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Fiscal Conditions of Brazil's Public Sector: an Analysis of the States in the North and Northeast Regions and Funding for Rural Development

by Rodrigo Octávio Orair (IPC-IG/Ipea); Sergio Wulf Gobetti (Ipea) and André Amorim Alencar, Consultant

The analysis in this study shows that Brazil's improved fiscal condition—coupled with rekindled economic growth in the middle of the last decade—enabled sufficient headroom for a shift in fiscal policy as of 2006, giving rise to a period marked by fiscal expansion (Schettini et al. 2011). This shift led to a loosening of the restrictions on state and municipal indebtedness and a reduction in the public administration's primary balance, which changed from a surplus of over 3 per cent of Gross Domestic Product (GDP) into a deficit of 0.59 per cent of GDP in 2014.

During most of this period, the gradual lowering of the primary balance did not prevent the public sector's net debt from continuing its decline, eventually reaching 31.5 per cent of GDP in 2013 (compared to 58.9 per cent of GDP at end of 2002). It was only in 2014—under a strong economic downturn and a sharp drop in primary balance—that the debt level would rise back to 34.1 per cent of GDP, which, in historical terms, is quite low and similar to the levels seen in the early 1990s. The problem is the cost of stabilising the debt—that is, the primary surplus required to prevent it from rising relative to GDP—which has become exceedingly high in recent years, due to another factor related to debt composition: namely, the simultaneous accumulation of assets and liabilities by the public sector and the interest rate differential between them.

With lower primary balances and a higher interest account, the debt returned. The Brazilian government's response to this challenging scenario was a fiscal adjustment (starting in 2015), which interrupted the period of greater fiscal flexibility to reclaim the credibility of economic agents in the sustainability of public finances and, in doing so, endeavour to resume growth. At least in the medium term, this type of policy will involve severe restrictions imposed by the Federal Government when authorising new loans to states and municipalities, greater control of expenditures (and investment cuts), as well as a review of a number of tax exemptions and subsidies put in place during the preceding period.

Since 1997, large states and municipalities have become debtors to the federal government, through an agreement under which the central government took over the debt securities of these entities, which, in turn, found themselves unable to continue issuing public bonds and were forced to channel a portion of their revenues to settle their debts with the National Treasury. Through this and other institutional arrangements—as well as a more favourable economic scenario—the net debt of states and municipalities fell 6.3 percentage points of GDP between 2002 and 2008.

This context has changed since 2008, not only due to the deterioration of the macroeconomic landscape as a whole but mainly to newly contracted loans from banks and abroad, with approval from the federal government. Between 2008 and 2014, renegotiated debt maintained its downward trend, dropping 4.2 percentage points of GDP and initially surpassing newly contracted loans. This trend in net indebtedness would only cease in 2011, when new loans began to offset or even exceed the Federal Government acquittances. The net debt of regional entities—which had decreased by 2.5 percentage points between 2008 and 2011 (to 10.8 per cent of GDP)—grew more stable between 2011 and 2013, rising to 11.6 per cent of GDP in 2014.

As such, the rising levels of bank and external indebtedness of regional governments should be seen as a change in debt composition, rather than as an upward trend of indebtedness. This phenomenon was more intense in the North and Northeast regions of the country, where the share of banking and external debt has become prevalent (79 per cent of the debt in the North and 66 per cent in the Northeast); the debt to the Federal Government has become secondary.

A breakdown by creditor institution shows that this phenomenon was driven primarily by loans taken by states from public banks and multilateral organisations. Although a portion of the loans has been used to restructure liabilities—replacing the debt contracted with the federal government by loans borrowed more 'cheaply'—the funds were allocated mostly to urban infrastructure projects and new Federal Government programmes to support investments. These credit operations were also used for other purposes, such as for funding rural development.

The assessment of indicators on the degree of indebtedness and payback capacity, as well as the credit risk rating assigned in accordance with the methodology developed by the National Treasury, show that the fiscal condition of most states in the North and Northeast regions is not a concern. However, indicators are likely to evolve unfavourably, as they begin to reflect the more recent trends of fiscal deterioration. This does not point to an explosion of indebtedness, partly because the fiscal adjustments carried out by the federal government will involve tightening the control over new loans, and also because the accumulated debt to the federal government should benefit from the restructuring measures recently approved by the Congress.

The influence of these factors will prevent the level of debt from becoming unsustainable. From a fiscal stance, however, the most alarming aspect is the deterioration of the primary balances of state governments, down from a surplus of 1.3 per cent of GDP in 2008 to a deficit of 0.2 per cent of GDP in 2014. This deterioration is due almost exclusively to increased expenses (primarily with personnel), seen in nearly all state governments.

Paradoxically, public investments—the main targets of fiscal easing and the main destination of new loans contracted by states and municipalities—remained relatively stable between 2008 and 2010, bringing the prevailing trend of expansion to a halt when the downturn in the primary balance first began. This occurred at the federal, state and municipal levels. Evidence suggests that state governments substituted funding sources, thereby releasing funds (previously committed to investments) to, instead, pay for personnel and, in many cases, maintenance.

Reference:

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International Policy Centre for Inclusive Growth (IPC - IG)
United Nations Development Programme
SBS, Quadra 1, Bloco J, Ed. BNDES, 13º andar
70076-900 Brasilia, DF - Brazil

E-mail: ipc@ipc-undp.org ▪ URL: www.ipc-undp.org
Telephone: +55 61 2105 5000