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Brazil

Strengthening the Framework for Subnational Borrowing

Paulo Medas, Majdeline El Rayess, Roberto Perrelli, Mauricio Soto, and André Glória

Technical Report

July 2019

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GLOSSARY

CAPAG	*Credit rating for subnational governments (Capacidade de Pagamento)*
FAD	Fiscal Affairs Department
FPE	Fund for revenue sharing with states (Fundo de Participação dos Estados e do Distrito Federal)
FPM	Fund for revenue sharing with municipalities (Fundo de Participação dos Municipios)
FRL	Fiscal Responsibility Legislation
FRR	Fiscal Recovery Regime
IFI	Independent Fiscal Institution
ICMS	VAT at the state level
IT	Information Technology
ME	Ministry of Economy
OECD	Organization for Economic Cooperation and Development
PFM	Public Financial Management
RAP	Accounts Payable (Restos a Pagar)
RCL	Net Current Revenues (Receita Currente Liquida)
SCU	States Court of Accounts
SNG	Subnational Governments (states and municipalities)
STF	Supreme Federal Court
STN	National Treasury Secretariat
Union	Federal Government
WEO	World Economic Outlook

PREFACE

In response to a request from the Minister of Economy, a Fiscal Affairs Department (FAD) mission visited Brasilia, Brazil from April 29-May 13, 2019 to provide technical cooperation on strengthening the fiscal framework for subnational governments. The mission was led by Paulo Medas and comprised Majdeline El Rayess, Roberto Perrelli, Mauricio Soto (all FAD), and André Glória (external expert).

The mission met with the Special Secretary of Finance Waldery Rodrigues Junior, the National Treasury Secretary Mansueto de Almeida Junior and with other staff of the National Treasury including Otavio Ladeira (Deputy Treasury Secretary), José Franco Medeiros de Morais (Under-Secretary of Public Debt), Pricilla Maria Santana (Under-Secretary of Intergovernmental Financial Relations), Pedro Jucá Maciel (Under-Secretary of Fiscal Planning and Statistics), Gildenora Batista Dantas Milhomem (Under-Secretary of Public Accounting). The mission also met with the following staff at the Ministry of Economy: Jefferson Luis Bittencourt (Director), Bruno Funchal (Director), Marco Antonio Freitas de Hollanda Cavalcanti (Deputy Secretary of Fiscal Policy), Allex Albert Rodrigues (Deputy Secretary of Pensions—RPPS), and Edson Leonardo Dalescio Sá Teles (Coordinator, Rio de Janeiro’s Fiscal Recovery Regime Council).

The mission also met with Luiz Fux (Vice-President of the Supreme Federal Court), Luiz Claudio Rodrigues de Carvalho (State Secretary of Finance from the State of Rio the Janeiro), Leonardo Rodrigues Albernaz (Secretary of Governmental Macro Evaluation at the Federal Court of Accounts), Marcos Mendes (Legislative Advisor to the Senate), Felipe Salto (Executive Director, Independent Fiscal Council), and Fernando Alberto Sampaio Rocha (Statistics Department Chief, Brazil Central Bank). The mission also held meetings with Rafael Muñoz Moreno (World Bank) and Hugo Florez Timoran (Interamerican Development Bank).

The mission would like to extend its gratitude to the Brazilian authorities for outstanding cooperation and candid discussions. The mission is especially grateful for the support received from the staff from the Under-Secretary of Intergovernmental Relations, including Gabriela Guerra de Queiroz, Acaua Brochado, Cecilia de Souza Salviano, Sarah Araujo Andreozzi, Itanielson Silveira Cruz, and Paulo Monteiro Gomes.

EXECUTIVE SUMMARY

Brazil's states have been facing severe fiscal pressures over the last years. As the economy went through a deep economic recession in 2014-16, Brazilian subnational governments had to adjust to much weaker revenue growth, while dealing with the consequences of past large increases in spending—especially on wages and pensions. Several states are now having to manage high debt levels, liquidity pressures, and accumulation of large payment arrears.

The economic and fiscal crisis represented a daunting test to the fiscal responsibility framework established in the early 2000s, leading to a new wave of bailouts. After the crises of the 1980s-90s, and several expensive bailouts by the federal government, a new framework was established to impose even stronger controls on the subnational finances and prevent future crises. However, the framework proved to not be resilient enough. The fiscal rules and administrative controls, over time, were increasingly ignored or circumvented and failed to prevent large spending increases and overborrowing by large states. The heavy involvement of the federation on subnational finances, as in past, led to a general expectation of future bailouts. This was confirmed starting in 2014 with a large debt relief to all states and judicial decisions in favor of the subnational governments. More financial support from the federal government is expected over the next years at a time when the fiscal position of the Union remains fragile.

A significant change in the institutional framework is needed to impose hard budget constraints and promote stable and sustainable policies. The severe incentives problems—with the deeply ingrained expectation that the federal government should always bailout subnational governments—requires a comprehensive reform of the borrowing framework accompanied by strengthening of the fiscal responsibility legislation. The approach proposed in this report is based on demanding greater transparency and accountability by subnational governments, while also making the framework more flexible. If adopted, the framework would introduce risk sharing among states, within an enhanced insolvency framework, and tighten fiscal rules. The proposed changes would also put more emphasis in market incentives. The changes in the framework will also need to be accompanied by progress in addressing fiscal pressures from rising budget rigidities (including pensions) and excessive tax incentives (the so-called tax wars).

The main changes to the legal and institutional framework are:

Significantly reform the subnational borrowing framework. This includes:

- *Restrict the use of federal guarantees to exceptional cases, or even eliminate them, and limit lending by public banks*. This would reduce the incentives for fiscal profligacy, contain the risks to the federal government, and resolve part of the institutional tensions between different levels of government and the judiciary.

- *Allow more flexibility to access private funding (banks and capital markets)*. This would allow for more efficient and transparent borrowing. The additional market discipline would also provide further incentives for fiscal discipline among subnational governments.
- *Improve the Fiscal Recovery Regime (FRR)*. The recently introduced FRR could become a core tool of the borrowing framework. However, it would be important to strengthen some key design issues, including: (i) the adjustment plan should be designed to bring the debt down to prudential levels; (ii) debt relief should be phased in tranches and conditional on performance under the adjustment plan; and (iii) the plan should have more clarity on treatment of all creditors (and not just the federal government).
- *The regime could include a fund for state debt that would promote risk sharing and more credible fiscal adjustment programs*. There could also be consideration for an insolvency regime for municipalities.

Strengthen the fiscal responsibility framework. This encompasses improvements in the subnational fiscal rules and enhancing transparency.

- Create an independent fiscal council that monitors fiscal performance and compliance of fiscal rules by subnational governments. One possibility is to add this mandate to the Independent Fiscal Institution, while strengthening its independence and provide enough resources.
- Strengthen fiscal rules. This could include adopting an expenditure rule that would constrain and stabilize total expenditure growth and reducing the debt limits to more prudent levels.
- Set up the fiscal management council (FMC) as envisaged in the fiscal responsibility law (FRL). The FMC would promote adoption of common accounting standards across all levels of governments.
- Accelerate implementation of *matriz de saldos contábeis* (information system to collect and share accounting data).
- Strengthening public financial management systems at the subnational levels, especially to ensure a transparent treatment of existing expenditure arrears and prevent the emergence of new ones.

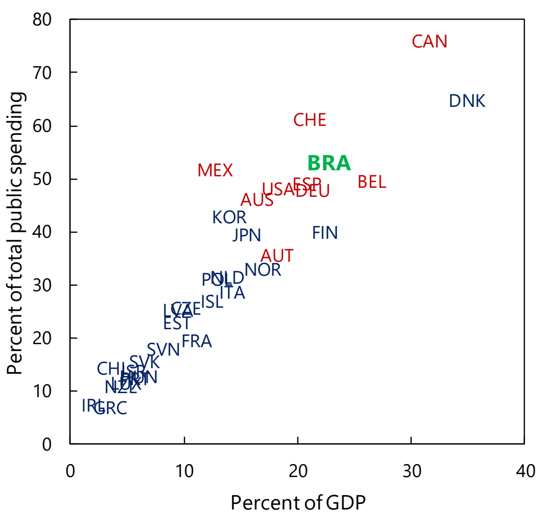
Further technical cooperation could be envisaged if the authorities decide to move ahead with the reforms proposed. This could include on strengthening subnational fiscal rules, setting up the debt fund, and improving fiscal reporting at the subnational level.

I. DIAGNOSTIC OF SUBNATIONAL FINANCES

A. High Degree of Decentralization

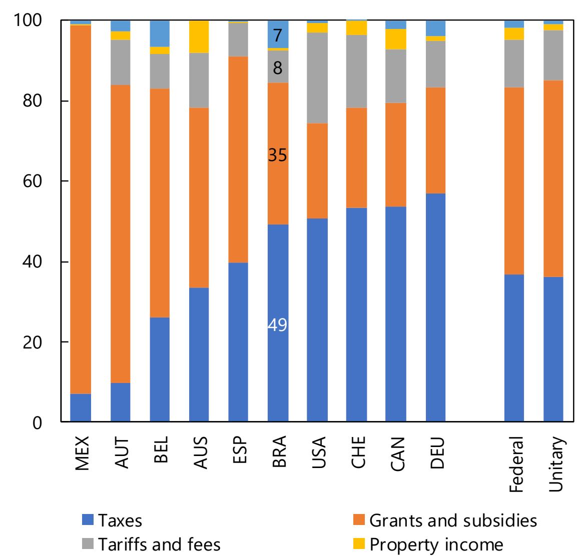
1. **Brazil has a high degree of fiscal decentralization.** Relative to OECD economies, Brazil's subnational governments play a larger role in public spending, with about 23 percent of GDP in spending equivalent to over half of total public spending (Figure 1.1). Subnational governments have considerable revenue autonomy, with nearly half of subnational government revenue coming from taxes—a level well above the average in other countries, but similar to other federations including Canada, Germany, and the United States (Figure 1.2).

Figure 1.1. Subnational Government Expenditure, 2016



Source: **[OECD](#)** (2016).

Figure 1.2. Subnational Government Revenue by Type, 2016



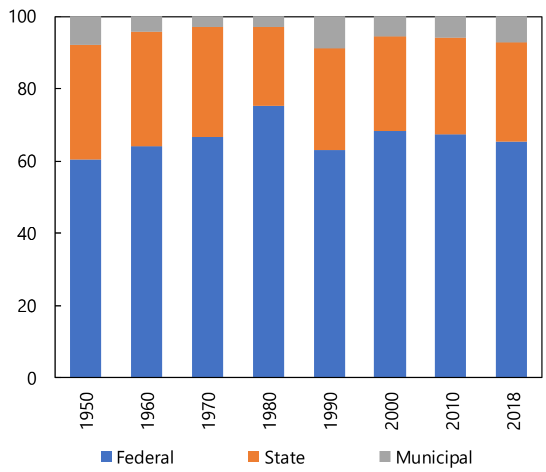
Source: **[OECD](#)** (2016).

2. **Subnational governments have always represented a significant share of tax revenues, particularly in the past 30 years.** The share of the state and municipal taxes in the national tax burden gradually declined from 40 to 25 percent in 1950-1980 (Figure 1.3). The 1988 Constitution included ample government spending mandates and reinvigorated the subnational governments.[1] This contributed to raising the total tax burden (from 25 in 1980 to 33 percent of

[1] The 1988 Constitution assigns exclusive powers to the federal government (including national defense. social security, emission of currency, control of public debt, regulation of interstate and foreign trade), and concurrent responsibilities shared with states (including taxes, education, and social assistance). States are granted the powers not prohibited in the Constitution, and municipalities are elevated to federal entities (World Bank, 2004).

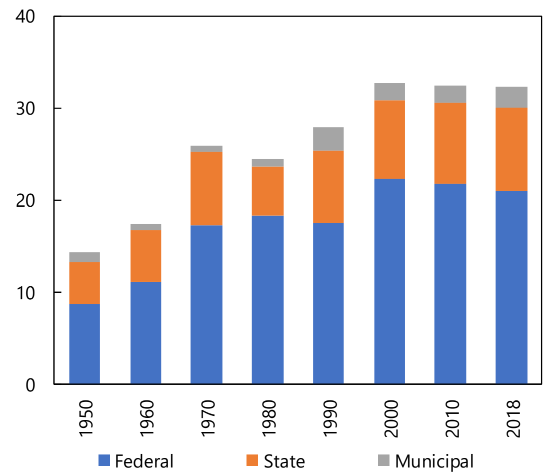
GDP today) as well as the share of revenue in states and municipalities (from 25 in 1980 to 35 percent of the total tax burden today) (Figure 1.4).

Figure 1.3. Tax Burden by Level of Government, (1950-2018)
(Percent of total)



Source: IBGE.

Figure 1.4. Tax Burden by Level of Government, (1950-2018)
(Percent of GDP)



Source: IBGE.

3. Intergovernmental transfers are largely formula-based and mainly directed to compensate for horizontal imbalances (e.g. differences between states). The Constitution assigns tax bases to different levels of government. The most important revenue sources are income, payroll, and turnover taxes for the federal government; value added taxes for states; and service taxes for the municipalities.[2] Vertical transfers across different levels of government largely depend on explicit formulas that put an important weight on redistributive principles.[3] For states, transfers are largely done through the *Fundo de Participação dos Estados e do Distrito Federal* (FPE), which receives 21.5 percent of the collection from income taxes and the federal government VAT (IPI) (Figure 1.6). For municipalities, the transfers are mainly done through the *Fundo de Participação dos Municipios* (FPM) which receives 24.5 percent of the income and IPI taxes.[4]

- The large share of revenues directed to subnationals ensures that vertical imbalances (difference between spending mandates and revenue assignments across levels of

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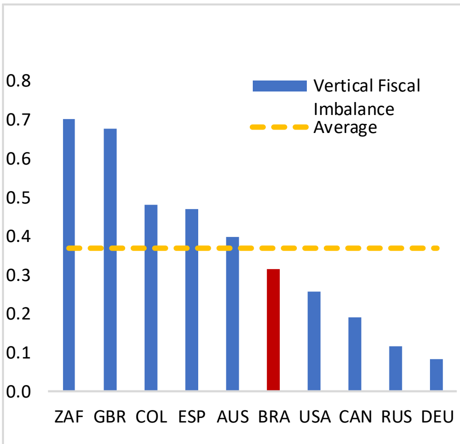
[2] Receita Federal (2018), Carga Tributaria no Brasil 2017.

[3] Secretaria do Tesouro Nacional (2016), Transferências Fiscais da União Princípios Básicos.

[4] In addition, important transfers to fund basic education in states and municipalities are done through the *Fundo de Manutenção e Desenvolvimento da Educação Básica e de Valorização dos Profissionais da Educação* (Fundeb) to which the federal government allocates 20 percent of the state collected on behalf of states and provides a complement to pay for teachers' salaries.

government) are not as significant in Brazil as in other countries (Figure 1.5), although there are significant variations across states.

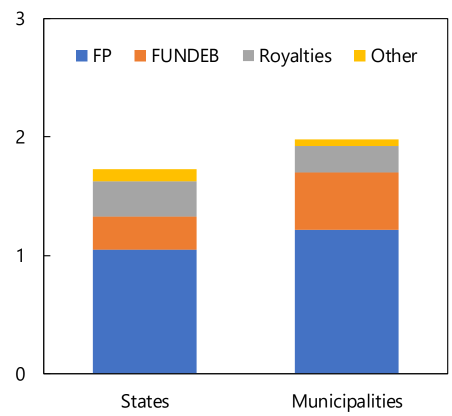
Figure 1.5. Vertical Imbalances, 2014-16



Source: IMF fiscal decentralization database. Vertical imbalance captures the difference between own spending and own revenue at a given level of government. It is calculated as 1 minus the ratio own revenue divided by spending (excluding transfers paid or received).

Figure 1.6. Federal Transfers to States and Municipalities, 2018

(Percent of GDP)



Source: National Treasury.

- Consistent with the redistributive nature of federal government transfers, the share of transfers in total revenue is larger in states with lower GDP per capita. On average, transfers represent 41 and 51 percent of total revenue for states in the Northeast and North regions, respectively (Table 1.1). This includes states like Acre, Amapá, and Roraima (where transfers represent about 64-66 percent of total revenue). In contrast, states in the other regions have higher revenue autonomy, with less than one-fifth of revenue depending on transfers.

Table 1.1. Revenue Composition by Region, 2017

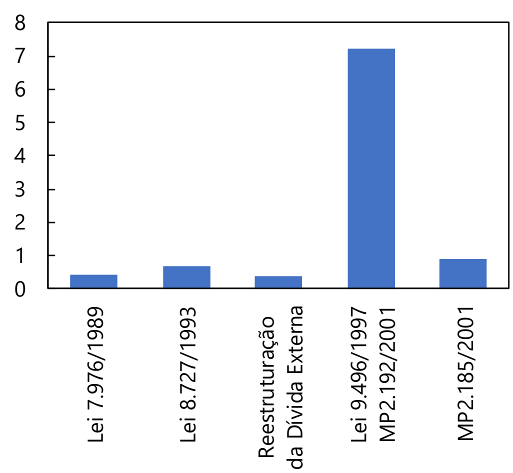
	GDP per capita (reais)	Percent of total revenue		
		Transfers	Taxes and contributions	Other
NE	16,400	41	52	7
N	19,657	51	40	9
S	37,630	16	73	11
SE	40,067	17	71	12
CW	41,680	20	69	11
Total	31,554	22	67	11

Source: National Treasury, Budget Execution of States.

B. Subnational Debt

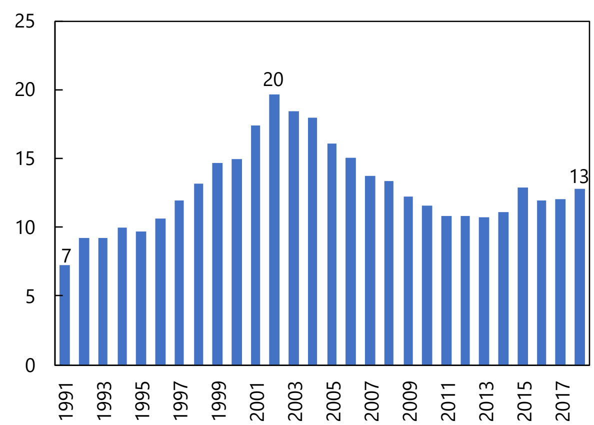
4. The management of subnational debt has defined intergovernmental relations over the past few decades. After the introduction of the 1988 Constitution, the federal government bailed out subnational governments several times (Box 1.1).[5] The combined amount refinanced by the major bailouts is estimated at about 11 percent of 2017 GDP (Figure 1.7).[6] Bailouts have generally been accompanied by measures to instill discipline on subnational government finances, including the introduction of the Fiscal Responsibility Law in 2001 which sets a general framework for fiscal planning, execution, and reporting. The increased discipline together with robust economic growth contributed to the decline in subnational government debt in the 2000s (Figure 1.8).

Figure 1.7. Major Bailouts
(Percent of 2017 GDP)



Source: National Treasury.

Figure 1.8. Subnational Debt, 1990-2018
(Percent GDP)



Source: ipeadata.

5. Subnational debt is concentrated in the larger and more developed Southeast region. Two-thirds of state debt is owned by Minas Gerais, Rio de Janeiro, and São Paulo, home to over 40 percent of the population and 50 percent of the national GDP (Table 1.2).[7] On average debt in these states is over 200 percent of the net revenue limit in the FRL (199 percent in Minas Gerais, 288 percent in Rio de Janeiro, and 202 percent in São Paulo).

[5] National Treasury (2018) Exposição da União à Insolvência dos Entes Subnacionais.

[6] Brazil has had the costliest subnational bailouts among advanced and emerging market economies between 1990-2014 (https://www.imf.org/external/pubs/ft/wp/2016/wp1614.pdf).

[7] The share of subnational debt in Minas Gerais, Rio de Janeiro, Rio Grande do Sul, and Sao Paulo has *increased* from 60 percent in 2000 to 75 percent today (Mora 2016).

Table 1.2. Debt Indicators by Region, 2017

	Share of national population	GDP per capita	Share of national GDP	Debt to national GDP	Debt to current liquid revenue	Debt to region GDP	Share of subnational debt
NE	28	16,400	14	1	67	9	10
N	9	19,657	5	0	48	8	3
S	14	37,630	17	2	132	11	15
SE	42	40,067	53	8	212	16	67
CW	8	41,680	10	1	67	7	5
Total	100	31,554	100	13	139	13	100

Source: National Treasury, Budget Execution of States and IBGE.

Box 1.1. Lessons from the Large Bailouts in 1989-2001

The recent period of fiscal crises and debt bailouts has some important similarities with the 1989-2001 period of large bailouts and can provide some lessons. The fiscal crises and overborrowing happen despite an array of controls that were undermined by loopholes or bad incentives that discourage enforcement (Rodden, 2003). Several states had high debt levels. As today, MG, RJ, RS, and SP, were among the states with higher debt in nominal terms—although several others had high debt levels as share of revenue. In addition, there were significant pressures for the federal government to come to the rescue of not only of the most indebted states but all.

Initial efforts to alleviate subnational government indebtedness included the refinancing and rescheduling of external debt of subnational governments in 1989, applying the favorable conditions in external debt negotiated by the federal government to subnational entities in 1991, and the rescheduling of subnational government debts with federal institutions (including a limit on debt service of 11 percent of revenue) in 1993. As a counterpart to the bailouts, limits to bond issuances were introduced in 1993. However, subnational debt continued to increase throughout the 1990s.

A comprehensive subnational debt refinancing framework was introduced in 1997-2001, including the refinancing of subnational debt instruments, with maturity up to 30 years and a real interest rate of 6 percent, substantially below the original real rates of 15-25 percent for many of these instruments. The framework included a limit on debt service increasing to 13 percent of revenue, with the difference capitalized in debt. The renegotiation was also extended to about 180 municipalities, for which the real rates vary from 38 to 9 percent.

The counterpart to these refinancing operations was requiring states to implement fiscal adjustment programs (PAF) and introducing numerical fiscal targets, which were solidified with the passing of the Fiscal Responsibility Law (2001), including limits to debt and personnel expenditure. The reforms were intended to introduce an unprecedent degree of controls by the center over subnational governments. However, as we show in the rest of the report, they did not prevent the same problems from arising again, including a new wave of bailouts, as they did not address the political economy constrains and incentives for soft budget constraints.

C. Current Framework

6. The current framework for subnational government combines credit restrictions, shared responsibilities through credit guarantees, and fiscal rules. The federal government can instill fiscal discipline in subnational governments through a combination of sticks (borrowing constraints) and carrots (provision of debt guarantees) that are guided by fiscal rules.

- *States are not allowed to issue bonds, but can borrow from banks.* This rule was introduced after the fiscal crises in the 1980s-90s and was part of an effort to increase control by the federal government.
- *The federal government provide incentives though credit guarantees*. Federal guarantees allow subnational governments to borrow at rates comparable to those prevailing for federal debt. In principle, the federal government provides guarantees based on ability to pay, through a grading system where states with healthier finances can qualify for guarantees and those with weaker finances cannot receive guarantees. Annual global limits for guarantees are approved by the senate, with separate limits for external and domestic debt.
- *The framework is supported by fiscal rules.* The FRL includes a limit set by the senate for debt, debt issuance, personnel expenditure, and debt service. States that breach one of the limits are forbidden from further credit operations and are prevented from receiving new voluntary transfers from the federal government.
- *A program for states in fiscal distress was introduced in 2017.* The Fiscal Recovery Regime (*Regime de Recuperação Fiscal*—FRR) provides financial alleviation to states that meet some conditions and agree on a fiscal adjustment plan with the federal government. These include reprogramming of debt service payments, guaranteeing all credit operations agreed in the program, and allowing for new voluntary federal transfers.

7. The framework that contributed to a gradual decline in subnational debt for some years after the passing of the FRL is starting to falter. In marked contrast with the decline in subnational debt of 0.8 percentage points of GDP per year over 2002-2014, subnational debt increased by 0.5 percentage points of GDP per year in 2014-2018, even after the 2014 debt relief. While the deterioration of the fiscal situation of states reflects in part the difficult economic conditions, it is also reflects important weaknesses in the current framework:[8]

- *Too many roles of the federal government created conflict of interests and eroded the credibility of the Union to enforce fiscal discipline.* Under the system, the federal government is the main creditor, the direct and indirect lender of first and last instance (via guarantees and public banks), sets many of the rules and supervises its application. As such, the federal government is seen too closely associated with the fiscal decisions of the subnationals, increasing the

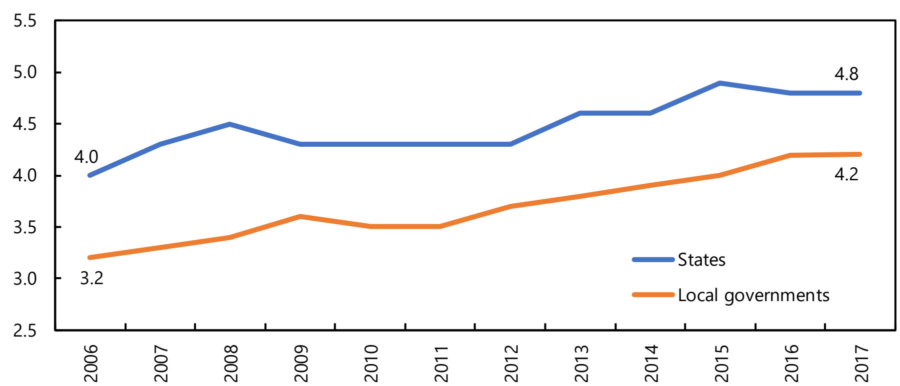
[8] Mora (2016) suggests that the deterioration in the subnational debt started in 2008, with an advent of credit operations with federal banks and external institutions.

expectation of bailouts. For example, the current framework depends on the credibility of the federal government to enforce the established rules. But the government was also involved in the weakening of some of the rules (e.g., excluding certain types of debts from the limits).

- *The FRL limits contribute to procyclical policies*. The limits on debt and personnel expenditure are expressed as a ratio to revenue. Thus, even temporary revenue increases allow states to boost expenditure. This partly explains the trend in compensation of employees in subnational governments, which have been gradually creeping up over time (Figure 1.9). One emblematic example is Rio de Janeiro, where generous wage increases provided during a period of high oil revenues, 2009-2014, resulted unaffordable after oil prices collapsed.
- *The enforcement of fiscal rules has been undermined by several factors, including weaknesses in fiscal reporting and inability to enforce sanctions.* The reporting of key fiscal variables has important weaknesses with significant divergent interpretations of the law and different and non-standardized practices of the auditors (states' court of accounts). For example, reports by the National Treasury show that in 2017, Rio Grande do Norte, Rio Grande do Sul, and Sergipe appear within the personnel limit under the state methodology, but above the limit under a standard definition.[9] The application of sanctions by the FRL has also been weakened by judicial decisions, where courts have prevented suspension of transfers as envisaged in the law.

Figure 1.9. Compensation of Employees in Subnational Governments, 2006-2017

(Percent of GDP)



Source: GFS.

[9] Treasury Secretary (2018) Boletim de Finanças dos Entes Subnacionais 2018.

- *Risks associated with federal guarantees are high.*[10] The federal government can only provide debt guarantees when these are backed by counter guarantees, such as state resources distributed in FPE or FPM or ICMS collection. However, the value of these counter guarantees can be put at risks by courts, which may prevent its execution on the grounds that the state needs the resources to provide basic services to its inhabitants.[11]
- *Subnational government budget rigidities constrain fiscal adjustment.* In 2017, between 51 and 67 percent of state governments expenditure was devoted to salaries, pensions, or debt service (Figure 1.10). Legal constraints to reduce salaries, pensions, and public employment limit the extent to which cuts in personnel expenditure can contribute to fiscal adjustment in the short term. Furthermore, given the assignment of responsibilities, subnational employment is concentrated in critical areas for service delivery, with over 55 percent of employment in health, education, and security.[12]
- *Subnational governments are finding alternative, low quality, financing options.* In many states, the financial imbalance has resulted in growing accounts payable (*Restos a Pagar*), which in aggregate grew by 0.3 percent of GDP between 2015 and 2017 (Figure 1.11). Most of the increase is concentrated in the Southeast, including Minas Gerais and Rio de Janeiro, but accounts payable are growing in all regions except for the North. Congress is also considering allowing subnational governments to commit future resources to access private credit, including borrowing backed by future collection of debt arrears.[13] Although the legality of these operations is debatable, some states have already used such mechanisms.

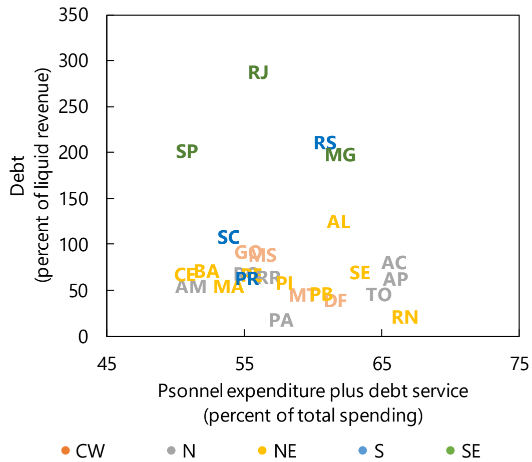
[10] Outstanding guarantees to state and municipalities reached R217 billion (3.2 percent of GDP) in 2018 equivalent to near 25 percent of total state and municipal gross debt (National Treasury Secretary (2018) Guaranteed Debt Report 2018). In 2018, the federal government covered R4.8 billion in guarantees (0.1 percent of GDP). All counter guarantees but the ones corresponding to the state of Rio de Janeiro are being executed (National Treasury Secretary (2018), Relatório de Garantias Honradas pela União em Operações de Crédito).

[11] For example, Açoes Cívies Originárias 2.972, 2.981 3.108.

[12] Karpowicz and Soto (2019) Rightsizing the Public Sector Wage Bill.

[13] See Senate draft law 204/2016.

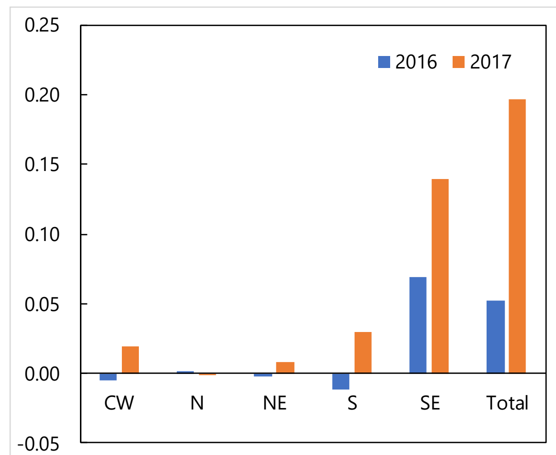
Figure 1.10. State Debt and Budget Rigidity, 2017



Source: National Treasury, Budget Execution of States.

Figure 1.11. Change in Accounts Payable 2016 and 2017

(Percent of National GDP)



Source: National Treasury, Budget Execution of States.

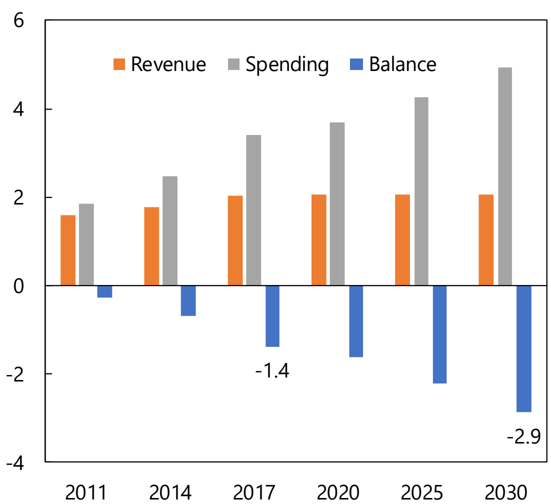
8. **As several states entered debt or liquidity distress, a new wave of bailouts started in 2014.** A retroactive debt relief was granted in that year with the loss for the federal government estimated at about 100 billion reais, or 1½ percent of GDP. In addition, in 2016, the debt service payments were temporarily reduced for 24 months (with the difference capitalized) and the repayment scheduled was extended for another 20 years. The main counterpart to this refinancing was requiring states to adopt an expenditure ceiling for two years; however, preliminary evaluations suggest that many states did not comply. This measure is estimated to have reduced the debt service to the federal government by 50 billion. Further measures are being considered (Box 1.2). While these measures will improve the financial situation of subnationals in the short term, they also weaken the responsibility framework—that intended to impose hard budget constraints—by confirming the expectation of bailouts.

9. **Furthermore, absent reforms subnational fiscal imbalances are likely to worsen over time.** Subnational governments administer pension plans for their own public employees. The aggregate deficit of these systems has widened over time, reaching 1.4 percent of GDP in 2017 (Figure 1.12). Looking forward, partly driven by population aging, absent a pension reform the deficit of the subnational pension systems is projected to increase to 2.9 percent of GDP by 2030. The impact could be particularly important for the South and South East regions which are

expected to continue aging faster than other regions.[14] Estimates of the pension reform suggest that an important portion of the projected increase would be offset by the reform currently under consideration of congress.[15] However, reforms might have a more limited impact because a large share of subnational employment is in special regimes (education and security) which are expected to retain some privileges even under the current proposal.

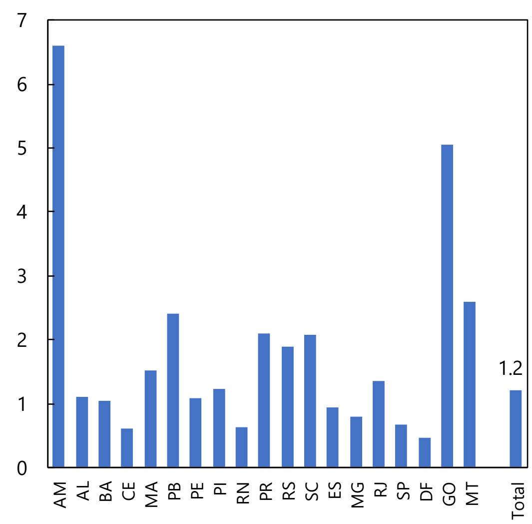
10. There is scope to increase subnational tax revenue, but a comprehensive reform at the national level would be preferable. Tax exemptions approved at the federal level—which are beyond the control of subnational governments—affect subnational government revenue by reducing constitutional transfers.[16] But states provide tax exemptions on their own, including those related to the ICMS, a mixed origin/destination-based VAT that is the largest revenue source for states. Predatory tax competition among the states results in revenue losses of at least 1.2 percent of national GDP per year, with large variations across states (Figure 1.13).

Figure 1.12. Subnational Governments Pension Balances, 2011-2030
(Percent of GDP)



Source: IMF staff calculations.

Figure 1.13. Subnational Governments ICMS Tax Expenditures, 2018
(Percent of State GDP)



Source: Pinto (2019).

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[14] Between 2015 and 2030, the ratio of the population age 65 and older to the population 15-64 is projected to increase by a factor of 1.8 in the South and 1.7 in the South East, relative to 1.6 in the rest of the regions. See IBGE, Projeções da População.

[15] See https://www.valor.com.br/brasil/6239931/reforma-poupara-r-700-bi-para-uniao-estados-e-municipios-estima-jp-morgan

[16] Pellegrini (2018) Gastos (benefícios) tributários.

Box 1.2. Additional Support to Subnational Governments

There are ongoing discussions to provide financial support to subnational governments in the short- and medium-term. These include a (1) a temporary fiscal plan (*Plano de Equilíbrio Fiscal*, PEF) to help states, in the near future, that have relatively bad credit ratings (but not the worse); and (2) share one-off bonus from oil auctions and future oil royalties that were allocated to the federal government.

Based on existing information, the PEF would allow the federal government to grant guarantees to debt for states that would not otherwise qualify. This will be conditional on the states adopting a fiscal adjustment, including involving the prior adoption of specific measures.

The stated objective of the PEF is to provide credit with federal guarantees (to reduce the borrowing cost) for states with liquidity problems and low debt—while demanding some fiscal adjustment. Among the states than can benefit from the PEF some have relatively low debt, and potentially could borrow without guarantees, while others have relatively high debt. The program is likely to help states in the short run and could potentially promote some fiscal adjustment. However, there is a risk it may generate the perception that the federal government is providing another bailout to states weakening the incentives for fiscal discipline. This is particularly the case as the PEF is creating an exception to the existing rules and there is legal uncertainty on whether the federal government will be able to enforce the conditionality.

The decision to grant oil revenues to subnational governments as an ex-post response to financial pressures could also create moral hazard. In addition, there needs to be care with sharing highly volatile and non-renewable resources with subnational governments that may not be well prepared to manage them. It could lead to procyclical policies and disruptive fiscal adjustments in the future (or large bailouts). It would be prudent to create a mechanism to smooth the oil revenue transfers to subnational governments.

It would be important that these programs are accompanied with efforts to significantly change the existing borrowing framework and incentives towards greater fiscal discipline over time.

II. RETHINKING THE SUBNATIONAL BORROWING FRAMEWORK

11. Addressing the weaknesses in the system requires a comprehensive reform of the existing framework. The approach proposed in this report represents a significant departure from the existing structure, but it also builds on some steps that have been taken in recent years (including the creation of the Fiscal Recovery Regime). The objective is to realign incentives towards introducing hard budget constraints for subnational governments, while at the same time creating a simpler framework with less administrative controls and more market-induced fiscal discipline. It puts more emphasis on borrowers' incentives and transparency. For that to succeed, it will be important to address fiscal pressures from rising budget rigidities (including pensions) and excessive tax incentives (the so-called tax wars)—which are beyond the scope of this report, but are critical for the financial health of subnational entities.

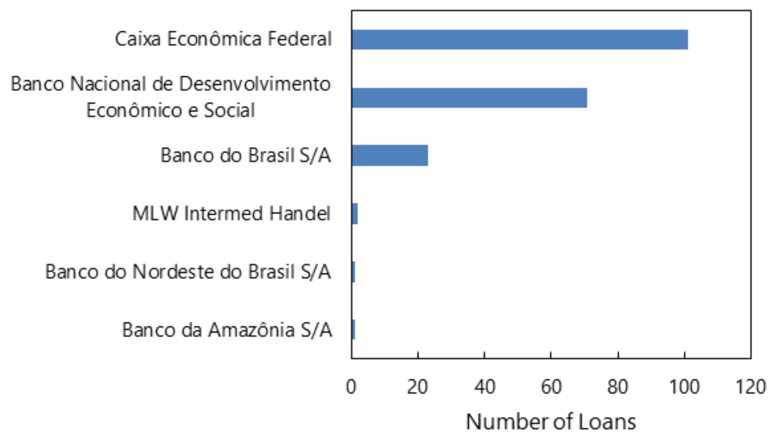
12. The proposed strategy requires advancing simultaneously on the different reform areas to ensure appropriate incentives and controls. That is, reducing the subnationals dependence on borrowing from other parts of the public sector (public banks and federal guarantees) should come together with greater flexibility to access private credit markets. This should be accompanied by strengthening transparency and subnational fiscal rules. Another key pillar is an effective framework to share the risk across states and address cases of highly indebted states and large municipalities. The next subsections discuss the proposals.

A. Reduce Dependence on Federal Guarantees and Public Banks

13. The Union has become the *de facto* almost exclusive creditor of the states and municipalities. Loans from or guaranteed by the Union represent 90 percent of the total debt of the states. This means that the federal government and, as shown below, federally owned banks carry nearly all the credit risk of the states. Being a large creditor led to pressures for bailouts and, once these bailouts occurred, a significant reduction in debt payments. For example, the interest expense of states as a percentage of debt decreased while the financial conditions of the states worsened.

14. Federally owned banks also account for a large share of the loans not guaranteed by the Union. In the period 2009-2019 there were only two private financing transactions (from *MLW Intermed* in the form of long-term financing for medical equipment) without security or a union guarantee (figure 2.1). The absence of private creditors from this market reduces the effectiveness of price discovery and concentrates the creditor oversight in the Union or federal public banks.

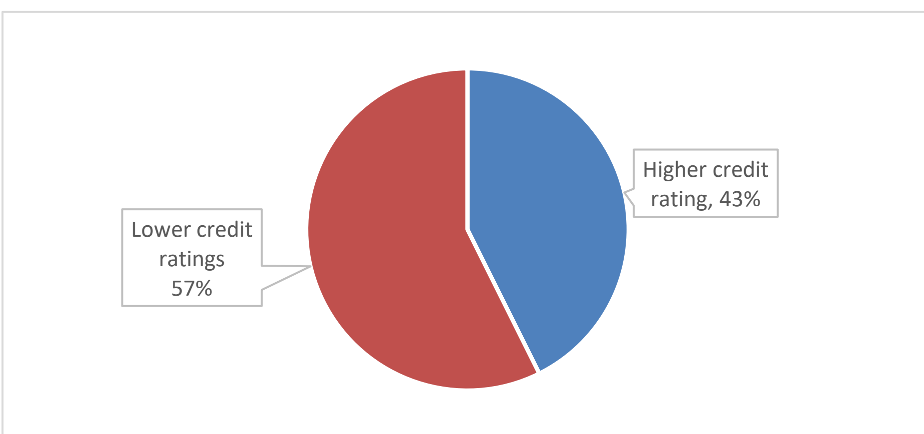
Figure 2.1. Number of Loans to States Without Federal Government Guarantees, 2009-2019



Source: National Treasury.

15. The concentration of risk in the Union has led to moral hazard due to the history of bailouts. This is further accentuated by provision of guarantees to states that have worse fiscal performance. At times, the states with lowest credit ratings have received the largest share of authorized guarantees (Figure 2.2).[17] This has happened even in a context of rules that are aimed at restricting the ability of states in frail fiscal conditions to borrow. Finally, the larger the exposure to a state, the larger the pressure to continue to rescue the debtor.

Figure 2.2. Federal Guarantees by Credit Rating (CAPAG), 2013-2016

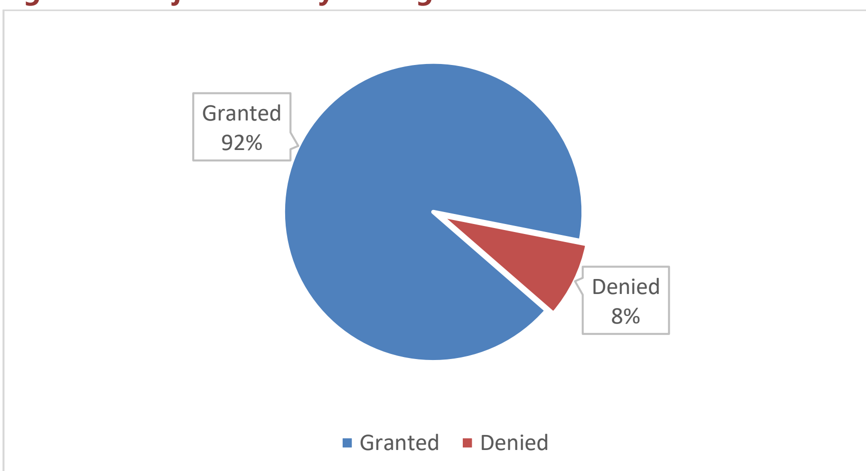


Source: National Treasury.

[17] As discussed below, the National Treasury uses a rating system (CAPAG) to assess the capacity of payment of states and municipalities.

16. Weaknesses in the existing framework, together with the large dependence on federal guarantees and loans, have also created incentives for strategic defaults. Court decisions have called into question the enforceability of the security obtained by the Union as collateral for its claims against states as well as for the issuance of guarantees for state indebtedness (counter guarantees).[18] Three states, among the largest debtors, have obtained injunctions against the Union to prevent the enforcement of collateral to either collect debt or rights of contribution resulting from the enforcement of guarantees issued by the union. By petitioning the court to grant injunctive relief when facing a fiscal crisis, states get temporary relief from servicing the debt without first having to obtain financing from other sources or introducing fiscal adjustment measures. It is noteworthy that states have consistently managed to avoid the sanctions for non-compliance with the fiscal responsibility legislation by initiating injunctions against the Union (Figure 2.3).

Figure 2.3. Injunctions by STF Against the Union Related to the FRL



Source: Echeverria (2019).

17. The decisions on the enforceability of the guarantees effectively subordinates debt service to expenditure on essential public services. Although similar concepts of subordination exist in legal systems with ex-post insolvency regimes for SNGs, the Brazilian system does not clarify what are the essential public services. This means that there is no distinction between expenditure at state level for any public services, leaving debt service of the states to the Union as a subordinated payment vis-à-vis all other spending. This is conducive to strategic default, making the Union the first creditor in line for non-payment (see below for further discussion).

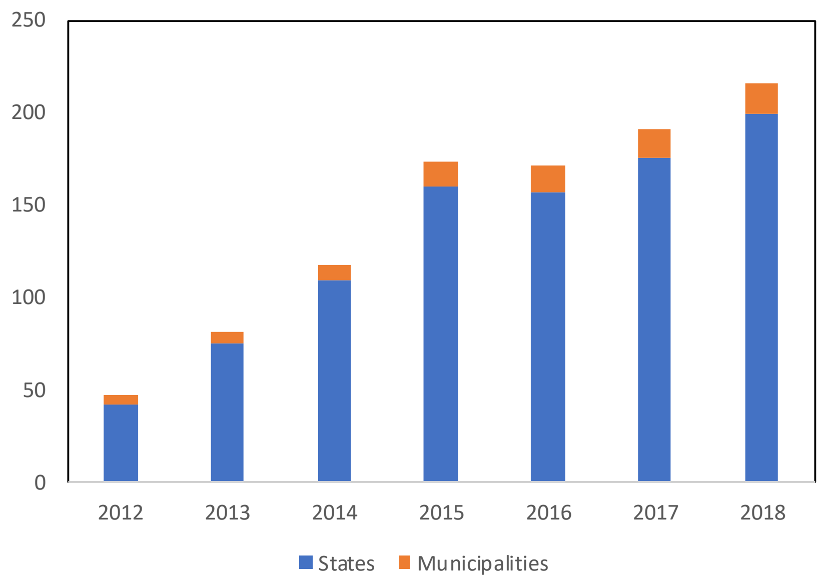
18. The abuse of the federal guarantees system, together with the legal uncertainty, calls for significantly reducing its use to exceptional cases. The role of the Union as the holder of credit risk of the states in its capacity as creditor and guarantor conflicts with its role as

[18] See, for example, Echeverria, Andrea de Quadro Dantas, 2019, "O Árbitro da Federação Pode Influenciar o Jogo do Resgate? O Impacto da Jurisprudência Federalista do STF na Crise Fiscal dos Estados Brasileiros," Ph.D. Dissertation, Centro Universitário de Brasília – UniCEUB.

overseer of the fiscal rules and as the primary taxing authority under the Brazilian constitution. Key examples are the decisions of the Supreme court that enjoin the Union from enforcing guarantees because doing so would (i) contradict its actions as a taxing authority under the Brazilian constitutional system, (ii) contradict its actions as the supervisory authority under the FRR regime, (iii) and violate the constitutional duty to contribute to the provision of public services. A possible way to reconcile these conflicts would be to exit its position as creditor and guarantor.

19. Restraining the use of guarantees would also reduce the incentives for fiscal profligacy. There have been periods when federal guarantees have been very low, including in recent years (Figure 2.4). The government could consider only granting guarantees in exceptional cases—e.g. external loans for investment projects that are in the interest of the country and there are strong assurances the subnational government will be able to repay. Or could even consider not using guarantees to subnational governments in the medium term. This should be accompanied by greater access to private borrowing, as discussed next, which would also help increase competition and reduce exposure of public banks.

Figure 2.4. Federal Government Guarantees (stock, R$ billions)



Source: National Treasury.

Recommendations

- Significantly reduce the use of federal guarantees to exceptional cases (e.g. for projects in the national interest) or even eliminate them.
- Reduce exposure to public banks.

B. Strengthen the *CAPAG* as a Risk Management Tool

20. Subnational entities applying for credit guarantees from the National Treasury are subject to a system of internal credit ratings. Efforts to rate Brazilian subnational entities according to their financial position(*Capacidade de Pagamento—CAPAG*) date back to 1997 and focused on primary balances and debt service.[19] In 2012, the authorities introduced a new CAPAG to assess the repayment capacity of subnational entities applying for Treasury guarantees.[20] The first version of the modern CAPAG consisted of two stages: (i) an analysis of credit risk based on the weighted average of eight financial and economic indicators; and (ii) the framing of the credit operations according to the subnational entity's level of indebtedness and debt service.

21. The system of internal credit ratings was further updated in November 2017.[21] The new CAPAG offers a more transparent and streamlined methodology to assess credit risk. It ranks subnational entities into four categories. Entities rated as A and B are considered to have a good fiscal position while those rated as C and D have a weak fiscal situation. The overall ratings are determined according to three indicators: (i) overall gross debt levels; (ii) current savings; and (iii) liquidity.[22] The overall rating D applies to subnationals with all individual indicators rated as C. The debt indicator aims to assess how solvent an entity is; the savings indicator is intended to show whether an entity can deal with large drops in its current revenues in a context of high budget rigidities, and the liquidity indicator captures whether the entity has sufficient cash to cover due financial obligations. The system assigns a partial rating to each indicator according to indicator-specific thresholds (text table). The subnational overall rating is the average of its three

New CAPG: Indicators' Thresholds and Ratings

Indicator	Thresholds	Partial Rating
Debt-to-net current revenue	Less than 60%	A
	Between 60% and 150%	B
	Equal or more than 150%	C
Current savings	Less than 90%	A
	Between 90% and 95%	B
	Equal or more than 95%	C
Liquidity	Less than 100%	A
	Equal or more than 100%	C

[19] The MoF regulation of the 1997 system (Portaria n. 089, issued on 04/25/1997) can be found at: http://www.fazenda.rj.gov.br/tesouro/content/conn/UCMServer/uuid/dDocName%3A1740010

[20] The MoF regulation introducing the CAPAG (Portaria n. 306, issued on 09/10/2012) can be found at: http://www.fazenda.gov.br/acesso-a-informacao/institucional/legislacao/portarias-ministeriais/2012/portaria-no.-306-de-10-de-setembro-de-2012.

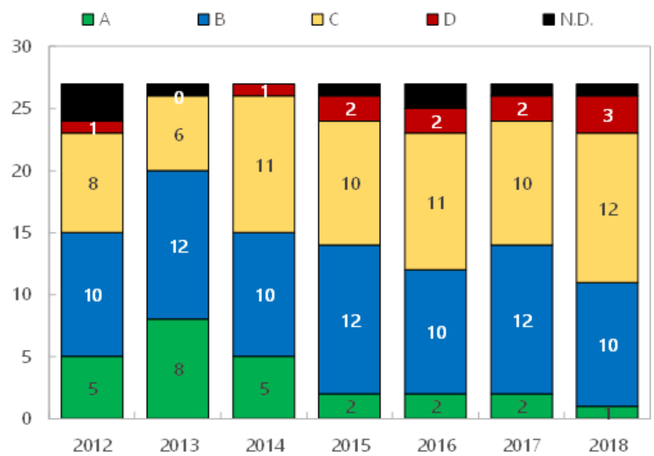
[21] The MoF regulation updating the CAPAG (Portaria n. 501, issued on 11/23/17) can be found at: http://www.fazenda.gov.br/acesso-a-informacao/institucional/legislacao/portarias-ministeriais/2017/arquivos/portaria-no-501-de-23-de-novembro-de-2017-0.pdf/view

[22] More specifically, overall indebtedness is the ratio of gross consolidated debt to net current revenues; current savings are the ratio of current expenditures to adjusted current revenues; and liquidity is the ratio of financial obligations to gross disposable cash balances. The financial obligations include the stock of payables ("Restos a Pagar") corresponding to processed but unpaid claims.

indicators' ratings.

22. To be eligible to receive a Treasury guarantee, a subnational must have at least an overall B rating. A close look at the historical distribution of internal credit ratings shows a steady decline in the number of Brazilian states rated as fiscally strong (A and B) and a substantial rise in the number of states rated as fiscally weak (C and D) (Figure 2.5).

Figure 2.5. States and Federal District: Internal Credit Ratings, 2012-2018



Source: Brazilian National Treasury.

23. The new CAPAG could be strengthened by improving and updating thresholds based on cumulative experience. Some of its indicators, such as the net current revenues that serve as a benchmark for evaluating subnational indebtedness, are procyclical. For instance, during years of commodity price boom, the states that export commodities could borrow more given the (often temporary) improvement in its CAPAG. Moreover, the thresholds for each indicator were chosen according to the recent economic situation of the states, in an attempt to separate the entities currently eligible from those that are ineligible to Treasury guarantees.[23] Further statistical analysis, for example based on the literature on fiscal crises and past episodes of subnational financial distress in Brazil could help improve the calibration of the thresholds.[24] We next explore some potential areas for improvements.

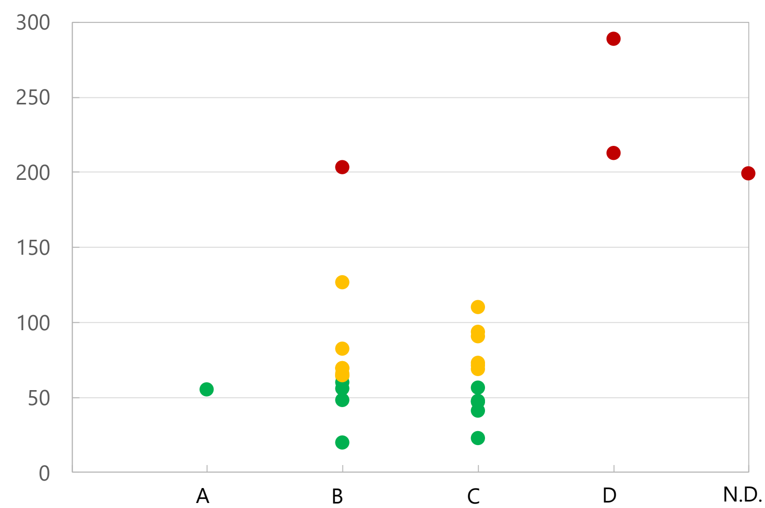
[23] See "Consulta Pública STN n. 01/2017" for a comprehensive discussion on the parameters of the new CAPAG.

[24] See Cerovic, Gerling, Hodge, and Medas, 2018, "Predicting Fiscal Crisis", IMF Working Paper 18/181 (Washington, DC: International Monetary Fund). The paper is available at: https://www.imf.org/en/Publications/WP/Issues/2018/08/03/Predicting-Fiscal-Crises-46098.

24. The CAPAG may place too little weight on the level of indebtedness. The threshold for the overall level of debt appears too loose and seems to play a secondary role on the determination of the overall subnational rating (Figure 2.6). Subnational entities with debt levels of up to 150 percent of net current revenues can be rated as B while very often these entities are subject to high debt service and unable to generate the primary surpluses necessary to stabilize (or reduce) their debt levels. The international experience suggests that not only the debt level but also the gross financing needs (primary deficits plus interest and amortization falling due over the next 12 months) is an important predictor of fiscal distress (see also discussion in the fiscal rules section). The recent experience shows that debt level and service are telling early warning indicators of fiscal distress. For instance, Rio de Janeiro's gross financing needs were above 30 percent of its net current revenues in 2014 (Table 2.1). In addition, the heavy debt burden led the states to request a relief in the interest rates applicable to their federal debt, granted by the Union in 2014 and a 20-year extension on the repayment period of those debt, granted by the Union in 2016.[25] These two bailouts substantially reduced the service on the subnational debt held by the Union.

Figure 2.6. States and Federal District: Debt and CAPAG, 2018

(Debt in Percent of RCL)



Source: Brazilian National Treasury.

[25] *Lei Complementar* n. 148 (2014) substantially reduced the stock of subnational debt outstanding owed by the Union by revising the indexation formula and reducing interest charges. The revisions were applied retroactively to all subnational debt stocks owed by the Union since the date when they were contracted.

Table 2.1. Rio de Janeiro: Gross Financing Needs, Other Flows, and Net Other Changes, 2018

(BRL million)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
A. Gross Financing Needs 1/	3,448	-1,179	7,094	3,181	6,744	5,782	15,068	13,588	12,969	10,741	7,743
(in % of net current revenues)	*10.8*	*-4.1*	*20.5*	*8.1*	*16.6*	*12.3*	*32.7*	*26.5*	*28.1*	*21.4*	*13.8*
o/w Primary deficit	-3,544	-2,212	-1,004	-2,727	-811	-1,332	8,011	868	1,742	1,777	-2,065
Interest	6,992	1,033	8,098	5,909	7,555	7,114	7,056	12,719	11,226	8,964	9,808
B. Other Flows 2/	523	-438	2,384	73	2,759	240	-642	12,223	-7,541	8,900	5,723
C. Change in Net Debt (A+B)	3,971	-1,617	9,478	3,255	9,502	6,022	14,425	25,811	5,428	19,640	13,466
Memo:											
Net Debt	48,720	47,102	56,581	59,835	69,338	75,359	89,785	115,595	121,023	140,663	154,129
(in % of net current revenues)	*153.1*	*162.6*	*163.8*	*152.4*	*170.7*	*160.1*	*195.0*	*225.7*	*261.8*	*280.2*	*274.9*

1/ Assumes full rollover of short-term debt. Based on actual data up to 2018Q3.

2/ Resulting from balance sheet revaluations and metodological adjustments in the state's accounts.

25. The analysis in the CAPAG does not cover all debt-related flows. News reports indicate that emerging financial pressures and the lack of Treasury guarantees have led some states to circumvent the limits of the FRL by securitizing tax arrears and future tax receipts.[26] Central Bank statistics have captured some of these transactions through the auditing of balance sheets of financial institutions that engaged on these transactions. It is not clear states are reporting such transactions in their consolidated balance sheets and fiscal management reports that serve as inputs to compute CAPAG's internal credit ratings. If unreported, these operations can artificially boost CAPAG's liquidity indicator without affecting the debt indicator, and therefore promoting the subnational entity to a higher credit rating.

26. A prospective analysis of the subnational capacity to repay the Treasury under the baseline scenario would be useful. For example, an analysis as done by the IMF with the "Capacity to Repay" matrix used in its financial arrangements with member countries could be very informative.[27] The matrix could include projected debt stocks and debt service flows in proportion to subnational net current revenues and expected proceeds from asset sales. This analysis would allow the Treasury to identify "pressure points" that could reduce the probability of a subnational regularly servicing its debt with the Union over the next 10 years.

27. A more explicit debt sustainability analysis could enhance the evaluation of subnational credit risk. A rigorous debt sustainability analysis (DSA) could be developed to

[26] See, for instance, the case of Sao Paulo's securitization company CPSEC.

[27] For a recent example of a Capacity to Repay table, see for instance the annex "Assessment of the Risks to the Fund and the Fund's Liquidity Position" in the IMF Country Report n. 15/69, available at: https://www.imf.org/external/pubs/ft/scr/2015/cr1569.pdf.

assess fiscal sustainability in the states and municipalities.[28] The approach could be anchored in a medium-term fiscal framework based on an analysis of recent fiscal developments and on medium-term macroeconomic projections. The debt sustainability analysis considers several elements of the debt profile, including maturity, currency denomination, indexation (inflation links), term structure of interest rates, residence of the debt holders, among others. Most importantly, the exercise could include an assessment of the realism of the projected fiscal adjustment compared to historical episodes. Its implementation would allow the Treasury to form a view of how outstanding stocks of subnational liabilities are likely to evolve over time, both under the baseline scenario as well as under subnational-specific stress tests, including growth, interest and exchange rates, primary balance, revenue, and commodity price shocks (see FRR section for an application of the DSA framework for the state of Rio de Janeiro).

28. The improved CAPAG could be used as a more effective risk assessment tool when monitoring subnational finances. Recent regulation grants to the National Treasury the ability to review the CAPAG ratings when evidences of noticeable deterioration in the subnational fiscal accounts emerge.[29] Going forward, given the limited availability of privately-issued credit ratings for states and municipalities, the CAPAG could continue playing a role on the risk analysis of subnational governments. As discuss next, the CAPAG , could also play a role in the development of subnational capital markets by providing transparency on the financial situation of states. The analysis of the risks, as proposed above, could also be included in the report on subnational finances produced annually by the STN to supplement the already high quality information and analysis.

Recommendations

In order to further strengthen the *CAPAG* and the National Treasury report on subnational finances, the authorities could consider:

- Giving more prominence to debt levels and debt service in the credit analysis.
- Elaborate prospective analysis of subnational capacity to repay their debt, including using a "Capacity to Repay" matrix.
- Consider a risk-based framework, like the debt sustainability analysis, that covers alternative scenarios and stress tests.

[28] See IMF, 2018, "Debt Sustainability Analysis for Market-Access Countries", available at: https://www.imf.org/external/pubs/ft/dsa/mac.htm. A template to run the debt sustainability analysis can be found at: https://www.imf.org/external/pubs/ft/dsa/templ/dsatemp_june18.xlsm.

[29] The MoF regulation allowing faster review of CAPAG ratings was introduced in 2017 (Portaria n. 501, issued on 11/23/17) and further detailed in 2018 (Portaria n. 882, issued on 12/18/2018, located at: http://www.in.gov.br/materia/-/asset_publisher/Kujrw0TZC2Mb/content/id/56128201/do1-2018-12-20-portaria-n-882-de-18-de-dezembro-de-2018-56128189).

C. More Emphasis on Market-Induced Fiscal Discipline

29. Subnational governments' reliance on private sector borrowing has been very limited. In response to recurring subnational debt crises, the Senate (1998) prevented states from issuing new bonds until 2010, which was subsequently made permanent in 2014. Subnational governments are only allowed to borrow from banks. The FRL imposed administrative controls on subnational borrowing covering a wide range of operations, including restrictions on accessing capital markets, inter-entity borrowing, and debt levels.

30. The legal and administrative controls, however, did not prevent overborrowing and led to distorsions in the pricing of risk and untransparent borrowing operations:

- The cost of borrowing does not reflect the financial situation of the state. In fact, states with worse credit rating (CAPAG) tend to have lower borrowing costs (Figure 2.7).
- Highly indebted states were granted waivers of compliance with the FRL, while for others, the administrative controls have exacerbated the liquidity crunch with low debt but high current expenditures.[30] As a result, states started to accumulate large amounts of arrears to suppliers and, in some cases, civil servants.
- Some subnational governments are using special purpose vehicles[31] to borrow from the market (and in some cases by using future revenues as collateral), even if the legality of these practices is not clear.

31. Further reliance on capital markets could help promote fiscal discipline among the entities. If states rely more on private funding (private banks and capital markets) without federal guarantees, the borrowing costs could provide an incentive for greater fiscal discipline than the existing system.[32] However, to be effective, it will require high fiscal transparency standards and an effective legal framework.[33] Therefore, in addition to the framework proposed in this report, several tools could need to be put in place to increase transparency and promote fiscal discipline, including: (i) expanded coverage of privately-issued credit ratings for state and municipalities; (ii) enhanced monitoring of entities' ability to repay encompassing the CAPAG, additional early warning indicators of fiscal distress, and a full-fledged debt sustainability

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[30] For example, the National Treasury granted Rio de Janeiro authorization for new credit operations amounting to R$2.0 billion during 2016, when the state's wage bill surpassed FRL limits. For further details, see page 15 of "Plano de Recuperacao Fiscal—Estado do Rio de Janeiro" available at: http://www.tesouro.fazenda.gov.br/documents/10180/602241/Plano+de+Recupera%C3%A7%C3%A3o+Fiscal/8fabd06f-10b0-424d-845f-9fa833235a88

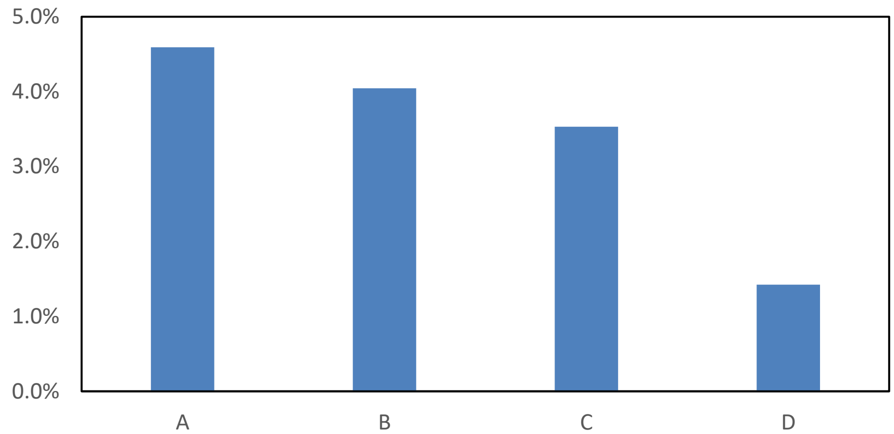
[31] For example, the case of Sao Paulo's securitization company CPSEC

[32]The mission learned about a potential demand for trading subnational bonds of well-rated entities—a step that would expand the Moreover, the provision of syndicated loans by a pool of privately-owned and federal banks could help to diversify subnational credit risk and promote market-based fiscal discipline.

[33] See, for instance, Giugale, M., Trillo, F. H., and J. C. Oliveira, 2000, "Subnational Borrowing and Debt Management," in *Achievements and Challenges of Fiscal Decentralization: Lessons from Mexico*, Giugale, M., and S. Webb, eds. Washington, DC: The World Bank.

analysis; (iii) comprehensive reporting system; and (iv) implementation of a national registry of subnational bond issuances, accessible to the general public.

Figure 2.7. Interest Bill as a Share of net Debt, 2016-17



Sources: National Treasury and IMF staff estimates.

32. The framework could be monitored by the National Treasury to ensure borrowing is in line with the fiscal rules. Tighter supervision by the central government could be adopted according to the level and complexity of the debt operation.[34] However, for this capital market to deepen the legal framework applicable to subnational debt should evolve to accommodate a more streamlined process. Current impediments to lending are an excessively lengthy approval process, high cost of compliance, a lack of standardized financial information from states and legal uncertainty about collateral and enforcement.

33. Borrowing at a greater degree from private markets will require upgrading financial disclosure and debt management. Cross-country experience shows that transparency standards, depth of credit information, and extent of disclosure drive the size of subnational capital markets.[35] Capital market transactions require scale and technical skills that may not be available to every state. Instruments that would allow states to pool together to gain scale could be used to address these issues, or technical support could be given to states and large municipalities to bridge gaps in technical skills.[36]

[34] Eyraud, L., 2019, "Constraining Subnational Borrowing through Rules and Controls," IMF How To Notes (forthcoming),

[35] Moldogaziev, T., S. Espinosa, and C. Martell, 2018, "Fiscal Governance, Information Capacity, and Subnational Capital Finance," *Public Finance Review*, Vol. 46(6), pp. 974-1001.

[36] The majority of municipalities is not expected to borrow (as is the case now), as they have no capacity.

Recommendations

- Allow more flexibility for subnational governments to access private financing (private banks and issuing bonds), while strengthening transparency and reporting standards.
- Improving the quality of information provided to the markets, including through privately-issued subnational credit ratings, CAPAG, early warning indicators, and a full-fledged debt sustainability analysis;

D. Enhancing the Fiscal Recovery Regime

34. In 2017 Brazil launched the Fiscal Recovery Regime (FRR), a subnational insolvency framework for the most indebted states. The program was created in response to growing financial distress among three of the largest Brazilian states—Rio de Janeiro (RJ), Rio Grande do Sul (RS), and Minas Gerais (MG)—which are facing a combination of high debt stocks and liquidity pressures. These states were accumulating arrears on their obligations to civil servants, suppliers, and creditors. At that juncture, subnational fiscal imbalances were so large that a voluntary insolvency scheme became unavoidable.[37] At this stage only RJ has entered the regime, while MG and RS are still negotiating a possible program.

35. The main goal of the program is to stabilize debt at the end of the program. A state that adheres to the regime is granted a suspension of (i) the service on its debt with the federal government and (ii) the enforcement of federal guarantees. In exchange for the debt relief, the state commits to a 3-year fiscal adjustment plan that can be extended for another three years if necessary. The plan consists of, inter alia, privatizing state-owned enterprises, suspending wage increases and new hires, reducing tax expenditures, and reforming the state pension scheme along the lines adopted by the federal government.

36. The introduction of the regime represents an important step in strengthening the borrowing framework; however, it could be strengthened in a few areas. Broadly, the system was designed primarily to provide a framework for negotiations between the debtor state and the federal government as a creditor. In addition, while the plan is relatively limited, the experience shows that some designs issues could be improved. We discuss some of the possible improvements next.

37. The insolvency triggers under the FRR are inconsistent with debt limits under the FRL. The sections of the FRL that address indebtedness limits (together with the Senate Resolution that implements the debt limits) are less strict than the triggers set out in the FRR law that grant access to the FRR regime. In particular:

[37] The legislation introducing the Fiscal Recovery Regime (Lei Complementar n. 159, issued on 05/19/2017) can be found at: http://www.planalto.gov.br/ccivil_03/LEIS/LCP/Lcp159.htm.

- The 70-percent limit for the ratio of personnel expenditure, interest and amortization over net current revenue is likely to apply before the limit under the FRL;
- The 100-percent limit of debt over net current revenue is triggered well before the absolute debt limit under the FRL, which is 200 percent.
- There is no liquidity requirement under the FRL like the liquidity ratio required under the FRR. On the other hand, there is no regard in the FRR to the limit on the ratio of debt service to net current revenue., which is 11.5 percent.

Fiscal constraints in the law provide a signal to both public and private agents. Therefore, the various limits for indebtedness should be consistent and serve as early warning indicators of distress. As shown above (Figure 1.11), many states are accumulating RAPs in the latest years, which may signal fiscal distress.

Box 2.1. Insolvency Triggers

The definition of insolvency for subnational governments is usually based on indicators of inability to pay debts as they fall due. However, because of government's unique role in providing public services, the meaning of inability is itself subject to different interpretations in different jurisdictions.

In this respect, triggers based on failure to pay debts are useful but may apply too late to avoid disturbing the provision of essential public services. Triggers that are early indicators of liquidity issues may be more useful, but if they apply too early may lead the state to use the insolvency rules strategically to avoid honoring commitments. Therefore, in addition to default or other indicators of liquidity issues, triggers often require that other efforts have been made pre-filing before letting a subnational enter insolvency.

Therefore, there are combined requirements indicating the presence of arrears as well as efforts to solve the issues through fiscal adjustment efforts pre-filing.

Annex 2 has selected examples of insolvency triggers in 6 jurisdictions.

38. Upfront debt relief affects incentives to adjust and allows free riding. The plan envisages immediate debt service relief once the state enters the fiscal adjustment program and, in some cases, debt relief is being granted during negotiations to enter a program (due to intervention by courts). This reduces states' incentives to swiftly and decisively promote fiscal discipline. It could also lead the state to postpone its adherence to the regime while (temporarily) benefitting from debt relief.[38] Moreover, predetermining the size of the relief may fall short or exceed the needed relief. The pace and scale of the fiscal adjustment could be optimized if debt relief was phased and subject to satisfactory performance under the conditionality requested in the adjustment plan (see below).

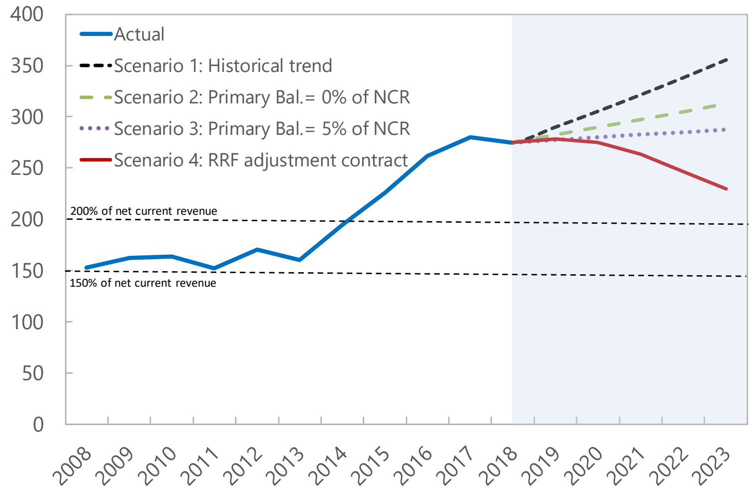
[38] Eligibility to the FRR is conditional on each state's fiscal position but some states have benefitted from debt relief before formally adhering to the regime. As of April 2019, three states were enjoying FRR-type debt relief but only one (Rio de Janeiro) were under a fiscal adjustment plan.

39. The monitoring framework could be strengthened. Performance under the FRR could be evaluated periodically (e.g. quarterly or semi-annual reviews) against quantitative and measurable performance criteria, indicative targets, and benchmarks for structural reforms with well-defined timelines. The agreed debt relief and provision of new federal guarantees could be split in tranches to be granted only when states meet pre-specified program conditionality applicable to specific reviews. Waivers could be provided in situations when states miss a performance criterion, but corrective actions are undertaken. To correct deviations from the originally planned targets, measures that include passing legislation and/or getting clearance from state courts could be treated as prior actions and implemented before the conclusion of a review.

40. The FRR's main operational target, the overall fiscal balance, may not ensure fiscal sustainability at the end of the adjustment period. This is likely to be the case in highly indebted states, where even a relatively large fiscal adjustment may still lead debt at high levels. The program may need an explicit approach to bring the outstanding stock of debt and the debt service burden to more sustainable levels, and in line with fiscal rules. At present, any restructuring of debt (e.g. reduce interest rate or extend amortization period) is done on an ad-hoc basis and outside of the FRR. Moreover, there are no explicit requirements in the law as to the goals of the adjustment plan. One of the purposes of ex-post subnational insolvency regimes is to provide transparency to the costs of insolvency and the expected burden sharing. As the FRR law lacks explicit goals, such as for example returning the indebtedness of the state to within legal limits, agents do not get a sense of the required adjustments until a plan is finally approved.

41. The planned adjustment should be credible and realistic—e.g., based on an examination of the proposed effort vis-à-vis the distribution of historical outcomes and considering structural changes faced by the subnational entity (e.g. demographic features). For instance, a debt sustainability analysis for the state of Rio de Janeiro suggests that, even under the scenario of the FRR adjustment, the projected ratio of net debt to net current revenue at the end of the 6-year FRR plan remains well above the prudential limit established by the FRL (Figure 2.8).

Figure 2.8. Rio de Janeiro: Net Public Debt, 2008-2023
(Percent of Net Current Revenue)



Sources: National Treasury and IMF staff estimates.

42. The Brazilian insolvency framework does not sufficiently address debt overhang. As set out above, the FRR regime does not address private creditors' claims and sets an automatic relief for debt service with the Union. However difficult, debt renegotiation is sometimes needed. When no agreement is achieved, the issue to be addressed is who holds the power to change the terms of the existing debt. A few countries have enacted rules for debt restructuring (Hungary, South Africa, and the U.S.). If an insolvency regime does involve an element of debt restructuring, then a court should be part of the process to ensure procedural and substantive fairness. A procedure for debt restructuring recognizes the fact that eliminating debt overhang at the end of a fiscal adjustment period through a process guided by law is preferable to going through repeated, costly, and often unsuccessful negotiations.

43. There is no provision for debt renegotiation with private creditors. The auction mechanism is the sole tool to address private debt burdens. Clear and predictable rules should provide a guide as to the order of priority of payments. Frameworks usually give different treatment to different types of claims in terms of priority of payment. Priority rules reflect country-specific preferences such as protecting employee claims, paying social security benefits, and maintaining public service levels. Any framework should protect the equal treatment of creditors of the same rank as well as protect contractual rights.[39] The FRR does not provide for a stay of execution for private debt, or inversely confirm that no such stay applies, which creates legal uncertainty as to the treatment of collateral granted to private lenders. This priority of payments will also anchor expectations in cases where debt renegotiation is needed to fully restore a sustainable debt load.

[39] See Herold, K., 2018, "Insolvency Frameworks for Sub-National Governments," *OECD Working Papers on Fiscal Federalism* No. 23.

44. The law lacks a clear definition of what constitutes essential public services under the Brazilian insolvency framework. The need to maintain public services should be one of the primary goals of a subnational insolvency regime. This means that when revenue is insufficient to meet all obligations, payments required to maintain essential services should be prioritized. Brazilian law does not contain an explicit list of essential public services that need to be protected in the context of subnational insolvency.[40] Given the very broad constitutional mandates of the states, the definition of what constitutes essential public services should be addressed in the insolvency framework to improve clarity on what happens when revenue is not sufficient to meet all committed expenditure—and could even apply to priority of payments outside of the regime. This would allow better pricing of default risk by private investors.

45. The FRR is subject to legal uncertainty and undermined by ad-hoc bailouts outside of the insolvency regime. The FRR differs from past approaches in that it provides a permanent ex-post mechanism for addressing financial distress of states. This is a positive development and, in principle, in line with best practices. However, the recent experience suggests that non-compliant states could get exemptions from the Supreme Court and/or from the Union and continue benefitting from debt relief without meeting the FRR conditionality. For example, the main incentive for states to access the FRR is the relief from debt service to the Union provided by Article 9 of the FRR law. However, this relief is limited to a maximum of 36 months and other conditions which the courts have not applied when granting injunctive relief to the states and, the courts have suspended some debt payments indefinitely. Moreover, in recent years, the Union has adopted ad-hoc measures to grant guarantees using discretionary powers to support states rated as C and D in the CAPAG system. This could lead states to hold out from adhering to the FRR waiting for a better deal.

46. The design of sanctions for non-compliance with the adjustment plan could be improved. The two main penalties for a state that fails to comply with an adjustment plan are (i) the end of the suspension of debt service to the Union and (ii) the inability to borrow under the exemptions provided in article 11 of the Fiscal Recovery Regime legislation. However, a state that would not comply with the plan would also be freed of the agreed fiscal adjustment plan as well as the prohibitions provided in the same law. Only the latter penalty may be binding considering the legal challenges currently under consideration regarding the ability of the Union to collect state debt and enforce counter guarantees. One possibility would be to delay reviews (disbursements or debt relief) until compensatory measures are taken. In addition, could consider other types of sanctions as used in other countries. For example, some have penalties for officials that do not comply with the plan, allow for temporary loss of fiscal autonomy for the subnational entity (intervention as envisaged in Brazilian law), or set that certain actions that breach the fiscal adjustment plan (e.g. grant a tax exemption) are null and void.

[40] Only a limited rule seems to address the protection of essential public services: the FRL exempts transfers relating to health, education and social assistance from penalties applicable to voluntary transfers (article 25).

47. The FRR could be expanded to apply to municipalities, at least the largest one, with the necessary adjustments. Further analysis is required to better determine the current situation of municipalities. However, the legal framework does not currently set an ex-post insolvency regime for municipalities. A possible approach would be to extend the FRR regime to large municipalities or introduce an insolvency or bankruptcy legal framework for municipalities as in other countries (see Annex 2).

Recommendations

- The limits under the FRL and the insolvency triggers under the FRR could be harmonized, although the current indebtedness limits set by the Senate Resolution are too lax.
- The term of the FRR programs should be more flexible. The FRR provides that its adjustment programs should have a 3-year term, which may be extended once. This maximum 6-year period may not be enough to ensure a state returns to a sustainable fiscal path.
- Debt relief should be phased in tranches and conditional on satisfactory performance under the adjustment plan.
- The FRR should provide more clarity as to what happens if debt service with private creditors is unsustainable.
- The legal framework should be more explicit on what constitutes essential public services that the different levels of governments have to provide. This would help when designing the FRR program (and when applying the sanctions on the FRL as discussed above).
- The legal environment lacks certainty and should be improved. One possible way to provide more legal certainty cold be to submit the plan to judicial review before final approval.

E. Introducing a Debt Fund for States

48. A risk sharing mechanism between states may create better incentives for maintaining fiscal discipline. Creating a mechanism (fund) by which states have a direct economic interest in subnational debt—such that states will benefit if all preserve sound finances and no state defaults on its debt—could realign incentives towards greater fiscal discipline. Under such mechanism, states would decide whether to support a state facing financial distress and what would be the conditions. Additionally, risk sharing would provide more broadly incentives for a cooperative approach where states would be more supportive of initiatives to strengthen the enforcement of fiscal rules or other measures towards fiscal discipline. As of now, states have an incentive to support each other to obtain as large as possible bailouts from the federal government (e.g. via Congress).

49. A fund that acts as a lender of last resort, in case of financial distress, could better manage the risk of strategic default and promote effective fiscal adjustment programs. States would have a share of the capital of the Fund and receive dividends from the loans granted by the Fund. The fund could also provide liquidity under the FRR, imposing conditionality and monitoring fiscal adjustment. The fact that states would have resources at risk under the fund framework could lead to more balanced negotiations of adjustment programs under the FRR—recent experience shows that, under the existing regime, the federal government has limited leverage in imposing conditionality when bailing out states. It would be important to establish legally that this would be the only mechanism to grant debt relief or liquidity, eliminating the possibility of bailouts by the federal government. An effective FRR and well-designed debt fund would help make the no bailout commitment more credible—reinforcing each other.

50. If there is a decision to move ahead with the fund, several design issues will need to be considered. The choice of roles for the fund, its capitalization, and the framework under which it acts will need to be thought through. Similar mechanisms have been implemented in other countries with positive results. (see Box 2.2 and Annex 1). The design of this mechanism should be carefully considered, including its initial capitalization, governance, and scope of powers.

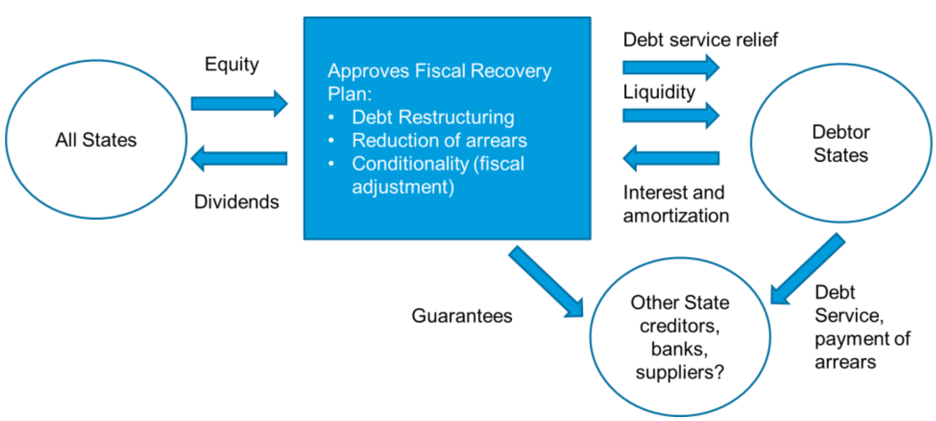
Box 2.2. Risk-Sharing Mechanism and Debt Redemption

Several countries have set up funds as part of their subnational finance framework. Examples are the budget stabilization funds or rainy-day funds of the US, Canada, Mexico and Sweden, which are individually state-level funds. There are also funds that pool resources directed to support subnational governments. For example, one-off debt redemption funds in Germany and Spain, and a permanent financial assistance fund in Portugal.

One of the key functions of these arrangements is to change the incentive structure of the subnational debt framework in order to lend credibility to fiscal controls and subnational distress frameworks. There is evidence that cooperative controls, whereby subnational governments agree to impose administrative as well as financial sanctions and penalties among themselves, tend to achieve better outcomes than centralized administrative controls (Singh and Plekhanov, 2005).

The role of a fund may also be to lend credibility to a no bailout commitment from the central government and to promote cooperation at subnational level in the enforcement of fiscal rules. The existence of pooled resources that can be called upon in case of distress signals that states are primarily responsible for honoring their debts and that only the assets of the fund are available to lend support.

Simplified model for a fund dedicated to debt redemption and conditional support in distress



Box 2.2. Risk-Sharing Mechanism and Debt Redemption (concluded)

Design choices for this fund would include:

- The governance structure of the fund, which could be comprised of a board where all states and, possibly, the Union are present, and a management committee with a technical focus. This includes deciding how to allocate shares of the Fund across states (e.g. all states could have similar shares or could be based on existing rules for the FPE).
- The functions to be performed by the fund: redemption of existing debt stocks, providing liquidity to distressed states, providing technical assistance in debt renegotiations and fiscal adjustment;
- The capitalization of the fund (which could be done over several years). The initial capital could include:[41] part of existing debt stock that states have with the federal government, , revenue from other sources, such as oil royalties. Future, regular contributions would come from the general budget of the states. States would receive dividends from the Fund.
- The temporary or permanent nature of the fund;
- The role of the fund and its coordination with the FRR framework, for example providing liquidity and funding under Article 11 FRR law;
- Rules for cash calls and dividends, to maintain sound prudential limits; and
- The role of the fund in enforcing fiscal rules and applying penalties for breaches.

Cooperative approaches work better in the absence of bailout expectations and require standardization of fiscal reporting, among other complementary reforms. Further work is required to assess the optimal design choices in the context of the current circumstances in Brazil.

III. ENHANCE FISCAL RESPONSIBILITY AND TRANSPARENCY

51. **Brazil's fiscal responsibility framework for subnationals has been under distress in recent years, undermining its credibility**. While not the main focus of this report, we discuss elements of the fiscal rules and transparency that should be revised and improved to promote greater fiscal discipline and accountability among states and municipalities.

A. Subnational Fiscal Rules

52. **Subnational fiscal rules have been ignored or circumvented in recent years**. Brazil has several subnational fiscal rules set by the FRL. These include rules regarding debt (stock and debt service), limits on wage bill (wages and pensions), among others. As discussed in other parts of the report, in some cases, the rules were circumvented, e.g. through exemptions, to allow subnationals to increase their borrowing. In addition, many states have breached the limits on the wage bill. In part this has reflected widespread creative accounting to circumvent the rules.

[41] In the case of Portugal (Fund for municipalities), the initial capital came from a loan from the central government to the Fund, which was repaid over time. In addition, the contributions from municipalities were done over several years.

The authorities are considering changes to the legislation to allow subnational governments more time to adjust to the limits (as the FRL has specific timelines to correct adjustments). While this is needed given the current situation, it undermines the credibility of the rule-based framework.

53. There needs to be greater effort to improve transparency and monitoring. A possibility could include the creation of an independent fiscal council that would provide a view of the health of the financial situation of subnational governments. This mandate could be given to the Independent Fiscal Institution (IFI) that already monitors the federal government fiscal accounts. However, it would be important to further strengthen the independence of the IFI by law and provide more resources. Another alternative would be to create fiscal councils at the state level.

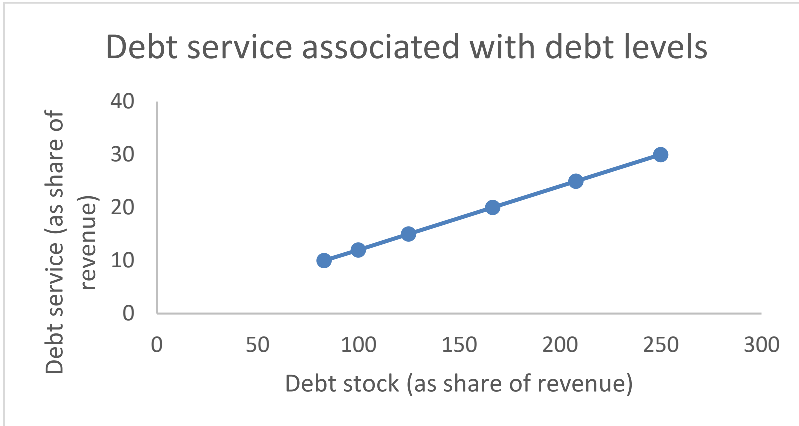
54. The design of the rules has also contributed to some degree to the recent fiscal distress. Most of the quantitative rules are designed as ratio to revenues. This implies that in periods of economic boom, the rules allow for large increases in spending and debt. In turn, it is very difficult to undue those increases during the economic downturns as it would be required by the rule. This is also undesirable as it would make fiscal policy highly procyclical. This is a particular problem in states and municipalities highly dependent on commodity revenues, which tend to be highly volatile.

55. There could be gains from moving to an expenditure rule for total spending if well calibrated. This could be particularly useful given the problems with creative accounting regarding the wage bill rule. Expenditure rules can strike a good balance between flexibility and simplicity, avoiding procyclical fiscal policy. This is possible by applying the rule to the growth rate of expenditure and setting the limit equal to the potential or trend pace of revenue growth, which can be proxied by the average pace of revenue or nominal GDP growth over the recent past (Eyraud and others, 2018). An expenditure growth limit of this kind would prevent procyclical spending increases in good economic times when revenue growth is above trend, while helping to avoid the need for disruptive cuts in bad economic times when revenue growth is below average. Expenditure limits calibrated in this way should cover both recurrent and capital spending, to contain excessive deficits and avoid creative accounting.

56. There could also be consideration to reduce the debt limit. The 200 percent of revenue debt limit appears too high. Among OECD countries, the debt ceiling varies between 60 to 150 percent of revenues, while debt services limits range between 12 to 25 percent of revenues. The Brazilian experience also suggests that a limit of debt at 200 percent of revenues (RCL) seems to high as states are already under debt distress at lower levels. A debt level of 200 percent of revenue is associated with relatively high debt service. For example, assuming a maturity of 20 years and an interest rate of 7 percent, the debt service would be close to 25 percent of revenue (Figure 3.1). It would be safer to adopt a more prudent level, especially if subnational governments are allowed to go to the capital markets. For example, a limit between

100 or 150 percent of revenues would imply more manageable debt services. Such prudential debt limits would allow time to take more gradual measures and avoid disruptive situations.

Figure 3.1. Debt Service Associated with Debt Levels



Recommendations

57. Strengthen fiscal rules by

- Creating an independent fiscal council that monitors fiscal performance and compliance with fiscal rules by subnationals. One possible alternative is to add this mandate to the IFI, while strengthening its independence by establishing it by law.
- Moving to an expenditure rule that would constrain and stabilize total expenditure growth.
- Reducing the debt limit to a more prudent level. International and Brazilian experience suggests that a limit of debt at 200 percent of revenues is high and increases the risk of financial distress.

B. Transparency and Enforcement of Rules, Standards, and Audits

58. The disclosing of subnational financial information has improved in Brazil in the past two decades. The introduction of the Fiscal Responsibility Law (FRL) led to an improvement in the transparency of the finances of states and municipalities by mainly requiring the publication of information three times a year (Articles 54-55). This has allowed both the National Treasury and Central Bank to publish aggregated and detailed data on the balance sheet of the subnational mainly focusing on the fiscal indicators required by the FRL.

Table 3.1. Brazil - Statement of Government Operations for the General Government, 2018

Millions of Reais	Central Government	State Government	Local Government	Consolidation	General Government
Transactions affecting net worth					
1. Revenue	523,340	224,366	162,409	(152,118)	757,997
2. Expenditures, *of which*	611,843	245,089	186,833	(152,118)	891,647
Consumption of fixed capital (CFC)	*8,864*	*9,520*	*8,686*	-	*27,070*
Gross operating balance (1-2+CFC)	**(79,639)**	**(11,203)**	**(15,738)**	**-**	**(106,580)**
Net operating balance (1-2)	**(88,503)**	**(20,723)**	**(24,424)**	**-**	**(133,650)**
Transaction in nonfinancial assets					
31. Net investments in nonfinancial assets	792	2,843	2,075	-	5,710
Net lending/borrowing (1-2-31)	**(89,295)**	**(23,566)**	**(26,499)**	**-**	**(139,360)**

Source: National Treasury - Estatísticas Fiscais Trimestrais Resultados do Governo Geral.

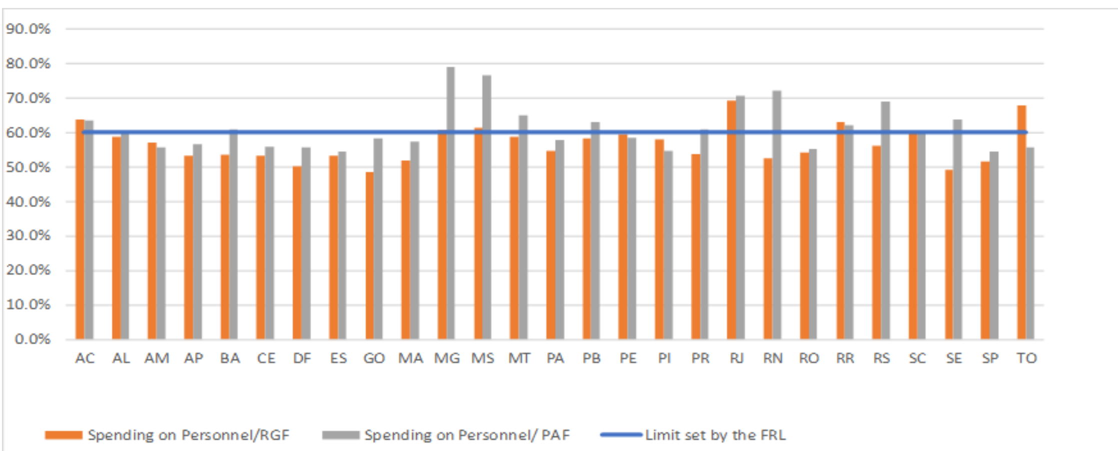
59. However major weaknesses persist related to the quality of fiscal reporting. Although the reporting requirements for states and municipalities have increased under the FRL, there still substantial weaknesses that prevent assessing the true fiscal position and fiscal risks:

- *Key fiscal indicators are not reported according to standards and in a timely fashion.* A key issue relates to spending with personnel given it is covered by the fiscal rules. It is defined by the sum of expenditures incurred for active and inactive workers, including expenditures for pensions, in-kind benefits, and social security contributions. In practice, it has been difficult to assess whether states and municipalities fully comply with this ceiling (see Figure 3.2) due to the different methods used in calculating the wage bill of which: (i) exclusion of social security and pensions expenditures, (ii) recording the wages and salaries on a net basis excluding the income tax; and (iii) exclusion of in-kind benefits to employees and outsourcing.
- *The very unequal quality of the data also reflected diverse and non-standard practices of the States Court of Accounts (SCU).* Currently 33 regional and municipal courts of accounts are responsible for monitoring the public finances of the states and municipalities. The constitution of each state provides for the establishment and functioning of these courts. This had led to various divergences in the practices of the regional court of accounts leading to different interpretations of financial and accounting regulations affecting the assessment on whether the fiscal rules were met.
- *Absence of standardized concepts in compiling the financial information.* In 2014, the Manual of Applied Accounting for the Public Sector (MACSP) was issued along with a standard chart of accounts (CoA). The manual is updated yearly to converge with international standards of accounting, namely the International Public Accounting Standards (IPSAS) and the Government Finance Statistics Manual 2014 (GFSM 2014). While the compliance with the MACSP is mandatory for entities of the public sector, the application of the norms within the manual varied among states and municipalities.
- *The absence of a fiscal management council.* To avoid different interpretations of the laws and standards, Article 67 of the FRL envisaged a fiscal council that, among other roles, would

adopt accounting standards for consolidation of public accounts and the standardization of accounts and reports. However, such council has yet to be created.

- *There are no reconciliation notes on various fiscal indicators for the states and municipalities.* The National Treasury and the Central Bank of Brazil are the two institutions assigned by the FRL to produce the official fiscal statistics. The above-the-line fiscal balance is computed by the Treasury, while the below-the-line calculation is provided by the Central Bank. While the Treasury makes sure that both calculations for the central government are reconciled in the primary balance tables it publishes every month, it is not the case for the state and municipalities (Table 3.2). Efforts to reconcile the data related to states and municipalities would help to have more assurances on the quality of the information and potentially identify PFM weaknesses and opportunities for reform.

Figure 3.2. Comparison of the Spending on Personnel between the States Definitions and the National Treasury Definition for 2017



Source: Boletim de Finanças dos Entes Subnacionais, 2018 – Staff calculations.

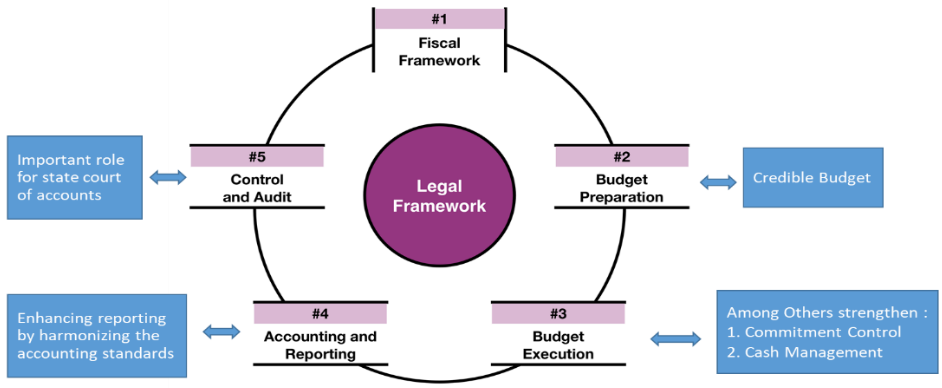
Table 3.2. Difference of Above and Below the line Balances of States and Municipalities

Millions of Reais	**2015**	**2016**	**2017**
Primary balance - Above the line	(1,763)	(2,827)	(13,873)
Primary balance - Below the line	7,135	4,519	8,812

Source: Boletim de Finanças dos Entes Subnacionais, 2018 – Estatísticas Fiscais Regionalizadas.

60. Weaknesses in the public finance management (PFM) systems further exacerbate the challenges in fiscal management and production of quality reporting. Figure 3.3 presents key PFM elements according to their position in the budget cycle. PFM institutions, systems, and processes at each stage are of equal importance, and affect each other. Issues such as lack of credible budget, absence of proper commitment control system, ineffective cash management system, or a robust integrated financial management information system (IFMIS) can lead to weak budget execution, deterioration in the financial information, liquidity constraints, or buildup of arrears. This in turn can lead to higher costs to the government, including as suppliers will likely require a higher price to manage the risk of arrears.

Figure 3.3. Public Finance Management and the Budget Cycle



61. The National Treasury, in the absence of the FMC, assumed the responsibility on accounting and reporting reforms. Eight sub-working groups were created and are actively working toward implementing reforms with the ultimate objective of enhancing transparency. The efforts include: harmonizing the accounting concepts, standardizing the reporting format, improving the quality of the data and engaging with the state courts of accounts (SCUs) to strengthen cooperation and development of competencies at the regional level. Among these reform initiatives are:

- *Implementation of a detailed matrix of fiscal accounts* (*matriz de saldos contábeis*) to be reported by the states and municipalities. The complementary law 156/2016 required that the Federal government, the states, the Federal District and the municipalities shall make available their accounting, budgetary and fiscal information and data according to the periodicity, format and system established by the central accounting body of the Federation. As a result, the detailed matrix of fiscal accounts was developed aiming at providing more transparency, improving the consolidation of the national accounts, and allowing for better reporting and analysis of the data. Starting January 2019, states and municipalities are obliged to report monthly data using this matrix or they will be at risk of withholding of voluntary transfers by the National Treasury.
- *Setting a platform, whereby, the subnational accounts can be consulted and shared with various technical partners, including the SCUs.*[42] This would allow that all public entities would

[42] The matrix could be consulted on: https://siconfi.tesouro.gov.br/siconfi/pages/public/consulta_msc/consulta_msc_list.jsf

have access to the same accounting data. Any inconsistencies identified by the state auditors could be shared with the Treasury with the aim to enhance the quality of the data.

62. These initiatives are positive and should be accelerated. The project of implementing the matrix of accounts, developing the platform, producing reports and providing access to the SCUs is expected to be completed by 2022-23 or later. However, it would be important to give priority to the transition work, as greater transparency will be critical for the success of the reforms discussed in this report. It would be useful to:

- *Accelerate the implementation of the matrix of accounts and the platform for generating reports and enhancing the analysis*. To encourage states and municipalities to fulfill the requirements of the matrix of accounts, it would be useful to showcase the benefits of this exercise by piloting two case studies (reporting and analysis). This might require an increase of resources to provide the needed support to the states and municipalities.
- *Provide access to this database for the SCUs*. The pilot exercise that the National Treasury led with the court of accounts of the state of Espírito Santo could be highlighted and advertised to encourage other SCUs to join the database and collaborate with the National Treasury to enhance the quality of the fiscal information.

63. The creation of the FMC, as required by the FRL, has become even more a necessity. The divergences in application of the accounting norms have hindered the comparative evaluations and prevented the presentation of the true fiscal situation. High-quality accounting standards contribute to transparent and accountable information that is made available to the public, as well as quality financial information to support decision making. The FMC could play a critical role to promote the convergence and provide more legitimacy to the standardization work led by the National Treasury. The FMC could be responsible, among others, for: (i) adoption of standards for consolidation of public accounts, standardization of accounts and fiscal reports; and (ii) dissemination of analyzes, studies and diagnoses. Having the right composition of the council is essential to undertake these functions. In general, overseeing accounting bodies in many countries have a mix of technical and political civil servants, academia, and experts representing the professional bodies (see Box 3.1).

64. The FMC could encourage the dialogue with SCUs towards convergence with international standards in compiling and reporting data. Although the International Standards of Supreme Audit Institution (ISSAI) does not adopt any standard for financial reporting , however it encourages the use of international standards of accounting such as the International Public Sector Accounting Standards (IPSASs) in establishing the financial statements. In particular, ISSAI 210, Article 8 indicates examples of international standards for financial reporting which include: (i) International Financial Reporting Standards (IFRSs), (ii) IPSASs, and (iii) accounting principles promulgated by an authorized or recognized standards-setting organization in a particular jurisdiction, provided the organization follows an established and transparent process involving deliberation and consideration of the views of a wide range of stakeholders. Also, it is being debated whether the Federal court of accounts (TCU) would have the mandate to set the jurisprudence over any doubts regarding decisions by SCUs.

Box 3.1. International Examples of Accounting Bodies

Canada

The Accounting standards are the primary source of generally accepted accounting principles (GAAP). The Public Sector Accounting (PSA) Handbook contains accounting standards that apply to (i) federal, provincial, territorial and local government organizations, (ii) government partnerships, and (iii) school boards. The handbook is issued by the Public Sector Accounting Board (PSAB) which is the entity in charge of establishing the accounting standards for the public sector. The Board also provides guidance for financial and other performance information reported by the public sector. The PSAB membership includes: (i) deputy ministers of finance, (ii) controllers' general, (iii) legislative auditors, (iv) prominent public accountants with public sector experience; (v) chief financial officers of local governments and government organizations; (vi) academia; and (vii) other senior government executives and experts in public sector financial reporting. The Chartered Professional Accountants of Canada (CPA Canada) provides funding, staff and other resources to support an independent standard-setting process.

Australia

The Australian Accounting Standards Board (AASB) is the Australian Government agency responsible for developing, issuing and maintaining accounting standards that apply under Australian company law. The mission of the AASB is to develop and maintain high-quality financial reporting standards for all sectors of the Australian economy and to contribute to the development of global financial reporting standards.

The major standard-setting objectives of the AASB are to: (i) issue Australian versions of International Accounting Standards Board documents, (ii) produce standards that treat like transactions consistently, (iii) significantly influence the development of International Financial Reporting Standards, (iv) identify areas requiring fundamental review and introduce standards to cover those areas, and (v) promote globally consistent application and interpretation of accounting standards.

The Financial Reporting Council (FRC) which is a statuary body responsible for overseeing the effectiveness of the financial reporting framework in Australia, appoints the members to the AASB. The members are appointed on merit, have a good technical knowledge of accounting and come from a variety of backgrounds to encompass "users" as well as "preparers" of financial reports. As well as technical expertise, members will usually have experience in business or government, a broad policy perspective, and a full understanding of the practical business or government environments in which accounting standards are applied. Members will also bring a keen public interest perspective to the Board. Appointments will aim to balance public and private sector expertise and also take gender considerations into account.

Source: Public Sector Accounting Board Canada, Australian Accounting Standards Board.

65. There is also a need to improve the publication of data by disclosing explanatory notes on differences in fiscal statistics published by various agencies. This exercise is been done by the Treasury for the federal government. A reproduction of this exercise for the states and municipalities can be beneficial to further highlight the issues raised with the quality of the data and to educate the population on the various numbers produced and avoid confusion (Table 3.3 shows the example of Finland). These notes can include information on the discrepancies due for example to methodological issues,[43] a weak reporting system, different sources of data, and inconsistencies in the institutional coverage.

Table 3.3. Finland – Reconciliation of National Balance and Net Borrowing/Lending According to ESA 2010 – Percent of GDP

	2010	2011	2012	2013
Working Balance in the government accounts (National Definition) (a)	**-4.0**	**-2.4**	**-2.9**	**-2.8**
Total Adjustments, *of which* **(b)**	1.4	1.3	0.8	0.4
Financial transactions included in the working balance	*-0.2*	*0.0*	*0.7*	*0.2*
Tax adjustments	*0.1*	*0.2*	*0.0*	*0.1*
Investments of muncipalities not included in the working balance	*-1.4*	*-1.5*	*-1.6*	*-1.6*
Holding gains/losses	*-0.7*	*1.4*	*-0.5*	*-1.1*
Net change in technical reserves	*1.9*	*-0.2*	*1.6*	*1.9*
Deferrable budgetary appropriations	*0.9*	*0.4*	*-0.2*	*0.5*
Net borrowing (-)/lending(+) (a)- (b)	**-2.6**	**-1.0**	**-2.1**	**-2.4**

Source : Statistics Finland, EDP Notifications

66. The need to enhance and strengthen the whole budget cycle management is even more relevant. The quality of the fiscal reports produced by the states and municipalities are not only impacted by the different interpretations of laws and regulations, but also by weak PFM systems. The weakness in the systems, which can be attributed to issues of enforcement and capacity of the systems, has contributed to the problems faced by states and municipalities such as liquidity constraints, buildup of arrears, or the breach of fiscal rules, such as in Italy and Spain.[44] In this context, there are three areas in the PFM systems that states and municipalities should focus in strengthen:

- *Credible budgets:* in many countries, as is the case with the states in Brazil, the budget rigidities (earmarked revenue and mandatory expenditures), overoptimistic revenue forecasts, and the inability to scale down its operations in response to falling revenues has led to disruptions in the budget process. Strengthening the budget preparation procedure and enhancing the medium-term budget framework could minimize the disruptive effect.
- *Commitment controls*: the key objective is to manage the initial incurrence of obligations to better enforce expenditure ceilings and avoid expenditure arrears. The limits on controls can

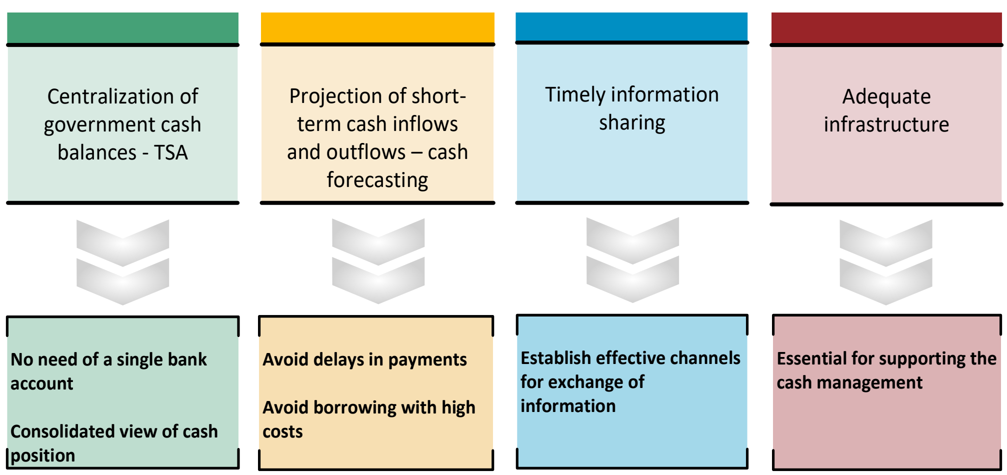
[43] The Treasury prepares the data of above the line based on the GFSM 2014, while the Central Bank up until recently (January 2019) was preparing the below the line data based on the GFSM 1986

[44] A. Bonfatti, L. Forni "Fiscal Rules to Tame the Political Budget Cycle: Evidence from Italian Municipalities", IMF working paper 17/6, International Monetary Fund, Washington DC; and M. Delgado-Tellez, V. Lledo, J. Perez "On the Determinants of Fiscal Non-Compliance: An Empirical Analysis of Spain's Regions", IMF working paper 17/5, International Monetary Fund, Washington DC

be based on budget appropriations or on cash plans. Ideally, commitments should be regulated by annual budget appropriations. However, this approach may prove to be insufficient in preventing the incurrence of arrears in the case of revenue shortfalls. Commitment controls based on expenditure ceilings or cash limits reconcile the availability of resources with commitments, thus ensuring that spending units are able to enter into contracts, or other obligations, only if sufficient resources are available, or likely to be available, at the time of their payments. It is necessary that expenditure ceilings should be guided by a well-functioning cash management system.[45] Box 3.2 provides an overview of design and operational arrangements in case of commitments in decentralized agencies.

- *Cash management:* proper cash management can ensure that enough funds are available for budget expenditures when needed. Figure 3.4 presents the main features needed to ensure effective cash management.[46] One of the key elements is the establishment of a Treasury Single Account (TSA). Many states still lack a TSA or its coverage is incomplete,[47] undermining an effective cash management and exacerbating the liquidity pressures (and buildup of payment arrears) that many states are facing.

Figure 3.4. Main Features of Cash Management



[45] IMF, Commitment Controls, 2009. https://www.imf.org/external/pubs/ft/tnm/2009/tnm0904.pdf

[46] IMF, Treasury Single Account, an Essential Tool for Government Cash Management, 2011. https://www.imf.org/external/pubs/ft/tnm/2011/tnm1104.pdf

[47] See "Desafios e Tendencias da Gestao Fiscal dos Estados Brasileiros", a report by CONFAZ, Comsefaz, and Ministry of Finance of Brazil (2017).

Box 3.2. Design and Operational Arrangements for Decentralized Agencies

Each ministry should have a commitment control officer (CCO). The head of a ministry/department should act personally or through an authorized person as a CCO and be responsible for managing commitment controls.

- All expenditure transactions should be processed through the commitment control system.
- The starting point should be for each ministry to prepare a quarterly expenditure plan in a format prescribed by the Ministry of Finance (MoF). This plan, supported by projected monthly cash requirements, should reach the cash management unit in the MoF by a specific day of the month preceding each quarter.
- Based on its annual and three-month rolling cash plan, the MoF would issue quarterly expenditure ceilings broken down by broad categories of expenditure.
- In the event that the quarterly expenditure ceiling is less than the quarterly expenditure plan submitted by a ministry, the plan should be adjusted to match the level of the quarterly expenditure ceiling. The CCO needs to ensure that commitments entered into are consistent with the quarterly expenditure ceiling—without incurring any payment arrears.
- No commitment could be entered into if it exceeds the uncommitted balance available under the relevant budget item and subitem. It is also necessary that the prescribed internal controls—such as administrative and financial authorizations—are complied with.
- Such a strict requirement is practicable for the recurrent budget—but not for capital investment or development projects, where contracts and commitment may extend for six or 12 months. For that reason, a separate six-month expenditure ceiling could be provided for development projects: again, CCOs would be required to approve any commitment entered into and satisfy themselves that it is consistent with the prescribed ceilings.
- The authorization of commitments is a particularly important control in such systems. Accordingly, the head of a line ministry should designate only specific officers to authorize the purchase of goods and services, and, to sign and issue a local purchase order. Thus, before any order for goods and services can be placed, or a commitment is otherwise incurred, a clearance needs to be sought from the relevant authorizing officer. A commitment requisition form could be used for initiating a commitment.

Source: IMF, Commitment Control, 2009.

Recommendations

67. Enhance transparency by:

- Set up the Fiscal Management Council as envisaged in the FRL
- Pilot two states and municipalities by calculating the fiscal indicators set by the FRL and for CAPAG using the different sources of data to highlight the differences and provide an analyses of the differences and the quality of the data. This would also help highlight the benefits of such exercise in strengthening PFM systems at the regional level.
- Establish TSA at state level.
- Develop a system to coordinate actions of the different state courts of accounts.
- Publish explanatory notes on the reconciliation and differences between various fiscal indicators.

Annex I. Portugal: Financial Support Fund for Municipalities

Following the severe sovereign debt crisis in 2011 Portugal entered a financial assistance program with the IMF. As part of its fiscal adjustment, Portugal adopted laws to address the accumulation of arrears in the public sector, including at municipal level, a new municipal finance law tightening fiscal rules, and a municipal financial recovery law aimed at addressing over indebtedness in the municipal sector.

As part of the municipal financial recovery, a fund was created to:

- Negotiate fiscal adjustment programs for municipalities under distress;
- Assist in debt renegotiation;
- Provide financial assistance in the form of conditional loans and guarantees under a fiscal adjustment program; and
- Monitor compliance with the program.

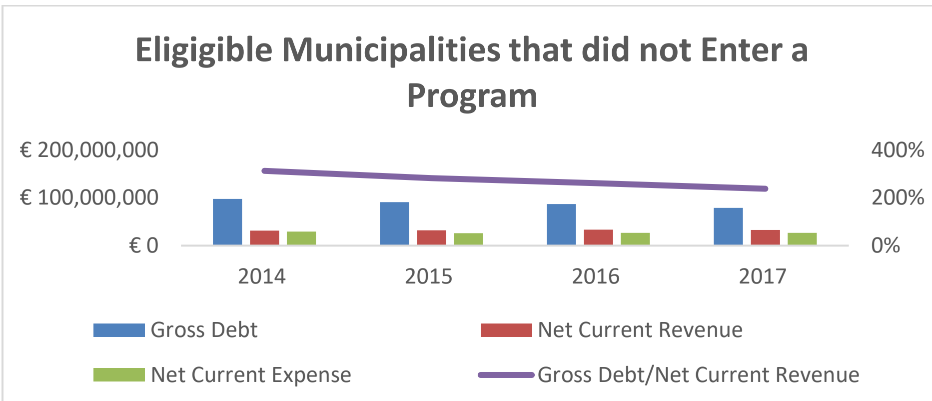
The financial support fund (FAM) was instituted by a 2014 law with the capital being divided between the central government (50 percent) and municipalities (50 percent). The initial capitalization was done with a loan from the central government that is being repaid by municipalities. In addition, the local governments contribution to the fund were made over seven years. The shareholders received dividends based on the financial investments of the FAM and interests on loans that it provides under the fiscal programs.

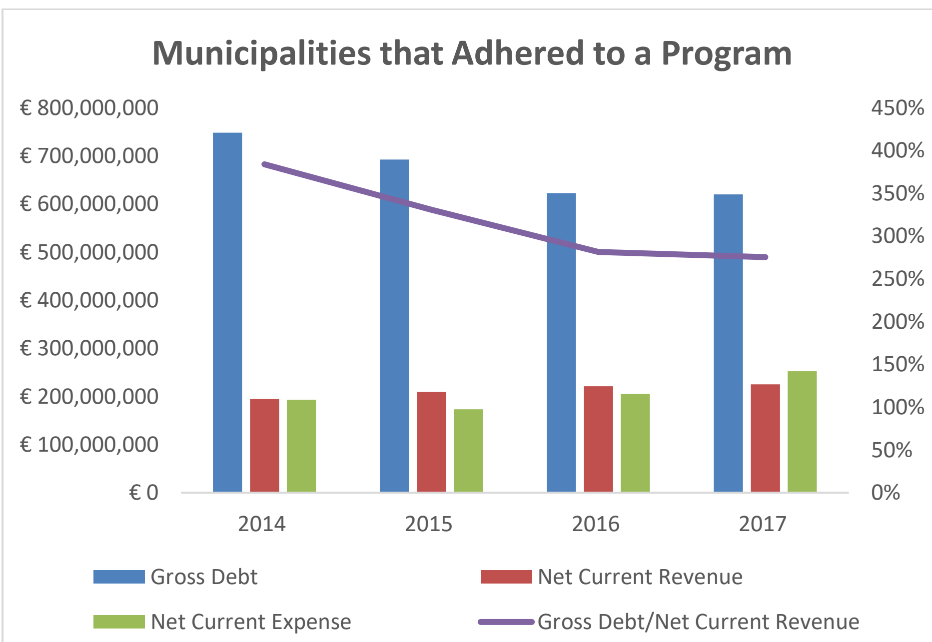
Financial recovery is mandatory for municipalities with a debt to revenue ratio of 3 times revenues and optional for municipalities with a debt to revenue ration of 2.25. As of 31 December 2018, 12 municipalities had accessed a fiscal adjustment program, out of approximately 30 that were eligible at the time the law was enacted. Prior to the introduction of the financial recovery mechanism, both limited administrative controls from the central government and a self-imposed fiscal adjustment plan was required by law. This arrangement failed to prevent 33 out of 308 municipalities exceeding debt limits and generally was perceived as ineffective, with a strong expectation of bailouts pervasive among creditors and municipalities.

In the period since the introduction of the law, municipalities in Portugal have significantly reduced their debt levels. The largest cuts in current expenditure came from municipalities at risk of being forced into the regime. Although the longer-term effects of the structure are yet to be fully assessed, the experience until now suggests the governance structure has been effective to address, and contain, high debt levels.

	Change in gross debt, 2014-2017	Change in Revenue, 2014 - 2017	Change in Current expenditure, 2014-2017
Eligible Municipalities that did not Enter a Program	-20%	6%	-9%
Municipalities that Adhered to a Program	-17%	16%	31%
All other Municipalities	-29%	15%	6%

Source: Direção Geral das Autarquias Locais





Annex II. Selected Insolvency Frameworks

Table 1. Summary of Selected Insolvency Frameworks

	Switzerland	**USA**	**Colombia**
Insolvency framework	Municipalities and other entities that fall under cantonal public law (e.g. parishes)	Municipalities including all political subdivisions, public agencies or instrumentality of a state	Departments, Municipalities districts as well as the parts of the decentralized service delivery sector
Type of procedure	Administrative	Hybrid	Administrative
Role of authorities	Cantonal bankruptcy authority confirms bankruptcy filing manages creditors meeting and mandates supervisory commission for fiscal adjustments Supervisory commission intervenes into fiscal policy	Bankruptcy court approves petition, confirms a plan of debt adjustment and ensures its implementation, It must not interfere with the political and governmental powers, the property and revenues and the use of income producing property of the debtor	Superintendency of Corporations exercise jurisdictional functions, settles disputes between claimants and issues interim measures Ministry of Finance and Public Credit confirms on filing, manages and supervises debt negotiation, supervises fiscal policy
Trigger/ eligibility requirements	Mun is unable to meet its bond obligations in time. - Fiscal crisis of the debtor cannot be solved by other means or at another time - Debt restructuring measure can only be applied, when all other reasonable measures are exploited and have been failed to avoid bankruptcy	Mun must be insolvent: Debtor generally not paying due debts. Inability to pay its debts as they become due Mun must be authorized to be a debtor by state law (allowed in 27 states) Mun must desire to effect a plan to adjust its debts Mun has shown pre-filing efforts to work out financial difficulties and negotiate in good faith and to obtain an agreement with creditor or	Mun is overdue on payments for at least 90 days or there are at least two payment lawsuits in court The accumulated value of the obligations in arrears must represent at least 5% of total obligations (fall due in < 1year)

	Switzerland	USA	Colombia
		these negotiations were impracticable	
Filing for bankruptcy	Voluntary	Voluntary	Voluntary
Stay on enforcement/ cessation of payments	Bankruptcy authority can mandate a temporary cessation of debt enforcement – if it does not deteriorate the creditors' financial situation and a provisory debt deferral Creditor can request to continue debt enforcement	Automatic, other than for special revenue bonds	Automatic
Cram down/Ability to impose restructuring on dissenting creditors	Yes	Yes	Yes
Priority of claims	Debt restructuring applies only for bond holders Statutory liabilities, pensions, salaries, insurance contributions, and other liabilities that are not seizable are exempted from restructuring	Defined by "fair and equitable" treatment	Specified by law: 1. pension contributions 2. Salaries 3. Payroll transfers 4. General expenditures 5. Other transfers 6. Interest payments 7. Amortization of debt 8. Financing of deficit of previous years 9. Investment
Essential services	Not explicitly defined, guaranteed through excluding operational assets from seizure	Not defined	The MHCP and the subnational agency should define the activities that are critical to provide essential services and guarantee fundamental human rights
Fiscal Adjustment	Bankruptcy authority can mandate supervisory	Determined on a case by case basis by the debtor, overseen by a judge	Any operation involving expenditures need to be

	Switzerland	USA	Colombia
	commission to intervene into MUN policy for max. 3 years with the option of extension by further 3 years.		authorized by the MFPC. Insolvency framework is complemented by a law providing a fiscal adjustment framework and regulating central government assistance

Table 2. Summary of Selected Insolvency Frameworks

	Hungary	South Africa	Portugal
Insolvency framework	Local governments companies owned by municipality or guarantees rule under corporate insolvency law	Only municipalities, not provinces	Minicipalities
Type of procedure	Judicial	Hybrid	Administrative
Role of authorities	Court decides on filing and crisis budget, appoints trustee, and if no agreement is reached decides on debt settlement Trustee leads and supervises debt settlement and financial reorganization procedure	Court approves stay, debt restructuring and discharge – approves debt distribution scheme developed by trustee Administrative intervention by provincial authority, elaborates detailed financial recovery plan	Municipal Support Fund approves financial recovery plan.
Trigger/ eligibility requirements	Invoice is not disputed or paid within 60 days of the due day - Recognized debt not paid within 60 days.	- early warning system - fiscal intervention by government - debt restructuring - Mun has shown serious financial problems and	States may apply for financial support if Consolidated debt over Current Revenue exceeds 2.25 and states must apply for financial support if the above ratio exceeds 3.

	Hungary	South Africa	Portugal
		persistent material breach (indicated by several factors) - Mun is unable to meet its financial commitments now and in the future - Assets not necessary for effective administration or provide minimum level of basic services are liquidated according to approved recovery plan (set up during mandatory provincial intervention) - Employees discharged (except those affordable according to financial plan)	
Filing for bankruptcy	Voluntary or mandatory if requested by debtor	Voluntary	Mandatory
Stay on enforcement/ cessation of payments	Automatic	Applicable under request of municipality	Automatic
Cram down/Ability to impose restructuring on dissenting creditors	Yes	Yes	No
Priority of claims	Stipulated by Act: 1. regular wages, salary, Severance 2. mortgage backed assets 3. dues to state government 4. social security debts, taxes 5. other claims (e.g. loans,	Specified by the act: 1. secured claims 2. preferences provided in Insolvency Act 1936 (e.g. salary/wages, tax income) 3. non-preferential (unsecured) claims be settled in proportion to the amount of different claims	Not specified by law

	Hungary	South Africa	Portugal
	bonds, arrears to suppliers) 6. interest, default penalties, fees on claims Trustee can ask the court to nullify contracts and transactions stipulated up to one year before filing, if they are grossly disadvantageous to the mun.	Claims are settled against the amount realized through liquidation as outlined in recovery plan	
Essential services	Clear definition of basic residential services (27 items) Emergency budget adopted to service these tasks	Term not defined, suspension of financial obligations only after provision for basic municipal services	Set out in the law: - civil protection and public safety - sanitation and water - waste disposal - road maintenance if necessary for the safety of persons and goods - regular operation of schools - social assistance - cemeteries - urgent situations
Fiscal Adjustment	MUN adopts emergency budget servicing only mandatory tasks. Trustee reviews financial management of local government – must approve all payments	Ex ante efforts before filing: - Discretionary provincial intervention by provincial executives and - Mandatory provincial intervention: provincial executive seeks support by Municipal Financial Recovery service. Mun must implement financial recovery plan	The Municipality must entre a fiscal adjustment plan agreed to with the fund The fund may provide financial assistance to the municipality in the form of loans

Source: K. Herold, 2018, Insolvency Frameworks for Sub-national Governments. OECD