States:
How to get past the fiscal crisis

As states are confronted with rigid spending mandates and falling tax revenues, public services are deteriorating. The states must now make a difficult and painful fiscal adjustment—and only institutional reforms will put their finances back on a sustainable path.

Chico Santos

THE END OF 2015 and early 2016 saw much bad news for Brazilians. The most perverse fiscal news was the transmission of *aedes aegypti* disease by seemingly invincible mosquitoes, especially in Rio de Janeiro state. But even without the epidemic Rio Grande do Sul, Rio de Janeiro, Minas Gerais, Sergipe, and Tocantins states were already finding it difficult simply to pay public employees. The 2016 budgets of Rio de Janeiro and Minas Gerais states



show large deficits—in Minas Gerais almost R$9 billion and in Rio de Janeiro, R$14 billion against budgeted spending of R$79 billion.

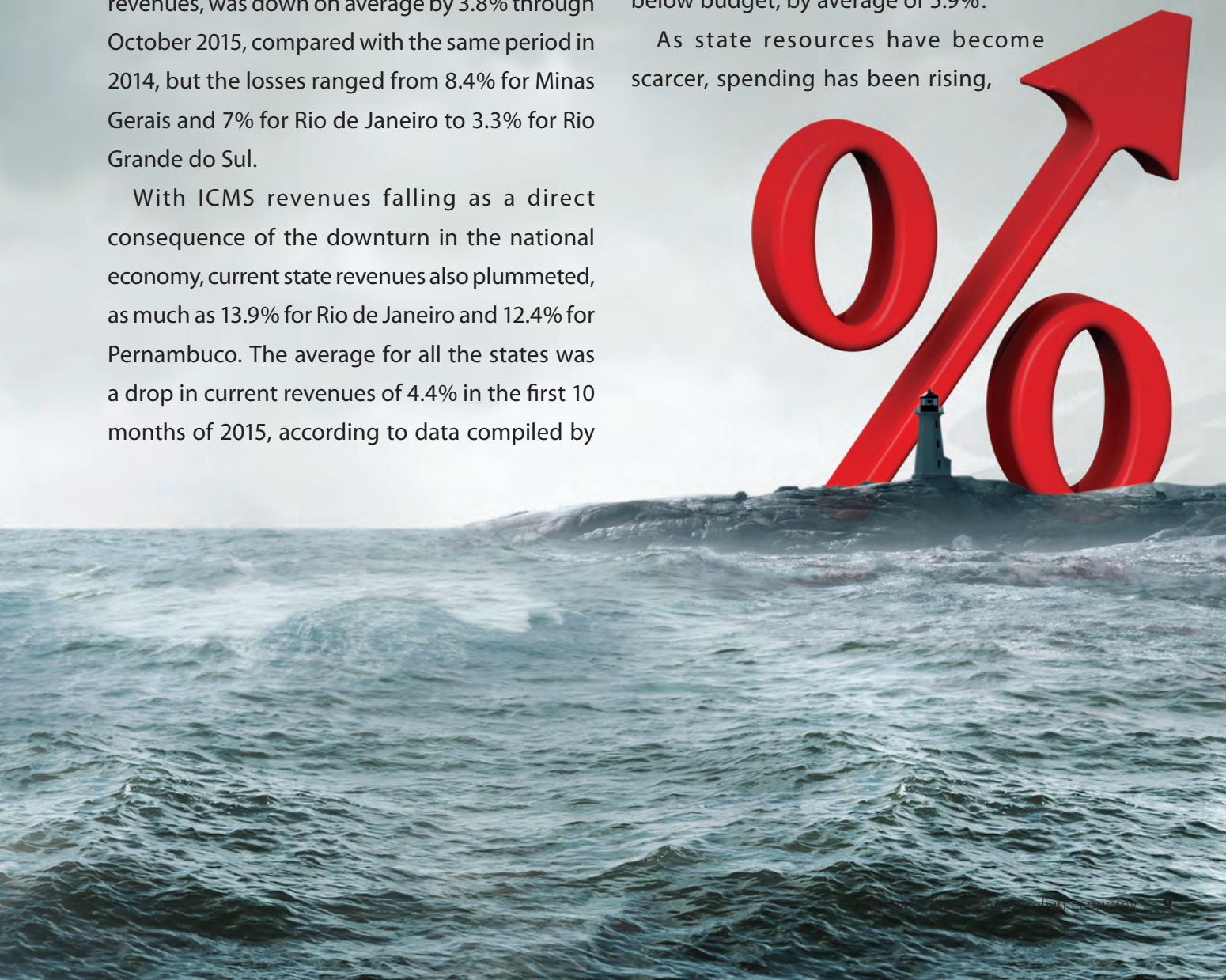
These numbers illustrate the very complicated situation of states and municipalities caused in part by the massive fiscal crisis affecting the federal government, and in part by structural problems created by the Constitution of 1988, says Fernando Rezende, professor at the Brazilian School of Public and Business Administration (Ebape) of the Getulio Vargas Foundation.

On the revenue side, financing from the tax on sales and services (ICMS), the main source of state revenues, was down on average by 3.8% through October 2015, compared with the same period in 2014, but the losses ranged from 8.4% for Minas Gerais and 7% for Rio de Janeiro to 3.3% for Rio Grande do Sul.

With ICMS revenues falling as a direct consequence of the downturn in the national economy, current state revenues also plummeted, as much as 13.9% for Rio de Janeiro and 12.4% for Pernambuco. The average for all the states was a drop in current revenues of 4.4% in the first 10 months of 2015, according to data compiled by Aequus Consulting. In fact, 2015 was the first year since 2010 that actual state current revenues were below budget, by average of 5.9%.

The federal government allowed the states to borrow from the National Development Bank (BNDES) and multilateral financial institutions because it was not making its mandatory transfers of resources to them.

As state resources have become scarcer, spending has been rising,



"States have been suffering from a structural crisis as they have lost more and more space in the federation."

José Roberto Afonso

especially to pay personnel expenses. Renato Villela, São Paulo State financial secretary, believes that a large number of Brazilian states may have started 2016 above the prudential limit set by the Fiscal Responsibility Law (LRF) for personnel expenses, which is 48.6% of net current revenue.

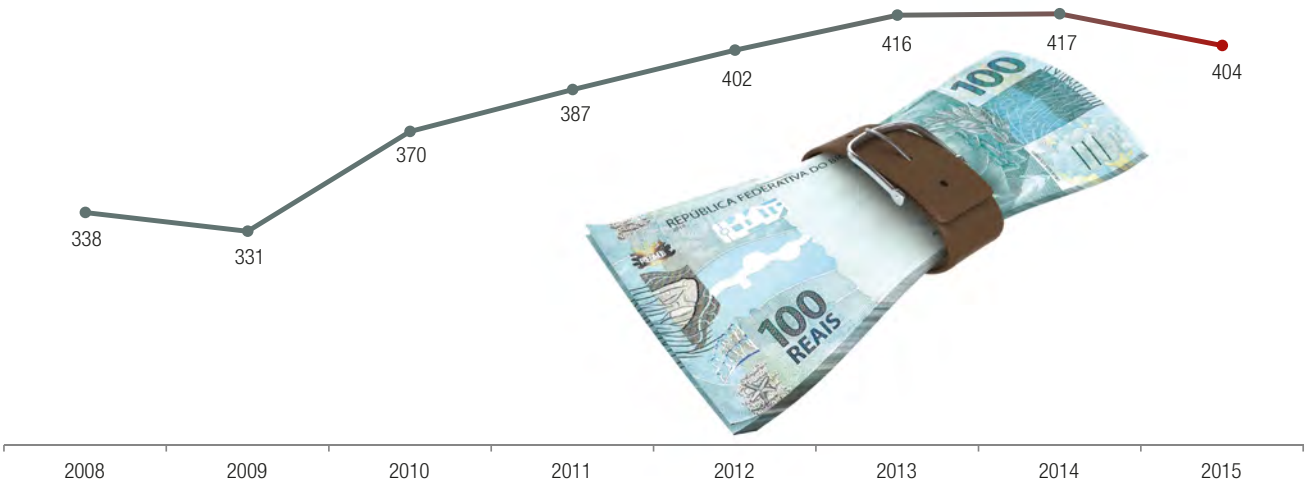
According to Aequus Consulting, while in August 2011 26 of the 27 states had personnel expenses below the LRF limit, in August 2015 seven states were between the prudential limit and the maximum of 54%, and two, Rio Grande do Norte and Rondônia, were spending above the LRF maximum. States are breaching the limits because of declines in revenue.

States have 16 months to comply with the LRF limits, Villela explains. Aequus estimates that states' personnel expenses were 5% higher in 2015. While Villela recognizes that it is essential for states to cut personnel costs, he says that will not be easy given the public employee hiring rules. "There is an inconsistency between what the Fiscal Responsibility Law calls for … and what states can possibly do," Villela says. For instance, only after personnel costs exceed 49% of net current revenues can the state executive lay off staff, and even then the rules are very strict.

Villela calls the situation "very worrying" in the short term, although it is less worrying for São Paulo state because it has long managed its finances prudently. To address the crisis, he thinks, states and municipalities need much more

State collections of ICMS, major tax revenue source has declined reflecting the downturn in the economy as well as erosion of the tax base.

R$ millions, adjusted for inflation



Source: Compara Brasil.

powerful fiscal management tools than those currently available.

To control spending, Villela recommends measures to reduce the rigidity in spending, reduce personnel, adjust public employee pensions and wages, and ease constitutional entitlements. On the revenue side, Villela supports initiatives to broaden the tax base, eliminate tax benefits, and end the "tax war" states are waging to attract investment.

Debt off the rails

Since 2010, the federal government has gradually relaxed state debt limits to allow urgent investments. Villela believes debt limits worked well as long as the federal government "maintained a fiscal stance according to established rules"—in other words, set a good example.

According to Villela, the federal government allowed the states to borrow from the National Development Bank (BNDES) and multilateral financial institutions because it was not making its mandatory transfers of resources to them: "The federal government abandoned the coordination of a fiscal responsibility policy for the states." According to an IBRE survey, between 2008 and 2014 Brazilian states borrowed R$15 billion, which pushed up their consolidated debt from R$404 billion in 2010 to R$577 billion in August 2015.

This explosive increase in the stock of debt led the states and municipalities to plead for, and get from, the National Congress changes in the terms of state debts to the federal

States have substantially increased their debts to offset part of declining revenues

R$ billions

	2014	August 2015
Acre	3.2	3.1
Alagoas	9.2	NA
Amazonas	3.4	3.5
Amapá	1.7	1.3
Bahia	10.3	13.4
Ceará	6.1	7.6
Distrito Federal	3.6	3.6
Espírito Santo	3.2	3.3
Goiás	14.9	15.6
Maranhão	4.7	4.9
Minas Gerais	85.3	92.4
Mato Grosso do Sul	7.9	NA
Mato Grosso	4.6	4.8
Pará	1.5	1.8
Paraíba	2.7	3.3
Pernambuco	10.7	11.3
Piauí	3.8	2.9
Paraná	16.5	15.4
Rio de Janeiro	82.1	93.5
Rio Grande do Norte	NA	0.6
Rondônia	3.4	3.2
Roraima	0.5	0.2
Rio Grande do Sul	59.9	64.4
Santa Catarina	8.1	8.8
Sergipe	3.4	3.4
São Paulo	200.5	212.8
Tocantins	1.9	2.2

Total state' debt

R$ billions



Source: IBRE.

A large number of Brazilian states may have begun 2016 above the prudential limit set by the Fiscal Responsibility Law for personnel expenses, which is 48.6% of net current revenue.

government. Today interest on what states owe to the federal government is equal to inflation measured by the National Index of Consumer Prices plus 4% or the central bank's policy interest rate, whichever is less; previously it was inflation measured by the General Price Index plus 6 to 9%. However, there was no change in the mandate to use 13% of net state current revenue to pay off debt to the federal government.

Júlio Bueno, who is secretary of finance of the State of Rio de Janeiro, believes that in the current situation it is more important to change the net current revenue commitment to pay off debt than to reduce the interest paid. "The interest change reduces the debt burden in the long term, but what states need right now is to reduce the debt payment flow," he says.

Secretary Bueno must deal with perhaps the most difficult state fiscal situation in Brazil. He attributes his troubles to a combination of economy's downturn and the fall in oil industry activity caused by both the state-oil company Petrobras crisis and the plunge in international oil prices from about US$100 per barrel in mid-2014 to less than US$35 in the first weeks of 2016.

As the largest oil producer in Brazil and headquarters of almost all the companies operating in the sector for Rio de Janeiro state, the oil industry is the main economic activity. The oil crisis hits its state and municipal budgets in two ways: Tax revenues go down because there is less economic activity and movement of goods and services, and collection of royalties and special contributions from oil production also drop.



The capital of Bahia earned only last year **94.5%** of 2015 budgeted revenue through October 2015

Although oil and gas production is still growing in Brazil, payment of royalties is based on international prices and consequently falls when they do. Bueno's department calculates that revenues from royalties and special contributions dropped

from R$8.7 billion in 2014 to R$5.5 billion in 2015, and ICMS tax collections were down to R$32 billion—R$6 billion less than was budgeted.

The estimated R$13 billion shortfall in budgeted revenue was covered, Bueno says, mostly with extraordinary revenues, which were not enough to cover the whole public wage bill at the end of the year; the state is paying it in installments and postponing other expenses. In 2016 the estimated deficit of R$14 billion will also have to be covered by extraordinary revenues, and spending cuts, he noted. In January, salaries were postponed for one week. ICMS went up for some products and services, and the state government is working on a securitization program for its outstanding debt as a way to anticipate revenue.

Nationally, Bueno sees a need for the federal government, states, and municipalities to coordinate to find a solution of common interest, observing, "Both the federal government and the states and municipalities are partners in this crisis."

The first item on the common agenda, Bueno says, is public employee pensions: since the legislation is federal, federal government intervention is indispensable, but without the support of states and municipalities the federal government cannot approve changes to the public employee pension fund without working out a sustainable balance. The pension imbalance is one of the factors tormenting Rio de Janeiro state as it tries to close its 2016 budget gap.

Among measures urgently needed to balance public finances in Brazil, Bueno calls for reinstatement of the controversial Provisional Contribution on Financial Transactions (CPMF),

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while recognizing that not all states would agree. But he does believe that all states would agree on relaxing revenue earmarking.

Bueno would also like to see a revision in the current exploration model for deep-sea oil, an issue that most affects his own state. At this point, for Bueno it is most important to rethink such crucial aspects of the law as the obligation that Petrobras operate all the blocks, with a 30% stake, and the local content rules.

Bueno says that if these oil exploration points are modified and there are new auctions for deep-sea oil blocks, it is likely that businesses will be ready to invest US$150 billion in the sector—though much will also depend on some recovery in excessively depressed oil prices.

An essentially structural problem

Professor Rezende is convinced that the current crisis is essentially a structural problem: "We are living with the illusion that the crisis is temporary and all problems will be solved if the economy resumes growth. This interpretation is refuted by the facts."

He also believes that Brazil's fiscal problems are having a more intense effect on the states. The problem, he says, originated with the

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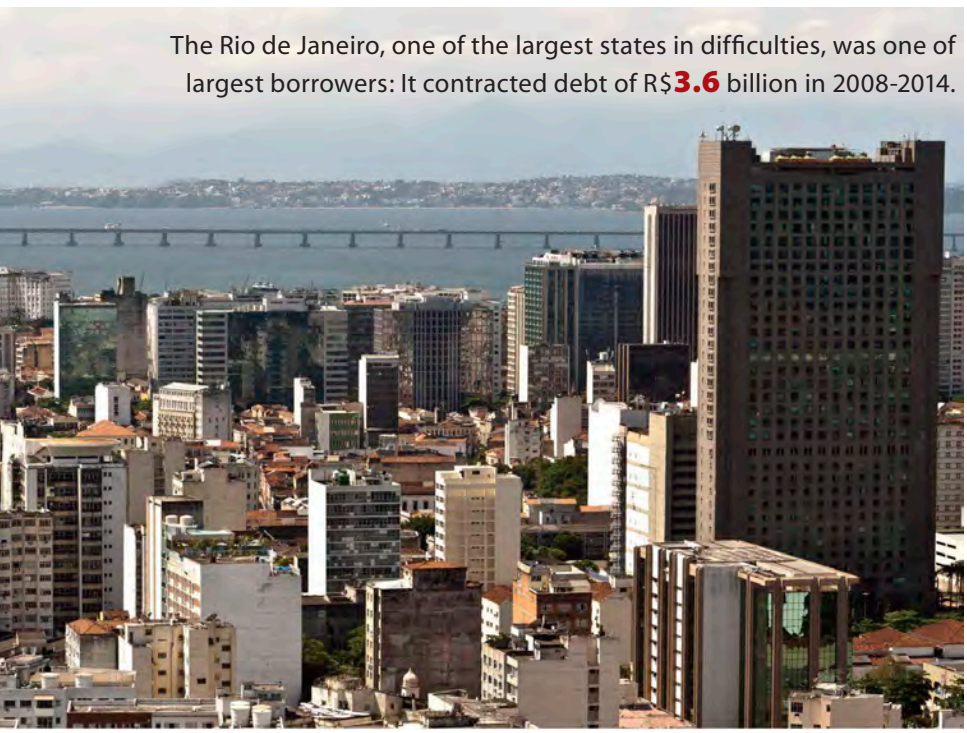
Júlio Bueno

drafting of the 1988 Constitution when large states opted for the ICMS, a VAT-type tax, which over time has become outdated while smaller states live mainly on the mandated transfers from the federal government: "Today the tax base of large states is suffering severe erosion."

Right now, the most important area making the ICMS outdated is telecommunications, where companies are losing business daily with new free Internet-based applications such as WhatsApp. Similarly, fossil fuels will eventually lose ground as environmentalist pressure for clean energy sources grows.

A second important source of ICMS erosion, Rezende says, is the precipitous decline of the share of manufacturing in Brazilian GDP, which was only 11% in 2015, down from 27% in 1985, according to the Federation of São Paulo State Industries.

Rezende points out that the Constituent Assembly that drafted the 1988 Constitution thought about the distribution of revenues but not a proportionate redistribution of spending responsibilities. "Traditionally, public safety remained the responsibility of state governments and medical assistance continued under municipal governments," he said. But as the 1988 Constitution expanded guarantees such as the labor entitlements of public employees and social security, fewer resources were allocated to such essential services as public safety and medical care. Rezende explains that "Today, state government control of their budgets is very low, almost zero. Everything is already decided by constitutional provisions or by federal regulation … . Not surprisingly, we are witnessing a significant deterioration of public security, urban public services, and public health."



The Rio de Janeiro, one of the largest states in difficulties, was one of largest borrowers: It contracted debt of R$**3.6** billion in 2008-2014.

While in principle the constitution guarantees resources for public health, Rezende notes, it shares revenues with Social Security, and as Social Security entitlements expanded, resources

for public health declined. While Social Security is an individual entitlement guaranteed by the constitution, he explains, public health is a collective right without legal individualization.

The return of the CPMF, Rezende says, will bring some immediate relief, but in the medium and long term "it will cause a further deterioration of our tax system and a loss of competitiveness of the economy."

Rezende sees no solution to state fiscal problems: "We will not be able to address the fiscal problem of states if we do not discuss reform of the federation. I am not talking about tax reform. I am talking about the constitutional allocation of revenues between the members of the federation, the states and federal government." He considers it even more urgent that the states have a centralized forum to debate their interests. Currently each tries to solve its financing needs by begging resources from federal government.

IBRE researcher José Roberto Afonso also believes that without structural reform the fiscal problems of states cannot be solved, noting that "States have been suffering from a structural crisis as they have lost more and more space in the federation." He thinks that states have to do "everything possible to make fiscal adjustment," but particularly cutting spending. "There is no magic and some states have already taken important initiatives that are sometimes unpopular," he says. Raising the ICMS, he says, would help momentarily but in the medium term the ICMS tax base is declining. The institutional reforms Afonso calls for start with the tax and budget systems, fiscal responsibility, social security and public administration. He agrees with Rezende that states need to create "a formal joint committee" so they can negotiate with the federal government collectively rather than individually.

"Either investment will be greatly reduced or simply cut."

Raul Velloso

Raul Velloso, a leading expert on public finances, regrets that the current crisis has had such a direct impact on investment at a time when the country most needs to address its chronic infrastructure deficiencies. "Either investment will be greatly reduced or simply cut," Velloso said, noting that "government energies are being primarily spent on plugging holes." He believes that given the magnitude of the state fiscal crisis, in 2016 Brazil will see "truculent [state] management with delays in paying public employees' salaries and resources for education and health threatened."

With expenditures mandated but revenues falling, Velloso sees few alternatives for states other than painful cuts. Since 2012 federal government encouragement of state and municipal borrowing also accommodated their lax personnel management. The borrowing was allegedly for investments only, but "That did not stop states and municipalities transferring money from investments to current spending," he noted. Last year former Minister of Finance Joaquim Levy, correctly Velloso thinks, closed the taps for new borrowing, so states will have to move beyond the fiscal crisis without further borrowing. He fears that policy makers may opt for a nefarious inflation tax as a solution, printing money to pay for public spending.

Municipalities also suffer



DURING THE PUBLIC HEALTH crisis in Rio de Janeiro state, many were surprised that the mayor of Rio de Janeiro city, Eduardo Paes (Brazilian Democratic Movement Party, PMDB), released R$100 million to help governor Luiz Fernando Pezão (PMDB) to deal with the problems that were piling up. Paes even took over management of two major state hospitals.

Does this suggest that although Brazilian states are doing badly, municipalities are not? Not at all. What happened, according to Alberto Borges, director of Aequus Consulting and former Secretary of Finance for Vitória city (Espirito Santos state), was that the crisis did not hit municipalities until a year later than the states.

Borges says that while state revenues were already falling in 2014, the problem did not start in the cities, especially state capitals, until May and June 2015, when revenues from municipal taxes (the tax on services, ISS) started to fall. The economic crisis had hit industry earlier than services, Borges explains.

Now the fiscal crisis has also reached municipalities. According to Aequus data, in the first 10 months of 2015 current revenues of state capitals were on average 1.3% lower than in with the same period of 2014. What kept the average from being worse was that São Paulo, the biggest city in Brazil, had managed to increase revenues by 1.8%.

For January–October 2015 revenues fell by 2.5% for Belo Horizonte and 3.2% for Rio de Janeiro city but by as much as 6.7% for Recife and 9.2% for Salvador. Meanwhile, collection of the ISS tax by capitals was down by 3.2%. Property tax in the capitals did go up in the 10-month period, by 0.5%, but Aequus estimates that it would have grown by an annualized 3–4% were it not for rising unemployment and declining income that drove taxpayer nonpayment.

As a reflection of the drop in the entire Brazilian real estate market, in the first 10 months of the year collection of the tax on transfer of real estate (ITBI) in state capitals fell by 5.1%, although it grew by 7.8% in São Paulo.

Proof that state capitals were already feeling the crisis in the fourth quarter of 2015 is that investment fell 3.3% through October, one year before municipal elections, when usually

administrations seek to invest more to impress voters. Investment by capital cities did not fall more because Rio de Janeiro city is experiencing an investment boom in connection with the August 2016 Olympic Games. Without Rio's 39.2% increase in investment (from R$4.7 billion to R$6.5 billion), state capital investments would have fallen by 22.5% through October 2015. But Borges believes that Rio de Janeiro city's investment expansion has already peaked and is now on the downswing.

In the capitals as well as in the states, although revenues are going down, personnel expenses are going up, though more modestly. In the first 10 months of 2015 they went up by an average of 1.8%, a result of the natural increase of the wage bill.

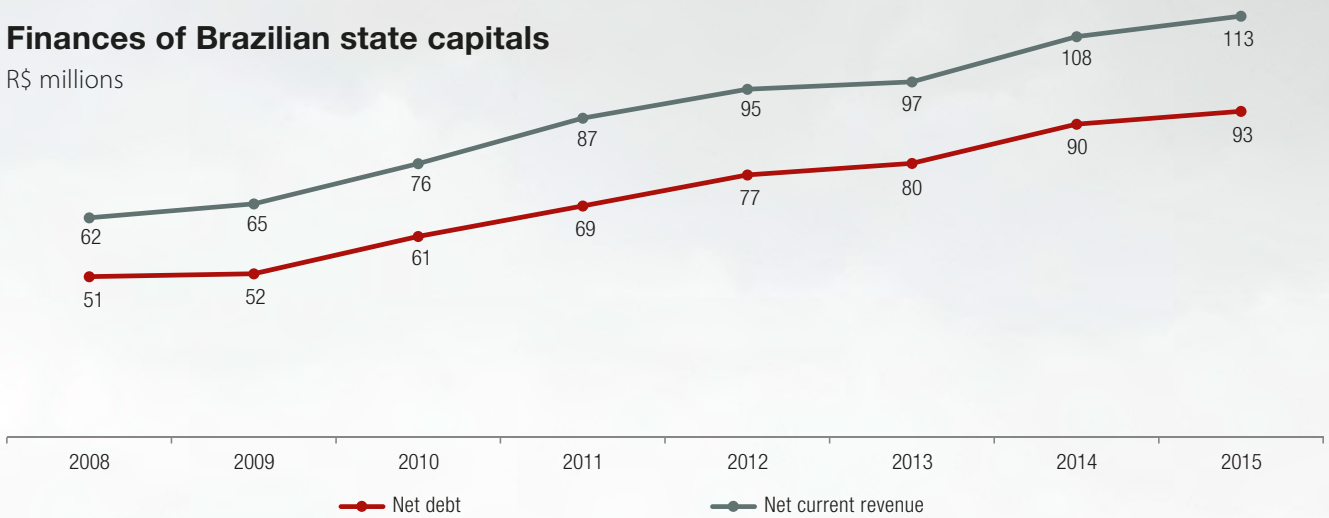
Marcio Lacerda (Brazilian Socialist Party, PSB) is not only mayor of Belo Horizonte, he is president of the National Front of Mayors (FNP). He says, "The current fiscal crisis was already apparent in 2014 and worsened in 2015, after a drop in major transfers to municipalities from both the federal government and the states." Lacerda says that "although the slice of the pie of public sector revenues for municipalities was 19% in 2014, the largest in the last 12 years, this share is not sufficient to pay for the increasing municipalization of public services."

The crisis did not hit municipalities until a year later than it hit the states.

Lacerda says the FNP has been working for "a comprehensive fiscal and tax reform" that would give more balance to the distribution of resources between the members of the federation. FNP has advocated for creation of a "federal forum" with the participation of federal, state, and municipal governments to discuss common problems. Emphasizing that political and economic crises feed back on themselves, he called for political agreement between the main leaders of the country as a precondition for addressing the current economic crisis.

Finances of Brazilian state capitals

R$ millions



Source: Compara Brasil.