscal adjustment early on (before bail-out is needed), or to enforce adjustment post-bailout.

2. Structural reforms to provide states with flexibility and reduce moral hazard:
   - Eliminate or reduce federal spending mandates and entitlements;
   - Reform pro-cyclical fiscal rules and transfers; and
   - Federalize the sub-national pension systems?

3. A road to market discipline?
   - Use markets to address incentive problems inherent to subnational finances (soft budget constraint, moral hazard, asymmetric information);
   - Access to capital markets could be revisited as a reward for the most prudent subnational governments; and
   - This will require a credible no-bailout commitment by the federal government.
• States are undergoing fiscal crisis and if nothing is done more State-bankruptcies are to be expected.
  • If nothing is done, between 10 and 17 States are expected to be bankrupt (up from the current 3) by 2021, depending on economic prospects.

• To restore sustainability of State finances, fiscal rigidities such as spending mandates and excessive pension obligations need to be reduced.
  • Current primary spending (without debt service or investment) took up on average 93% of States’ revenues in 2017 (up from 83% in 2008).
  • RPPS deficits, which currently account for about 15% of revenues on average, will increase to 30% of revenues in some of the large States assessed (Bahia, Rio de Janeiro).

• The Federal Government should provide not only debt relief but also short-term liquidity to States willing to undergo structural adjustments.
IV. Annexes

The Brazilian States' dependence on transfers from the Federal Government is not excessive compared to other countries.

**Vertical Fiscal Gap**
(% Subnational Expenditure - % Subnational Revenue)

- PER
- GBR
- NOR
- DNK
- LUX
- IRL
- SVN
- PRT
- BRA
- SWE
- FRA
- CAN
- ISL
- UAE

**Horizontal Fiscal Gap**
(taxes as % of total revenue, by state)

The level of dependence on transfers from the Federal Government varies among States – the poorest and more rural States are more dependent.