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Brazil

Strengthening Fiscal Responsibility at the Subnational Level

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ABBREVIATIONS

CAPAG	Credit rating for subnational governments (<i>Capacidade de Pagamento</i>)
CoA	Chart of Accounts
CONAC	National Council of Internal Control
FAD	Fiscal Affairs Department
FMC	Fiscal Management Council
FMIS	Financial Management and Information Systems
FPE	States and Federal District Participation Fund
FRL	Fiscal Responsibility Law
FRR	Fiscal Recovery Regime
GFSM	<i>Government Finance Statistics Manual</i>
IFI	Independent Fiscal Institution
ME	Ministry of Economy
NCR	Net Current Revenue (<i>Receita Corrente Líquida, RCL</i>)
OECD	Organization for Economic Cooperation and Development
PFM	Public Financial Management
RAPs	<i>Restos a Pagar</i> (account payables)
SCA	State Court of Accounts
SNG	Subnational Governments (states and municipalities)
SS	Social Security
STF	Federal Supreme Court
STN	National Treasury Secretariat
TCU	Federal Court of Accounts
Union	Federal Government

BRAZILIAN STATES

AC	Acre	MA	Maranhão	RJ	Rio de Janeiro
AL	Alagoas	MG	Minas Gerais	RN	Rio Grande do Norte
AM	Amazonas	MS	Mato Grosso do Sul	RO	Rondônia
AP	Amapá	MT	Mato Grosso	RR	Roraima
BA	Bahia	PA	Pará	RS	Rio Grande do Sul
CE	Ceará	PB	Paraíba	SC	Santa Catarina
DF	Distrito Federal	PE	Pernambuco	SE	Sergipe
ES	Espírito Santo	PI	Piauí	SP	São Paulo
GO	Goiás	PR	Paraná	TO	Tocantins

PREFACE

In response to a request from the National Treasury Secretary, a Fiscal Affairs Department (FAD) mission visited Brasília and the states of Goiás and São Paulo, Brazil, from February 10-21, 2020, to provide technical cooperation on options for subnational fiscal rules. The mission was led by Paulo Medas and comprised Roberto Perrelli (both FAD) and Fernando González (external expert). Daniel Cunha (economist from the IMF's local office) provided research support to the mission.

The mission met with National Treasury Secretary Mansueto de Almeida Junior and other staff of the National Treasury, including José Franco de Moraes (Under-Secretary of Public Debt) and Pedro Jucá Maciel (Under-Secretary of Fiscal Policy Strategic Planning). At the Ministry of Economy, the mission met with Marco de Hollanda Cavalcanti (Under-Secretary for Fiscal Policy). The mission also met with Izabel Nogueira de Andrade (General Secretary for the Judiciary of the Advocacia Geral da União) and her team; Felipe Salto (Executive-Director of the Independent Fiscal Institution); Leonardo de Araújo Ferraz (National Council of Internal Control); Carlos Eduardo Girão de Arruda (General Comptroller of the State of Mato Grosso do Sul); Gustavo de Queiroz Chaves (Deputy Federal Secretary of Internal Control); Weder de Oliveira (Minister-substitute of the Federal Court of Accounts); Renato Rainha (Vice President of ATRICON, the association of Courts of Accounts); and Federal Senator Marcio Bittar.

In Goiás, the mission met with Governor Ronaldo Caiado; Gilvan Cândido (Secretary of Social Security); Selene Nunes (Under-Secretary of the State Treasury); and Sérvulo Nogueira (Secretary-Adjunct of Economy). In the State of São Paulo, it met with Tomás Bruginski de Paula (Executive Secretary of Finance and Planning); Roberto Yamazaki and Emilia Ticami (Subsecretariat for Planning, Budget and Finances of the Government of São Paulo); and Paulo Massaru and his team (State Court of Accounts). The mission also met with Gustavo Barbosa (Secretary of Finance of the State of Minas Gerais) and Andrea Senko (Chief of Staff); and Aldemir Freire (Secretary of Planning and Budget of the State of Rio Grande do Norte); and a representative of the State Court of Accounts. It also met with Marco Alves (Secretary of Finance for the state of Roraima) and his team.

The mission would like to extend its gratitude to the Brazilian authorities for all the cooperation and candid discussions. The mission is especially grateful for the support received from the staff of the Under-Secretary of Intergovernmental Relations, including Acauã Brochado, Gabriela Guerra de Queiroz, Paulo Monteiro Gomes, Cecilia de Souza Salviano, Carlos Reis, and Thiago Dominoni.

EXECUTIVE SUMMARY

The fiscal challenges of Brazil's states and municipalities can have a significant impact on the economy and the provision of core public services. The subnational governments (SNGs) account for a large share of public expenditures, including public investment. As such, their fiscal problems can hamper the economic recovery and the public finances of the federal government. In recent years, many states and municipalities have been struggling with high debt or severe liquidity pressures. Some have already defaulted on part of their debt and are running payment arrears (wages and suppliers). The federal government has already provided a substantial package of financial support through debt service relief.

The fiscal responsibility legislation was intended to prevent this harmful scenario, but its effectiveness has been diminished over time.¹ Since the late 1990s–early 2000s, Brazil has developed a complex and heavy framework of administrative controls and fiscal rules intended to promote fiscal transparency, constrain excessive borrowing by SNGs, and promote public investment. The reforms had some positive effects in the first years, but the framework gradually unraveled. Crucially, the framework did not eliminate the expectation of bailouts by the federal government. Over time, several problems emerged:

- The debt of most states was significantly reduced; however, this was not the case in the largest states, and they became increasingly vulnerable to economic shocks. This in part reflected the loosening of administrative controls that allowed excessive borrowing. The complex framework has also led some states and municipalities to run arrears even if their debt levels were relatively low.
- Public expenditures have been highly volatile and procyclical, which reflects weaknesses in the design of the rules, as well as widespread revenue earmarking in conjunction with mandatory spending.
- The lack of consistent accounting standards and poor data quality make it difficult to monitor the fiscal rules and risks. Weaknesses in internal and external controls have facilitated the use of creative accounting to circumvent the rules; in some cases, these weaknesses undermine budgetary processes due to the use of extrabudgetary spending and arrears.
- Significant legal uncertainty has arisen over the application of the Fiscal Responsibility Law (FRL) because the courts have been granting temporary injunctions that prevent the enforcement of the sanctions for several years.

¹ This report was prepared based on a mission before the COVID-19 pandemic. The analysis does not cover some of the additional deterioration of the fiscal situation in many SNGs. The proposals are directed to structural reforms for the future and the report does not discuss possible exceptional, temporary, and targeted measures, for example grants from the federal government, to help address the pandemic.

The challenge is to enhance the fiscal responsibility framework at the subnational level by promoting appropriate incentives. Brazil needs a new subnational fiscal framework that imposes credible hard-budget constraints and reduces the expectation of future bailouts by the federal government. We propose a reform that promotes mutually reinforcing elements: greater fiscal transparency, rely to a greater degree (but not exclusively) on market discipline, and improved design of fiscal rules. Such a reform would also grant greater flexibility to SNGs—including how to spend and when to borrow—if they abide by the fiscal rules. The framework would reduce the number of sanctions and make them more gradual to improve their effectiveness. There is also a need to strengthen the legal tools to address cases of highly indebted governments and eliminate ad hoc bailouts. These efforts should also be accompanied by broader reforms to address the significant structural challenges, such as budgetary rigidities.

Strengthening the rule-based framework will require enhancing the quality of fiscal reporting and external auditing to ensure that SNGs abide by the FRL. It will be important to intensify the efforts to promote greater harmonization of accounting and adequate reporting. The creation of a technical Fiscal Management Council to develop common standards for all levels of government would be a step forward. The council could be granted the power to verify whether government agencies at all levels abide by the standards. Other reforms include: (1) improving internal controls to ensure the integrity of the data and budgetary procedures; (2) moving forward with reforms being discussed to strengthen the governance of the Courts of Accounts and to promote harmonization in the interpretation of the FRL; and (3) mandating the independent fiscal institution or a new independent body to monitor fiscal policy and compliance with fiscal rules at the subnational level. There is also a need to develop a strategy to reduce, and effectively prevent in the future, the large stock of spending arrears.

Allowing SNGs more freedom in accessing debt markets, without federal guarantees, would instill greater market discipline and complement fiscal rules. At present, states and municipalities rely heavily on the federal government for guarantees or on public banks for credit. As a result of the many bailouts, the states with worse fiscal records in practice benefit from the lowest borrowing costs—distorting incentives. Giving SNGs freedom to access debt markets, without federal guarantees, would promote more discipline. States with better fiscal policies would receive lower borrowing costs, and SNGs would receive more flexibility in the management of their finances. The framework should include an enhanced Fiscal Recovery Regime (*Regime de Recuperação Fiscal*, FRR) as the sole legal mechanism to address cases of highly indebted states or large municipalities in exchange for a fiscal adjustment. To reduce legal uncertainty, the programs under the FRR could be overseen by the judicial system, possibly the Federal Supreme Court.

The design of the fiscal rules could be improved to reduce procyclicality and promote safer debt levels. The existing debt limits appear too high; states tend to suffer from fiscal crises even at lower levels of debt. The report recommends lower safe debt limits that would allow better management of adverse shocks and that would be consistent with the capacity of SNGs to service their debts. Another reform would be to introduce subnational spending caps on the growth of total primary expenditures. This reform would help reduce the volatility and procyclicality of public expenditures. It would also avoid many of the problems associated with the existing personnel spending limit, which has led to widespread creative accounting, is procyclical, and has not prevented a rise in subnational current expenditures. For municipalities, a balanced budget rule and the introduction of rainy-day funds could be considered.

I. EXPERIENCE WITH SUBNATIONAL FISCAL RULES

A. A Complex and Evolving Fiscal Framework

1. **Brazil has a high degree of fiscal decentralization.** The 1988 Constitution included ample government spending mandates and reinvigorated SNGs.² Their share of total taxes rose from 25 in 1980 to around 35 percent more recently. Relative to the Organisation for Economic Development and Co-operation (OECD) countries, Brazil's SNGs play a larger role in public spending; about 23 percent of GDP in spending is equivalent to more than one-half of total public spending. Overall, Brazilian states have considerable revenue autonomy, as taxes provide nearly one-half of their revenue. This percentage is significantly higher than in other countries, but it is similar to other federations, including Canada, Germany, and the United States.

2. **The fiscal framework for SNGs has evolved considerably in the past 20 years, following a debt crisis in the 1990s.** Brazil took several steps to strengthen fiscal responsibility in response to the successive fiscal and economic crises in the 1980s and 1990s. These steps included a new framework to impose greater federal control over subnational finances, in exchange for large federal bailouts, which grew more complex over time (Figure 1).³ The framework is based on two pillars: (1) the fiscal adjustment programs (PAFs) introduced in late 1990s and (2) the 2000 FRL.

3. **The fiscal adjustment programs allow the federal government to set fiscal targets and measures to reduce subnational debt.** States and several municipalities signed contracts with the federal government in the late 1990s, in which they made a commitment to implement fiscal adjustments in exchange for federal government help to restructure their debts—thereby avoiding defaults. In addition, states and municipalities with programs committed to reduce debt to 100 percent of their revenue at an agreed pace; this was later changed to ensure consistency with the FRL. These programs allowed the federal government to control the primary balance and debt levels for all levels of government.

4. **The second pillar of the framework was the introduction of fiscal rules and administrative controls under the fiscal responsibility legislation** (Table 1).

- *Fiscal rules:* The FRL includes a limit set by the Senate for debt, debt issuance, and debt service. It also introduces limits on personnel expenditures. States or municipalities that breach the debt limits are forbidden from further credit operations and are prevented from receiving new voluntary transfers from the federal government. States or municipalities that

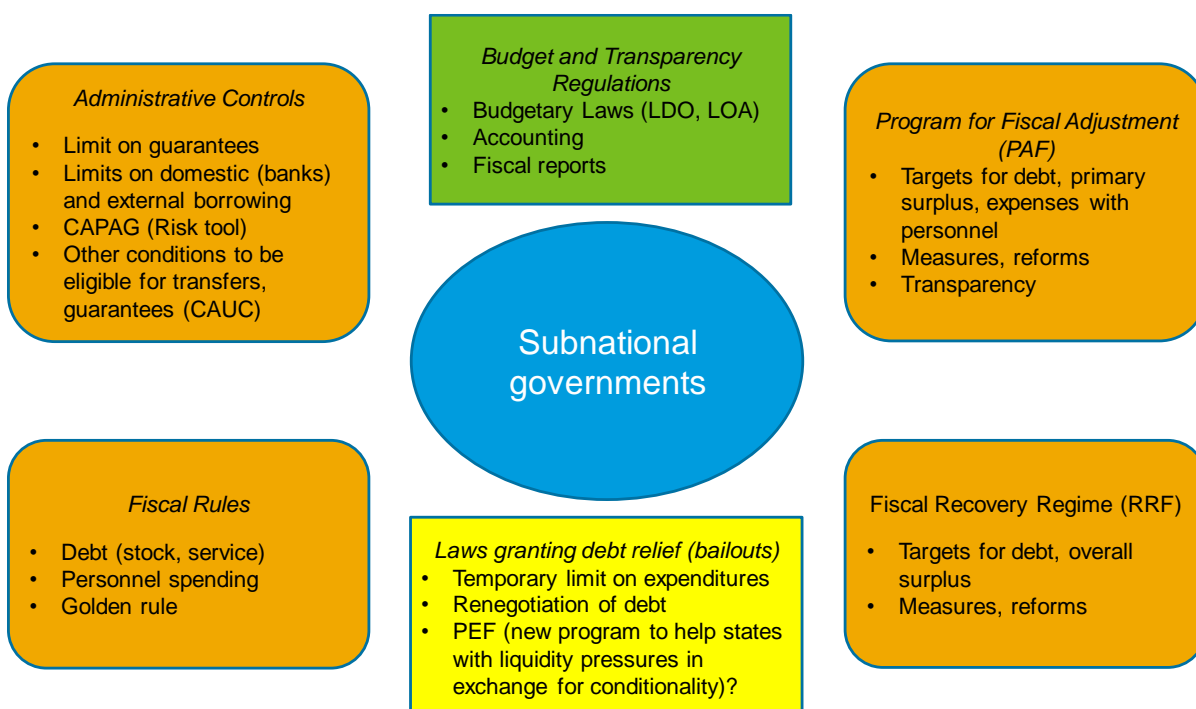
² The 1988 Constitution assigns exclusive powers to the federal government (including national defense, social security, issuance of currency, control of public debt, and regulation of interstate and foreign trade), and concurrent responsibilities shared with states (including taxes, education, and social assistance). States are granted the powers not prohibited in the Constitution, and municipalities are elevated to federal entities.

³ See IMF. 2019. "Technical Assistance Report: Strengthening the Framework for Subnational Borrowing." IMF Country Report No. 19/302, Washington, DC, September.

breach the personnel limits are prohibited from hiring and from raising salaries, as well as from receiving guarantees and new voluntary transfers from the federal government.

- *Administrative controls:* The framework also comprises a series of restrictions, including those on guarantees that the federal government grants to SNGs and on limits on annual external and domestic loans. SNGs are not allowed to issue bonds. The FRL also introduced important innovations to strengthen the budget process and fiscal transparency.

Figure 1. Brazil: A Complex Framework to Control the Finances of Subnational Governments



5. As the fiscal situation of many states deteriorated in recent years, the framework was expanded with new tools and temporary fiscal rules. The FRR was introduced in 2017 for highly indebted states that agree to undertake a fiscal adjustment plan. These plans include rescheduling of debt service payments, guaranteeing all credit operations agreed in the program, and allowing new voluntary federal transfers. Moreover, under a 2016 law, states that received debt service relief would need to abide by a temporary limit on expenditure growth (zero real growth for two years); this limit. This support was in addition to a large bailout granted by a 2014 law that benefited some states and municipalities and led to a large reduction in the stock of debt. In addition, PAFs were changed to align them with the FRL.

Table 1. Brazil Subnational Governments: Fiscal Rules and Administrative Controls

	Legal basis	Definition	Limit
<i>Fiscal rules:</i>			
Golden rule	Constitution	Credit operations (includes financial revenues) cannot exceed capital expenditures (includes amortizations)	
Limit on personnel expenses	Fiscal Responsibility Law (FRL)	personnel expenses as share of net current revenues (RCL)	60%
Debt ceiling	FRL, Senate resolution	Net debt as share of RCL	States: 200%; municipalities: 120%
Debt service ceiling	Senate resolution	Annual debt service as share of RCL	11.5%
Spending limit (two years)	Law 156/2016	Limit on expenditures growth	zero real growth
<i>Administrative controls:</i>			
Annual limit for federal guarantees	Senate		
Limit on banks' credit	Resolution by National Monetary Council		
Limit on external credit	COFIEIX		
Limits set in debt refinancing contracts (fiscal adjustment programs)	Laws 9496/97, 8727/94 and 156/16, and MP 2185/2001	Targets for debt stock, primary surplus, personnel expenditures, cash, among others	
Limits on tax benefits	FRL		

B. The Effectiveness of the Rule-Based System Has Been Limited

6. The new rule-based framework had mixed success in bringing subnational debt to more sustainable levels. In several states, including the largest ones, debt remained high throughout the period after the introduction of the FRL (Figure 2) and some are now facing significant debt distress. In other states, however, debt did decline significantly to less than 100 percent of revenue (Figure 3). Several states have entered, or applied to enter, the FRR and have already stopped paying their debt service to the federal government (AP, GO, MG, RJ, RS). Other

states have defaulted on the debt guaranteed by the federal government (AP, GO, MG, RJ, and RN); although the federal government promptly paid the creditors, it could not recover the counter-guarantees from the defaulting states.

Figure 2. Brazil: Debt in More Indebted States, 2001–19 (Share of revenue)

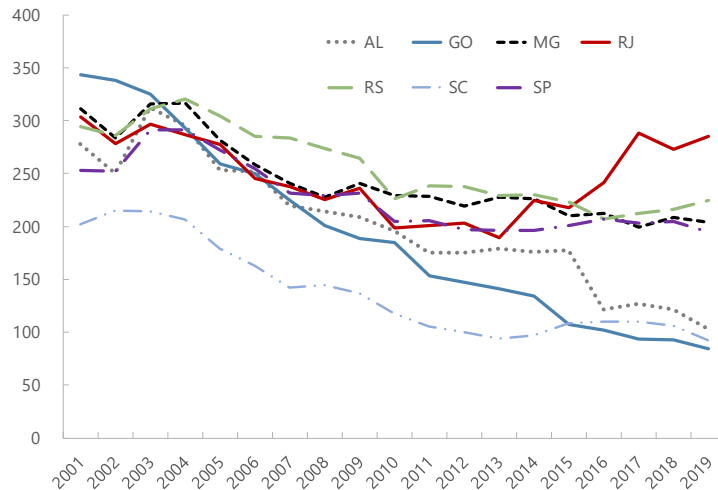
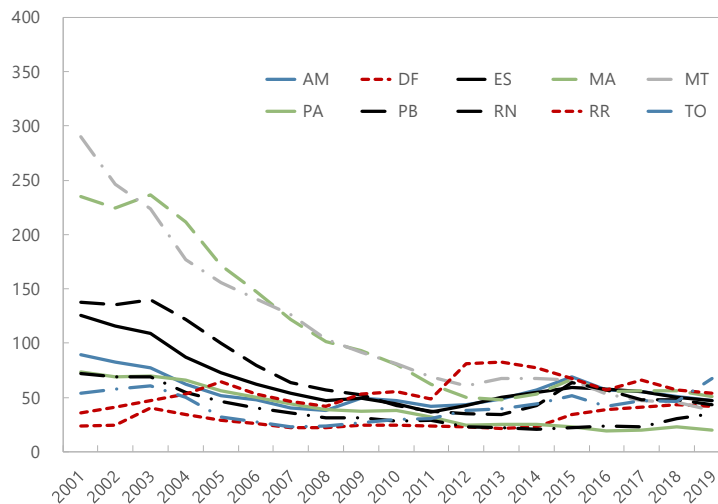


Figure 3. Brazil: Debt in Less Indebted States, 2001–19 (Share of revenue)



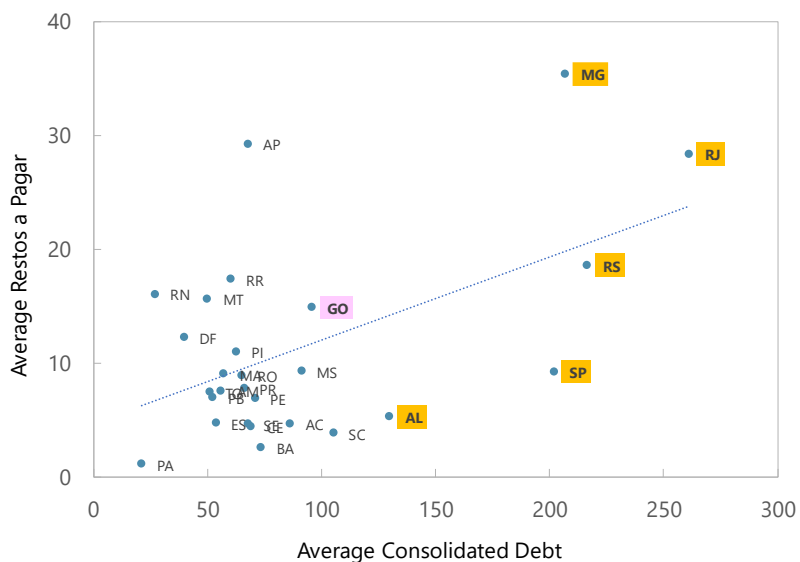
Sources: Brazilian National Treasury and IMF staff calculations.

Note: Data from 2001–14 reflect financial debt as a ratio of RLR; data from 2015 onward reflect consolidated debt to RCL ratio. Data from 2019 were reported by the states but not yet checked by the National Treasury.

7. Many states have also accumulated significant account payables (*Restos a Pagar, RAPs*). This is the case even for states with lower debt in recent years (Figure 4) and reflects significant liquidity pressures, because available cash is lower than short-term liabilities (Figure 5). This suggests that states facing liquidity pressures are not able, or willing, to borrow under the existing framework. Several state capitals also present high levels of RAPs (as a share of

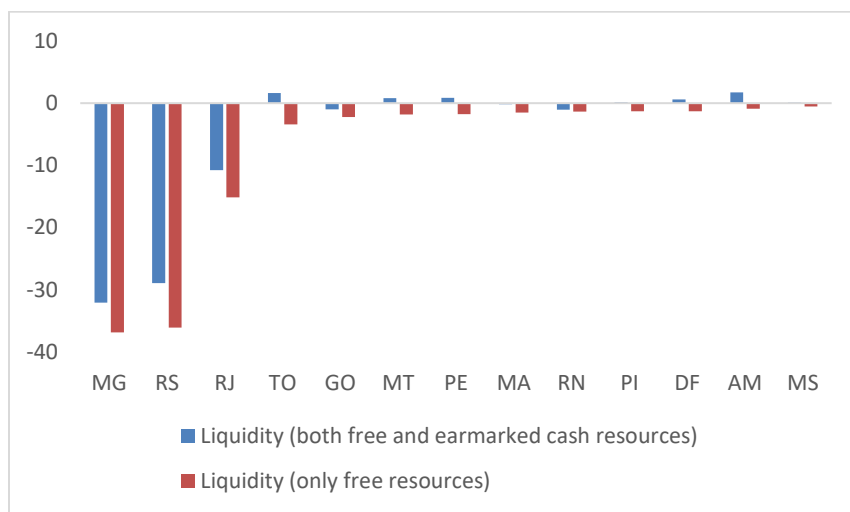
revenues).⁴ More than 1,100 municipalities ended 2019 with more RAPs than cash, indicating severe liquidity constraints.⁵

Figure 4. Brazil: *Restos a Pagar* and Debt Levels, 2015–19
(Share of net current revenues)



Sources: Brazilian National Treasury and IMF staff calculations.

Figure 5. Brazil: Liquidity Pressures in Several States, 2019 (R\$ billion)



Sources: Brazilian National Treasury and IMF staff calculations.

Note: Liquidity is the total (or free) cash minus short-term liabilities.

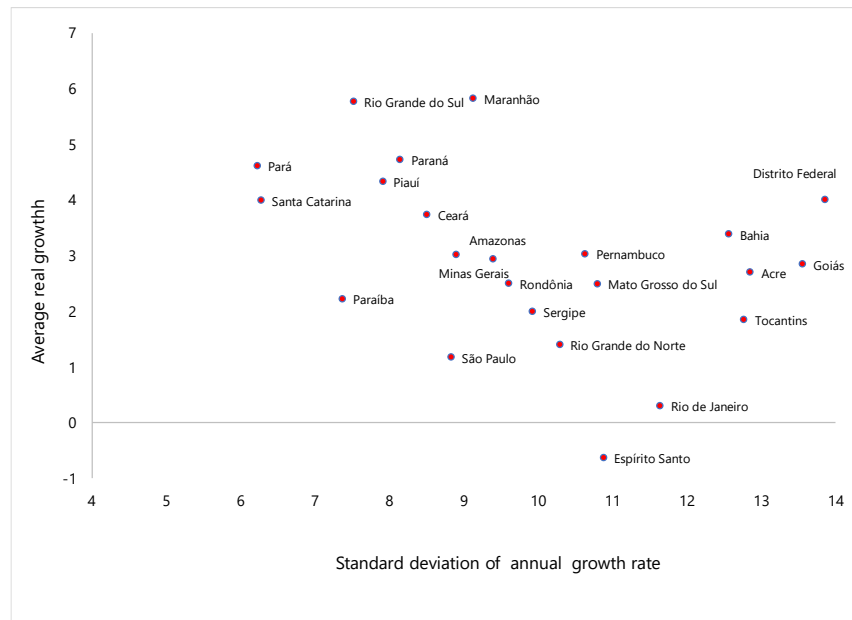
⁴ See the Brazilian National Treasury “Boletim de Finanças dos Entes Subnacionais” (2019).

⁵ Firjan’s report “Índice Firjan de Gestão Fiscal” (2019).

8. Many subnational governments have also breached several elements of the FRL, including the limit on personnel spending. All but three states breached the intermediate limit of 54 percent of net current revenue (NCR); some breached the 60 percent limit in 2018, based on data from the National Treasury.⁶ In addition, about one-half of all municipalities had personnel expenditures that exceeded the intermediary limit or the 60 percent limit in 2018, according to research conducted by the Federation of Industries of the State of Rio de Janeiro (Firjan 2019). There are also concerns that states and many municipalities have breached the rules on RAPs; governments in the last year of their mandates are expected to only accumulate RAPs up to the level of available cash. For example, according to the State Court of Accounts, about one-half of the municipalities have breached this limit in the state of São Paulo.

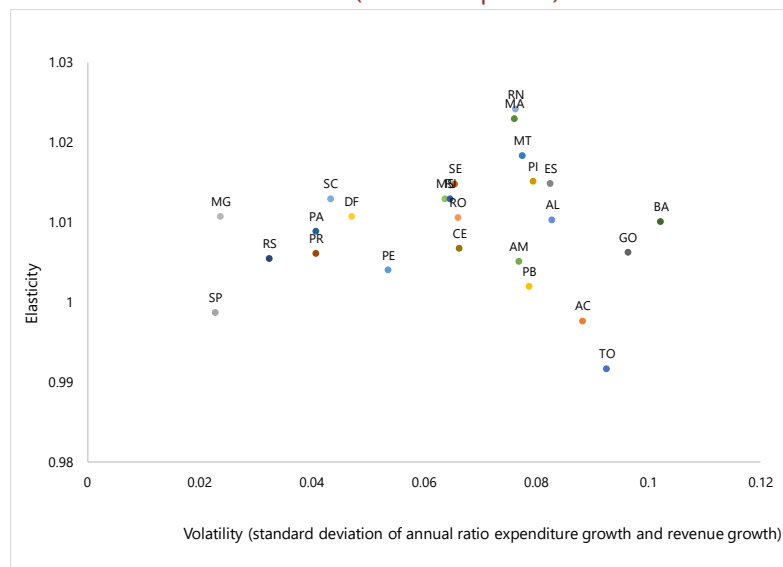
9. The framework has also permitted spending at the subnational level to be volatile and procyclical. Expenditure real growth (in constant prices) tends to be unstable in several states (Figure 6), which partly reflects revenue volatility because the elasticity of expenditure growth relative to annual current revenue tends to be high (Figure 7). For example, over the past 10 years, expenditure growth in the states of Rio de Janeiro and Espírito Santo has been, on average, very low (or negative) but with large fluctuations that reflect oil price shocks and, in the case of Rio, high levels of indebtedness.

Figure 6. Brazil: Real Current Primary Expenditures, 2008–18 (Percent)



⁶ The National Treasury calculates the indicator with a consistent methodology across all states and in line with the FRL. See National Treasury. 2019. "Boletim de Finanças dos Entes Subnacionais."

Figure 7. Brazil: Elasticity of Current Primary Expenditures Relative to Current Revenue, 2008–18 (Constant prices)



10. Several factors explain why the framework did not deliver the expected improvements in the financial health of SNGs. In part, it reflects economic reasons. Brazil experienced a deep recession in 2015–16 that affected all levels of government. Structural factors, such as rising pensions, also contributed. Other important weaknesses included the following:

- The framework tends to promote procyclical behavior. Many of the FRL limits and rules are calculated as a share of net current revenues, which are highly volatile in most states. Accordingly, fiscal policy tends to be reactive to annual changes in revenues. For example, personnel spending and borrowing can grow faster in periods of temporary high revenue growth. But it also implies, however, that, once revenues fall, governments will have to either breach the rules or contract sharply spending growth. This procyclical behavior is exacerbated by widespread revenue earmarking.
- There is also a history of federal bailouts and of loosening administrative controls to allow for excessive borrowing.
- It is difficult to monitor the fiscal rules due to the lack of consistent accounting standards and, in some cases, the poor quality of data.
- Weaknesses in internal and external controls allowed for creative accounting to circumvent the rules and, in some cases, undermine budget processes through extrabudgetary spending and payment arrears.
- Significant legal uncertainty exists with respect to the application of the FRL, because the courts grant injunctions that prevent the enforcement of the sanctions; for example, when a state defaults on federally guaranteed debt, the Union has not been able to collect on the counter guarantees.

11. The next section discusses these issues in more detail and presents a proposal for a reform agenda. This agenda, in part, reflects the ongoing efforts by the authorities.

II. STRENGTHENING THE SUBNATIONAL FISCAL FRAMEWORK: GETTING THE BASICS RIGHT

12. Reforming the current rules-based framework will not be successful without strengthening budgetary systems, increasing transparency, reinforcing controls, and reducing structural rigidities. Weaknesses in key governance and public financial management (PFM) areas have undermined the Brazilian fiscal framework. A reform of the fiscal rules that fails to address these shortcomings is unlikely to be successful and could undermine the credibility of any new rules.

A. Enhance Reporting and System of Controls

Reporting

13. The FRL was crucial to set reporting requirements and accounting standards across all levels of government; however, they have not been followed consistently.⁷ The FRL refers to transparent planning as a principle guiding fiscal management. Chapter IX of the law is devoted to transparency, control, and audit. It establishes reporting obligations for all levels of government. It also establishes the obligations to submit public accounts audited by internal control systems, the Courts of Accounts, and the legislative body. In practice, fiscal data are reported inconsistently, and the quality varies significantly across states and municipalities. This reflects the differences in capacity as; some states and municipalities have important weaknesses in the financial management and information systems (FMIS) that they use, which undermines the integrity of the fiscal data.⁸

14. The different account standards and fiscal statistics make it difficult to assess compliance with the FRL, make comparisons across SNGs, and assess the aggregate fiscal situation of states and municipalities. The calculation of key fiscal indicators can vary significantly across states. For example, personnel expenses in some cases exclude the costs of pensions of civil servants' dependents, although the FRL indicates it should include them. Differences in methodology also apply to other fiscal indicators in the FRL, such as debt and revenues. These different interpretations of accounting are used by SNGs to meet the fiscal rules and other requirements of the FRL and avoid sanctions or prohibitions—for example, to increase wages if the personnel expenditures are above the limit.

⁷ See IMF. 2019. "Technical Assistance Report: Strengthening the Framework for Subnational Borrowing." IMF Country Report No. 19/302, Washington, DC, September.

⁸ The FMIS vary across states and municipalities and do not usually follow the federal system.

15. The delay in creating a Fiscal Management Council (FMC) responsible for setting accounting standards, as envisaged in the FRL, has contributed to the problems. The STN has assumed that role; it has issued the *Manual of Applied Accounting for the Public Sector* (MACSP), as well as a standard chart of accounts (CoA). The manual is updated yearly to gradually converge to international standards of accounting (IPSAS) and the *Government Finance Statistics Manual 2014* (GFSM 2014). However, while compliance with the MACSP is mandatory for public sector entities, the application of the manual's norms vary among states and municipalities.⁹ Nevertheless, there are efforts to converge to common accounting standards through technical working groups, including federal and subnational entities. The full development of the *matriz de saldos contábeis*, a comprehensive and consistent database for all levels of government, would be a significant step forward.

16. The creation of the new FMC, currently under consideration by Congress, could enhance compliance with the standards. Article 67 of the FRL envisaged a fiscal council that, among other roles, would adopt accounting standards for the consolidation of public accounts and the standardization of accounts and reports. However, such a council has yet to be created. The important challenges its creation will face include the nature of its composition: whether it should be primarily a technical body and which agencies should be represented, such as the SCAs. Having a technical council, with the representation of different levels of government, could improve its credibility and influence. The FMC could also be granted the authority by law to verify that government agencies at all levels abide by the standards (see Box 1).

Box 1. Examples of Approaches to Ensure Harmonization in Public Accounting

Mexico: The National Council for Accounting harmonization (CONAC) coordinates the national accounting. According to the decree reforming the General Law of Government Accounting (LGCG), each federative entity will also establish an accounting harmonization council that will assist the CONAC in its tasks. The public entities will have the obligation to adopt and implement the decisions made by the CONAC. Its Technical Secretary can establish requirements for the councils on issues related to harmonizing accounting and financial information.

Spain: The General Comptroller of the Central State (IGAE) has two main tasks: (1) internal control of the Executive Power of the Central State and (2) public accounting in the Central State. The General Plan of Public Accounts (2010) is in line with international standards, and subnational governments are required to adapt their accounting systems to the plan. The IGAE manages the system and publishes a database on norms and interpreting reports interpreting the norms.

17. An independent fiscal council could contribute to monitor the fiscal accounts of subnational governments and compliance with fiscal rules. This mandate could be given to the Independent Fiscal Institution (IFI) that already monitors the federal government. However, doing this would require to further strengthen the independence of the IFI by law, be clear on its

⁹ Some also question whether the National Treasury has the authority to impose the standards, given the autonomy of the different levels of government.

mandates, and provide additional resources. Another alternative would be to create fiscal councils at the state level, but it would be important to ensure their independence and capacity. The IFI could monitor states and large cities, such as capitals, annually; it could monitor other cities less regularly, for example, a random sample every year.

System of Controls

18. Internal controls remain weak across many subnational entities, requiring efforts to improve them and to ensure the integrity of the data and budgetary procedures. Although the mission was not in a position to conduct a thorough review, widespread evidence indicates significant weaknesses exist with respect to internal control in states and municipalities. For example, with commitment controls: the commitment, liquidation, and payment stages must be registered in the FMIS; otherwise, payments cannot be processed. These rules, however, are breached in many cases. For example, some states and municipalities have been able to spend outside of the budget; the treasury single account (TSA) statements are not consistent with actual cash; and the account payables (RAPs) have been canceled to meet end-year targets while the debt still existed. There are also cases of constitutional transfers to municipalities in arrears. Although the legal framework has provisions on the need for internal controls, the audit reports show that these controls do not exist or are too weak to be effective.

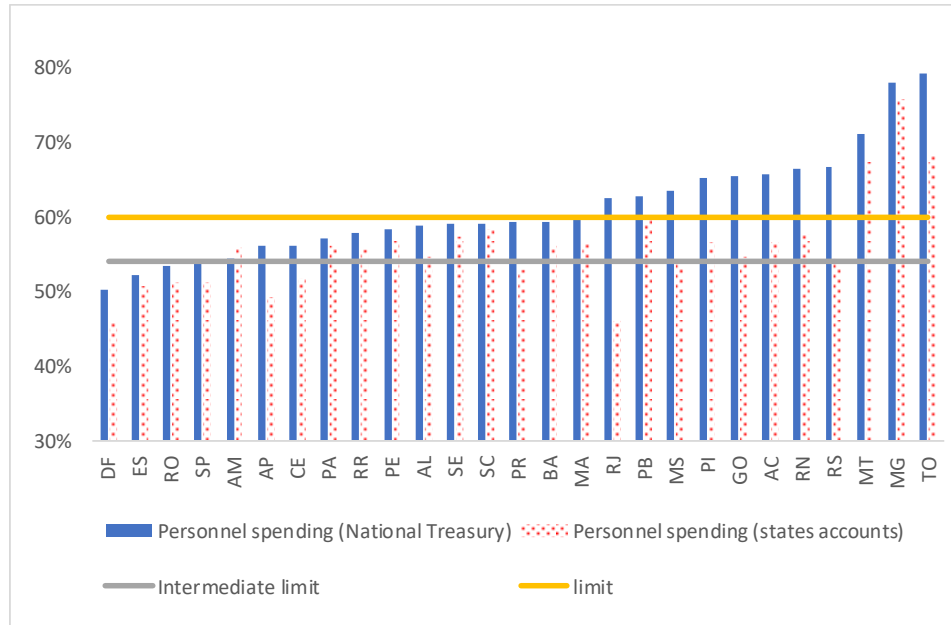
19. The current auditing practices of the state and local courts of accounts (SCAs) vary significantly, including those on interpreting and enforcing the FRL. The SCAs are the external auditors for states and municipalities.¹⁰ They play a vital role in ensuring that SNGs abide by the FRL, including meeting the fiscal rules and approving the accounts of the states or municipalities. However, there is a widespread perception that transparency and fiscal responsibility have weakened as courts have allowed creative accounting practices or have promoted interpretations that contributed to excessive deficits and debt.¹¹ One motivation appears to be that some SCAs are reluctant to trigger potential sanctions or restrictions that affect all of the branches of government: executive, legislative, and judicial. One of the best-known examples is the different interpretations regarding the FRL limit on personnel expenses—in several cases, there are significant differences between the method used by the National Treasury and applied consistently across states, on the one hand, and the ones used by states, on the other hand (Figure 8). Breaching the limit can have major policy implications, for example, on wage policy or being able to receive federal guarantees or voluntary transfers. Another difference has been on how lenient courts have been regarding the excessive use of RAPs and the recognition of expenditures only on future years, which undermines the budgetary process and

¹⁰ There are 33 Courts of Accounts, including those of the state, four for the municipalities, one for the city of São Paulo, and one for the city of Rio de Janeiro.

¹¹ A study on the activities of the state Court of Accounts identified many decisions that contributed to weaken the FRL. See Nunes, S. P. P., G. F. Marcelino, and C. A. T. Silva. 2019. *Os Tribunais de Contas na interpretação da Lei de Responsabilidade Fiscal. Revista De Contabilidade E Organizações*, 13, e145151. <https://doi.org/10.11606/issn.1982-6486.rco.2019.145151>.

fiscal transparency. The criteria used to approve the accounts of SNGs have also varied significantly (Box 2)

Figure 8. Brazil: Most States Have Personnel Spending Above Prudential Limit, 2018
(Share of net current revenues)



Source: National Treasury.

Box 2. State Court of Accounts and Review of Accounts of State Governments

The approval of the accounts of state governments by SCAs has varied significantly across states. For example, in Minas Gerais and Rio Grande do Sul, the accounts have been approved despite significant problems, including large deficits; data suggest that the FRL was breached in several areas, including personnel spending limits. In addition, both states have seen (1) questionable use of sources of funding for the budget, including payment arrears related to wages, suppliers, and transfers to municipalities; and (2) the use of judicial deposits—which required changes in legislation to ensure its legality.

Some SCAs, however, have been more active in raising alerts about problems and in rejecting accounts in recent years. For example, in Rio Grande do Norte, the SCA rejected the 2016 and 2017 accounts of the state on several grounds, including the undue cancellation of RAPs and the breach of the personnel spending limit. The SCA also noted inaction by the state government in addressing key challenges, including rising pension deficits and tax arrears.

The Court of Accounts of Goiás identified a series of problems with the 2018 accounts of the state, which raised questions about the integrity of the budget systems and financial and fiscal information. These problems included operations such as the following:

**Box 2. State Court of Accounts and Review of Accounts of State Governments
(Concluded)**

- Opening of additional credits originating in collection and financial surplus without budgetary resources.
- Expenses without previous commitment or without budgetary authorization.
- Breaching the personnel expenses limit and noncompliance with mandatory minimum spending on education.
- Registration of account payables (*Restos a Pagar*) due to insufficient financial availability in the last semester of the political term.
- Failing to comply with the provisions of the SCA to reduce the negative balance in the Treasury Single Account.
- Lower transfers to FUNDEB than mandated.

A court subsequently suspended the disapproval of the accounts by the Court of Accounts on the bases of the lack of right of defense during the proceedings.

20. When the SCAs detect problems, there is often a lack of follow-up actions or enforcement of sanctions, especially with respect to compliance with fiscal rules. The Courts of Accounts can disapprove the accounts if their recommendations are not followed. In the case of general accounts, the court has the options to approve, approve with reservations, or reject. These opinions are sent to the appropriate legislative power that decides on follow-up actions; in many cases, however, no action is taken. At other times, the general courts issue an injunction to suspend the rejection of the accounts. In the case of irregularities identified outside of the scope of the general account, the Courts of Accounts can apply sanctions that can involve fines of up to 30 percent of the wage (of respective authority) and, in some cases, can require disqualification from holding public office from five to eight years.

21. Several reforms to strengthen the governance of the Courts of Accounts and promote more consistent interpretations of the FRL are under consideration.¹² One proposal consists of changing the composition of the judges (*conselheiros*). The SCAs consists of seven judges; five are politically appointed, and two are chosen based on professional background or technical expertise. The proposal envisages that four judges would be chosen based on relevant professional background, and three would be chosen based on political considerations. Another proposal in Congress would grant the Federal Court of Accounts (TCU), in consultation with the SCAs, the authority to settle the different interpretations of the FRL, with binding power for all courts. Other initiatives include adopting a common procedural code of the Courts of Accounts and centralizing information from different courts. There are also regular

¹² As noted by the International Organization of Supreme Audit Institutions (INTOSAI), it is critical to ensure the independence and professionalism of the audit institution.

reviewers of the Courts of Accounts, but these are not published unless the individual SCA agrees to do so.

22. The fiscal responsibility framework has also been undermined by courts' injunctions (*liminares*), including those by the Federal Supreme Court (STF), that can take years to be decided. The STF grants temporary injunctions, which, in practice, can last many years and can have significant financial consequences for the Union and subnational governments, because they affect debt owed to the federal government, guarantees, and transfers between levels of government. This practice creates judicial uncertainty and incentives to escape sanctions through injunctions.¹³ Courts tend to side with states against the Union in the majority of the cases, on the basis of the defense of the provision of basic public services or on the basis of procedural issues, such as the lack of right of defense when a guarantee is to be executed by the Union. Sanctions are usually not progressive and involve severe consequences when infringements occur, which may partly explain the reluctance of courts to enforce the FRL and apply the sanctions.

23. Although sanctions are needed to support the FRL, gradual sanctions and remedial measures could be more effective and credible. The system could put more emphasis on progressive measures that would apply at the risk of infringement (preventive measures), at the verification of noncompliance (corrective measures), and at the persistence of noncompliance (coercive measures), with progressively harder consequences in each phase. In some cases, the corrective measures may not necessarily entail sanctions. The legislation could specify the steps necessary to correct deviations from debt or expenditure limits, and the subnational entity could avoid the sanctions if it takes the necessary steps, for example, by means of an adjustment program. Positive incentives could also play a supportive role. The current framework emphasizes sanctions, but it provides limited incentives for cooperation and compliance. Finally, there could be consideration of measures to reduce the complexity and to increase the flexibility in the framework; our reform proposals would eliminate the need for some of the administrative controls and procedures.

B. Structural Imbalances and Rigidities

24. The implementation of fiscal rules, and achieving fiscal sustainability, is compromised by structural challenges. The primary challenge is most likely the high degree of budgetary rigidities. For example, in the State of São Paulo, discretionary spending accounts for less than 10 percent of total expenditures; in Goiás, it is even less. A key source of spending

¹³ In recent years, at least four highly indebted states (Goiás, Minas Gerais, Rio de Janeiro, and Rio Grande do Sul) and one less indebted state (Amapá) have obtained injunctions from the Supreme Court to suspend debt service payments and/or to prevent the execution of collaterals on debt guarantees. Echeverria (2019) provides a comprehensive analysis of the legal impediments for the federal government to execute collaterals on such guarantees. See Echeverria, Andrea. 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.

pressure comes from social security (SS) due the aging population; several states are already considering or implementing reforms to contain rising SS deficits.¹⁴ This pressure is one reason why the sum of personnel expenses and interest expenses represent the lion's share of the budget; it averaged 60 percent of total expenditures across states in 2017. Additional rigidities arise from constitutional minimum expenditures on health and education, revenue earmarking, indexation rules such as minimum wage growth, and other spending mandates that are set at the subnational level. In such an environment, the fiscal rules are less effective and, at times, incompatible. It will be important to reduce the degree of budgetary rigidities to allow better fiscal management and to facilitate the ability to abide by the rules.

25. The problems with excessive revenue earmarking and mandatory spending are exacerbated by the lack of medium-term fiscal frameworks. For example, SNGs grant large wage increases with little consideration of their medium- and long-term impacts. There is also limited analysis of risks, including the high volatility in yearly revenue.

26. The design of the intergovernmental transfers is also key to ensure equilibrium in the subnational accounts and allow fiscal rules to be effective. Transfers to states and municipalities are very significant and can be the main source of revenue. For example, they represent from 70–90 percent of all revenue for states in the Northern region. For small municipalities, the transfers can constitute 90 percent of their resources. Ensuring that transfers are well-designed involves complex questions that need to be reviewed regularly.¹⁵ Fiscal imbalances may be the result of several factors, such as an assumption of too many spending responsibilities, an inefficient provision of public goods and services, and insufficient revenues to pay for the spending responsibilities—which could indicate that SNGs do not use all of their revenue capacity. The issues identified in Brazil include the following:

- Many small municipalities have a very limited capacity to tax or spend well or to comply with the FRL. This limitation has led to an ongoing debate in Congress on reducing the number of municipalities that have very low populations or that collect very low own revenues.
- Many transfers are earmarked, which contributes to the high degree of budgetary rigidities. Because some of the earmarking is set at the national level, SNGs have limited tools to effectively manage their resources. This limitation has created significant pressures in some states and municipalities, as well as attempts to circumvent earmarking and mandatory spending rules.
- Federal government decisions on the tax system, including tax incentives, have implications for transfers received by subnational governments.

¹⁴ 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. Looking forward, partly driven by population aging and absent a pension reform, the deficit of the subnational pension systems is projected to increase to 2.9 percent of GDP by 2030.

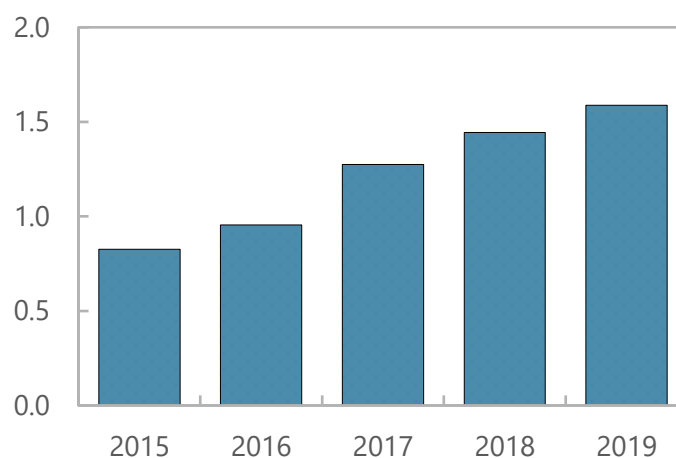
¹⁵ See Annex 1 for a summary of the intergovernmental transfer system.

- The transfers framework is based on outdated criteria that no longer reflect the current realities. In some cases, the design leads to distortions; for example, it favors small municipalities, thereby contributing to their large numbers. In general, the transfers also do not consider the revenue capacity or the needs of different SNGs. A review of the framework would be beneficial.
- Some caution is also needed on ongoing discussions to assign more oil revenue to SNGs, given the high volatility of this revenue. SNGs are likely less able to manage well such volatile and nonrenewable resources—which may lead to excessive spending growth during oil price booms and difficult fiscal adjustments when oil prices fall.

C. Addressing the Rising Expenditure Arrears

27. Arrears have risen significantly, reflecting the difficult financial conditions faced by many states and municipalities. There is no definition of payment arrears in Brazil, but governments publish the data of RAPs—which we use as a proxy for arrears. For states, it rose to an estimated 1½ percent of GDP in 2019 (Figure 9). The combination of lower revenue growth, restrictions on borrowing, and budget rigidities contributes to the accumulation of account payables and might result in arrears. Minas Gerais is one of the main examples; the average financing through RAPs has been equivalent to one-third of its net current revenues in recent years. This practice has also been followed by states with lower debt-to-revenues ratio, such as Amapá, Mato Grosso, Rio Grande do Norte, and Roraima.

Figure 9. Brazil: The Use of *Restos a Pagar* by States Is Growing
(Percent of GDP)



Sources: Brazilian National Treasury; IBGE; IMF staff calculations.

Note: includes both processed and not processed RAPs.

28. The accumulation of expenditure arrears can have a negative effect on economic activity and can raise fiscal costs in the future. A large flow of arrears may disguise the true size of government deficits. It may also contribute to reduced economic growth as it hurts

financially firms that supply the government both as a result of payment delays or restricted credit access from commercial banks.¹⁶ They may also lead to higher future costs for governments if suppliers increase prices to protect themselves from the risk of not being paid.

29. There is no effective framework to contain RAPs across levels of government, except in the last year of government mandates. The FRL only imposes limits on RAPs in election years. The approach to clear arrears also varies significantly. In some cases, states have a strategy to clear arrears (publish timeline and criteria for resolving arrears). In others, however, this process is done in ad hoc ways; for example, using auctions, paying suppliers that agreed to a larger discount first, and paying part of wage arrears depending on cash flow. The mixed action of external auditors to prevent the misuse of RAPs and expenses from previous years contributes to the problem. In some cases, the Courts of Accounts have acted and sanctioned abuses.¹⁷ In other cases, there has been lack of enforcement of the rules. In addition, in some cases, expenditures are made without being properly registered and some RAPs are cancelled at the end of the mandate, but are recognized in subsequent years. Finally, the use of expenditures from previous years (*despesas de exercicios anteriores*, DEA)—an account to register payments from previous years, which should be used only in exceptional cases—is increasing to mask the actual amount of the deficit and arrears.¹⁸

30. Considering the large amount of the RAPs, a strategy to clear the current stock of spending arrears is warranted. A standard strategy to clear arrears should start by taking stock of arrears to understand the extent, composition, and vintage of the government's unpaid bills and to prioritize their clearance. It would include the following:

- Collecting data on the outstanding stock of arrears and verifying them to ensure that the claims are genuine. A database of valid outstanding payments should be established and maintained centrally by the state's Secretariat of Finance. The database should show the discharge of arrears and any subsequent additions to the stock.
- Setting criteria for prioritizing the verification and clearance of arrears. These might include socioeconomic impact, vintage, cost (arrears that accrue interest and penalty charges should be prioritized), risk (of legal action, disruption of essential services, or cost escalation of

¹⁶ See Flynn, Suzanne, and Mario Pessoa. 2014. "Prevention and Management of Government Expenditure Arrears." Technical Guidance Note, IMF, Washington, DC.

¹⁷ For example, the state Court of Accounts of Parana sanctioned the secretary of finance for unduly canceling RAPs in 2015 related to recurrent expenditures; canceling RAPs in 2015 and subsequently registering them in 2016 as expenditures of past exercises (DEA) in 2016; and recognizing as DEA in 2016 expenditures effectively done in 2016 but not registered.

¹⁸ Campos da Silva, Claudiane, Carlos Eduardo Chagas Batista, and Valeska Farias da Silva. 2017. "Despesas de exercicios anteriores (DEA) como instrumento de gestão de resultados fiscais nos estados brasileiros." In *Revista do BNDES* 48:105–58.
https://web.bndes.gov.br/bib/jspui/bitstream/1408/13854/1/RB%2048%20Despesas%20de%20exerc%C3%ADcios%20anteriores%20%28DEA%29%20como%20instrumento%20de%20gest%C3%A3o%20de%20resultados%20fiscais%20nos%20estados%20brasileiros_P_BD.pdf.

future supplies to government), and currency and creditors (clearance of intra-government debts can be done administratively through the annual budget at minimal net cost).

- The repayment modalities could include: cash payments, possibly with a discount; rescheduled payments with creditors according to a predefined calendar and interest rate; earmarked loans; and securitization of arrears by issuing promissory notes discountable by commercial banks, marketable treasury bills, or bonds directly to creditors.

31. Other measures could be considered to prevent the accumulation of expenditure arrears in the future. The legal framework could be clarified to ban or discourage this source of funding, for example, by establishing a definition of payments in arrears that specifies the number of days after which penalty interests on late payments would apply. Strengthening transparency requirements on SNGs could also help to introduce discipline into the management of payments, for example, by requiring detailed publication of the stock of arrears, with its vintage and type of creditor. Finally, progressive corrective measures on the governments could also be considered in cases of late payments.¹⁹ Other actions have proven successful in preventing the accumulation of payments in arrears, such as good practices codes and regular contact with suppliers to help identify possible problems and improvements.

Recommendations

32. Promote transparency and strengthen the system of controls:

- Promote the greater harmonization of accounting and reporting standards. The creation of the Fiscal Management Council, which would develop common standards for all levels of government, would be a crucial step forward. The Council could also be granted the power to verify that the different government agencies at all levels abide by the standards
- Create an independent fiscal council to provide a view of the financial health of SNGs and their compliance with fiscal rules. This mandate could be given to the Senate's IFI that already monitors the federal government. Doing this would require strengthening the independence of the Senate's IFI by law, clearly stating its mandates, and providing it with additional resources.
- Invest in improving internal controls to ensure the integrity of the data and budgetary procedures. Reinforce the integrated financial management system so that it increases controls prior to payments.
- Move forward with reforms under consideration to strengthen the governance of SCAs and promote a harmonization in the interpretation of the FRL.

¹⁹ Spain is an example of a country with a strategy to deal with arrears by SNGs at a time of economic crisis. See Annex 2 for details.

- Review the current sanctions to improve their effectiveness, and add more gradual sanctions and remedial actions.

33. Reduce budget rigidities:

- Reduce excessive budget rigidities, including revenue earmarking, mandatory spending, and indexation. Doing this would help improve fiscal management and compliance with the fiscal rules.
- Review the system of transfers to ensure a proper balance of revenue assignments and spending responsibilities. Consider the effective cost of the provision of public services, the responsibilities of expenditures assumed by the governments, the transfers that SNGs receive from the federal government, and whether SNGs use all of their tax capacity.

34. Clearance of arrears:

- Design a strategy for the clearance of arrears, including temporary and structural measures. It should start by taking stock of arrears to understand the extent, composition, and vintage of the unpaid bills and to prioritize their clearance. Publish the arrears strategy.
- Consider other measures to avoid the accumulation of future payment arrears by SNGs. Expand the legal framework to ban this source of funding, for example, by establishing a definition of payments in arrears and by specifying a number of days after which penalty interests on late payments would apply.
- Require the detailed publication of the stock of arrears, with information on its vintage and type of creditor.

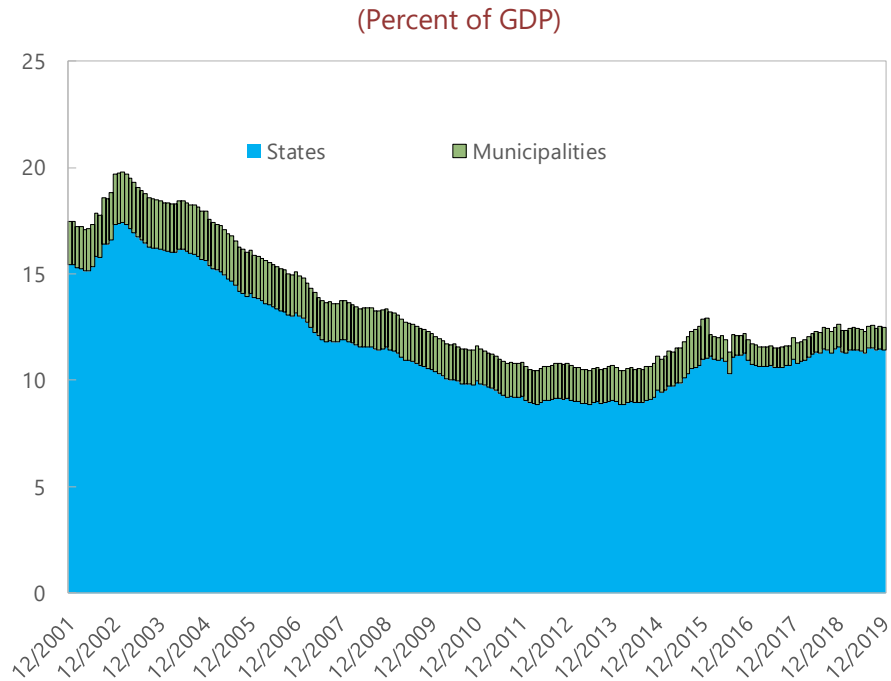
III. DESIGN OF SUBNATIONAL FISCAL RULES

A. An Enhanced Rules-Based Framework

35. The FRL sets limits on debt and personnel expenditures, but it has not been able to prevent subnational fiscal distress. According to the law, the states that breach one of the limits on debt (levels, services, and issuance) or on personnel expenditures are forbidden from further credit operations and are prevented from receiving new voluntary transfers from the federal government. The FRL contributed to a substantial decline in subnational indebtedness during its first decade of operation, reducing the stock of public sector debt of states and municipalities from almost 20 percent of GDP in 2002–03 to nearly 10 percent of GDP a decade later (Figure 10).

Despite considerable debt relief granted by the federal government in recent years, subnational debt has increased by 2 percent of GDP since 2014.²⁰

Figure 10. Brazil: Net Debt of States and Municipalities, 2001–19



Source: Brazilian Central Bank.

36. Given the long history of bailouts, the fiscal rules will only be effective if they are part of a broader set of reforms. This report proposes a revamped framework based on a mutually reinforcing mix of fiscal rules, greater fiscal transparency, and market discipline. In terms of transparency, this framework would include the preconditions discussed above to ensure that the data are reliable and that they accurately reflect the fiscal and financial situations of the individual states and local governments. Subnational governments should have hard-budget constraints—that is, they should be responsible for ensuring a sound and sustainable fiscal management and not dependent on regular bailouts by the Union (see Box 3 for specific reforms). Under such a framework, the many regulations could be reduced, giving more flexibility to SNGs. For example, governments that abide by the fiscal rules would be allowed to decide when and how to borrow in debt markets without federal guarantees. Participation in debt markets would also add incentives for SNGs to be more transparent and to have more prudent

²⁰ In 2014, the federal government conceded to SNGs a retroactive debt relief estimated in near R\$ 100 billion (1½ percent of GDP). In 2016, the federal government reduced the debt service payments of SNGs for 24 months while extending the repayment schedule by 20 years. This measure is estimated to have reduced SNGs' debt service by R\$ 50 billion. In exchange, the federal government required states to adopt a spending cap for two years, with mixed evidence of compliance.

fiscal and borrowing policies—because states with weaker record on fiscal responsibility would face higher borrowing costs.²¹

Box 3. Deeper Reform to Increase Flexibility and Fiscal Responsibility

To ensure appropriate incentives for greater fiscal discipline, while granting more flexibility to states and local governments to manage their own accounts, several changes to the existing framework are recommended.²²

Allow greater access to debt markets, introducing some market discipline. About 90 percent of the states' outstanding debt involves the federal government—either via direct lending through federally owned banks or via federal guarantees. This situation creates incentives for strategic defaults by subnational governments.²³ Granting more freedom to SNGs to access debt markets, without federal guarantees, would promote greater market discipline—and should be complemented by fiscal rules. States with better fiscal discipline would receive lower borrowing costs, contrary to what happens now. At the same time, more freedom would give SNGs greater flexibility in managing their finances, including when to borrow for investment or manage negative shocks, such as temporary declines in tax revenues.

An enhanced Fiscal Recovery Regime (FRR) could become a core element of the framework because it would work as a tool to address cases of highly indebted states (or even large municipalities)—and when the debt ceiling is breached—in exchange for a credible fiscal adjustment. The FRR should be the only mechanism to provide debt relief to SNGs to avoid ad hoc bailouts. Some of the elements that could be introduced include the following:

- Debt relief should be granted gradually as the highly indebted state meets the conditionality in the FRR (structural reforms and fiscal targets). Granting a large debt relief upfront creates incentives to delay the fiscal adjustment. It could also include a more gradual system of sanctions that enables the insolvent state to continue pursuing fiscal consolidation in the event of limited deviations from original program targets. One possibility would be to delay debt relief until compensatory measures are taken.
- The program should include an explicit approach to bring the outstanding stock of debt and the debt service burden to more sustainable levels, in line with fiscal rules. At present, any restructuring of debt—such as reducing the interest rate or extending the amortization period—is done on an ad hoc basis and outside of the FRR. Moreover, the law should set explicit goals for the adjustment plan. Doing this would help provide transparency with respect to the costs of insolvency and the expected burden sharing.

²¹ The process could be gradual to ensure that SNGs return to markets with a sound strategy. See Annex 3 for the example of Spain.

²² For more details on these proposals, see IMF. 2019. "Strengthening the Framework for Subnational Borrowing," Technical Assistance Report, Washington, DC.

²³ In recent years, several states have stopped paying their debt to the federal government or have stopped paying debt service on debt guaranteed by the Union.

Box 3. Deeper Reform to Increase Flexibility and Fiscal Responsibility (Concluded)

- The framework should be extended to include the participation of private creditors. The existing FRR allows insolvent states to auction arrears, but it has no provisions for private creditors in general, not even the obligation for a plan to clear RAPs. A rules-based framework that includes private creditors in the debt negotiations and establishes clear priorities on the treatment of collaterals granted to private creditors would be warranted to address debt overhang at the end of the program period.
- To reduce legal uncertainty, the FRR could be overseen by the judicial system, possibly the Supreme Federal Court. This level of oversight is especially important if the FRR involves an element of debt restructuring; court participation would ensure procedural and substantive fairness.
- Finally, the overall framework could include a fund that acts as a lender of last resort in cases of financial distress and could better manage the risk of strategic default and complement other control mechanisms. The fund would be owned by states, which could lead to more balanced negotiations of adjustment programs under the FRR. The fund would be an alternative to the provision of liquidity under the FRR, imposing conditionality and monitoring fiscal adjustment. It would also be important that the federal government commits to a no-bailout policy to ensure the credibility and effectiveness of the FRR and the fund framework.

B. Options for New Quantitative Fiscal Rules

37. The existing fiscal rules, which rely mainly on debt limits and spending caps, could be maintained—but with significant enhancements. Debt limits are the most frequently adopted fiscal rule by members of fiscal federations. However, there is growing interest in the adoption of expenditure ceilings as operational rules. These ceilings can achieve a more stable fiscal policy, and they are simple and easy to monitor.²⁴ When changing the design of the rules and their calibration, it will be important to ensure consistency with the rules at the federal level. In principle, the rules proposed in the following section could readily be made consistent with broader national objectives. It would be important that the calibration of the rules is consistent with broader objectives, especially if there are changes at the federal level, for example, if a debt limit is introduced for the federal or the general government.

Debt limits

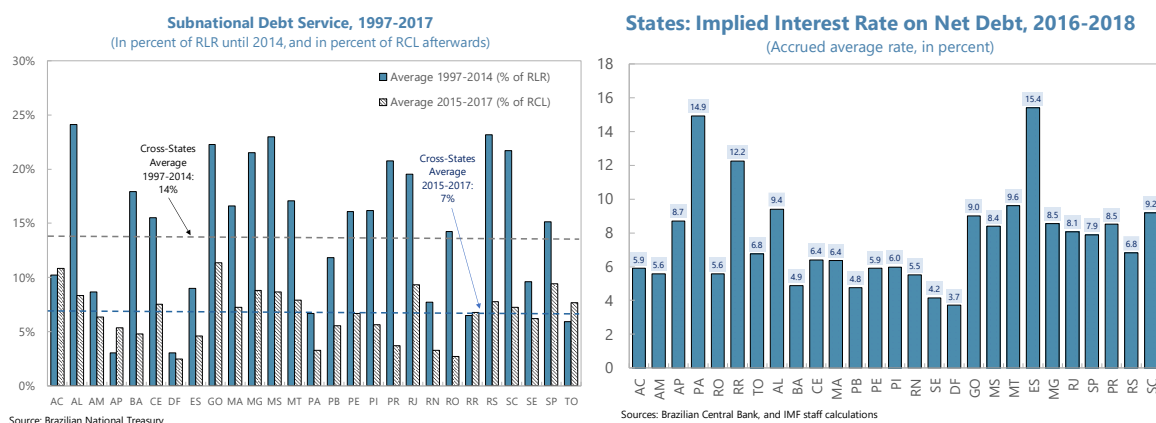
38. The existing debt limits are not binding for most states and municipalities, and they seem too high, given the past experience of debt distress. At present, Brazil's states can be divided in two groups: (1) four states have consolidated debt above 200 percent of net current revenues (NCR), accounting for approximately 75 percent of all states' consolidated debt; (2) the

²⁴ Subnational spending caps can also facilitate taxpayer oversight and enhance credibility. Sutherland, Douglas, Robert Price, and Isabelle Joumard. 2006. "Fiscal Rules for Sub-Central Governments: Design and Impact," Working Paper 1, OECD Network on Fiscal Relations across Levels of Government, OECD, Paris.

other states have debt-to-revenue ratios considerably below that level.²⁵ The present debt limit established in the FRL—net consolidated debt of 200 percent of NCR—appears too high as states that reach that level tend to be in difficult position and face the need for large and disruptive fiscal adjustments, often requiring sizeable bailouts by the federal government. Even states with debt stocks well below the limit have experienced fiscal pressures.

39. Lower debt ceilings would help ensure with high probability that states can withstand most negative shocks without facing debt service distress. The debt limit should be a stable fiscal anchor—regardless of short-term fluctuations—that is consistent with an affordable debt service. For instance, the average debt service for Brazilian states used to be equivalent to around 14 percent of their net current revenues from 1997–2014. Since 2014, the average debt service was cut by one-half, reflecting significant debt relief by the federal government and the low interest rate environment (Figure 11, left panel). Even so, the average implied interest rate on the net debt has been more than 6 percent for most states in recent years (Figure 11, right panel).

Figure 11. Brazil: Subnational Debt Service and Implied Interest Rates



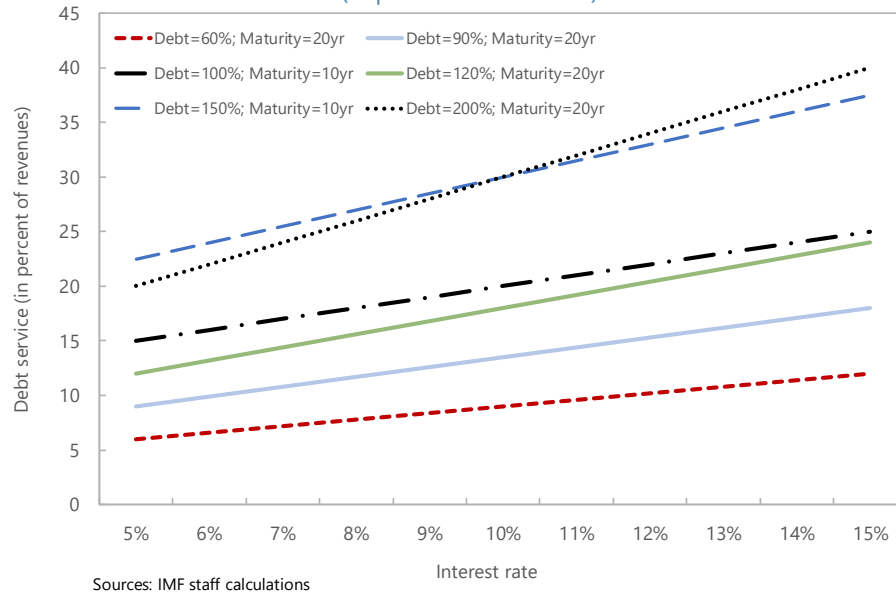
40. Simulations show that debt levels above 150 percent of revenues will, in general, be associated with debt service that is higher than what states have been able to manage.

Figure 12 illustrates the impact of different interest rates and maturity profiles on the debt service to be paid by borrowers, according to the level of indebtedness. For an SNG with a debt-to-net-revenues ratio of 90 percent and average residual maturity of 20 years, the debt service will range around 10 and 15 percent of net revenues—a range that encompasses the average burden faced by most Brazilian states over the past two decades. Moreover, the figure illustrates how this burden can change significantly when the debt stock is higher or has shorter maturity and interest rate changes.

²⁵ The four highly indebted states are Minas Gerais, Rio de Janeiro, Rio Grande do Sul, and São Paulo. In addition, three smaller states have somewhat high debt-to-revenues ratio: Alagoas, Goiás, and Santa Catarina. Together, these seven states account for more than 80 percent of the total subnational debt outstanding.

Figure 12. Brazil: Debt Service Simulations

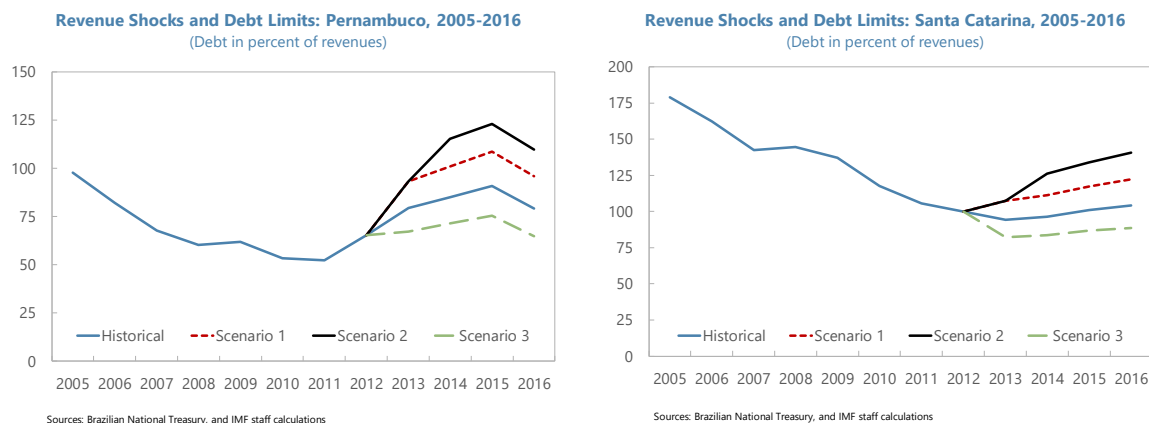
Debt Service Simulations for Interest Rate and Maturity Scenarios
(in percent of revenues)



41. Stress tests for two states highlight the risks of debt shocks during the boom years.

Based on the historical volatility of their revenues, we developed three shocks scenarios for Pernambuco and Santa Catarina: a one-standard deviation downward shock on the annual rate of growth of revenues for one year (Scenario 1), the same for two years (Scenario 2), and a one-standard deviation upward shock for one year (Scenario 3). We simulate the impact of the fall in revenue on the deficit and stock of debt, assuming there is no policy response. Given the historically high volatility of revenue, these shocks highlight how fast debt can rise. As Figure 13 shows, the impact can be very large. Under scenario 2, Pernambuco's debt-to-revenue ratio could jump by close to 50 percentage points in the space of a few years.

Figure 13. Brazil: Debt Limits: Scenario Analysis for Two States



42. A safe debt ceiling of around 100–120 percent of NCR would be compatible with an affordable debt service and would create a buffer to manage adverse shocks. The debt ceiling could be set as share of an average of past years (for example, five to 10 years) net current revenue to reduce the volatility of the indicator.²⁶ A debt ceiling of around 100–120 percent would also allow space to manage a negative shock; even if the state were to get close to the threshold (or even if it breached it), it would have time to adjust before experiencing heightened debt distress. Significantly reducing the debt ceiling to the suggested values would require an adjustment plan for only a few states, although the largest ones have debt considerably above the ceiling.

43. A gradual automatic correction mechanism could also be introduced. If a state were to breach the limit, the FRL could specify measures to ensure a gradual adjustment—beyond what is envisaged in the law at present. For example, the law could set intermediate thresholds under which the state would need to adopt a plan (such as including a primary balance target) to bring debt under control over a prespecified time horizon. As long as the state is between the intermediary threshold and the limit, the prohibitions regarding new borrowing and transfers could be less restrictive while the state approves an adjustment program. Such adjustment program could be reviewed by an independent fiscal institution.

44. States under debt distress should enter the fiscal recovery regime (FRR). States with debt-to-revenues ratios significantly above the debt ceiling should join the FRR—this could be mandated above a specified debt level. The FRR should be the only legal mechanism to address cases of highly indebted federative entities that breach debt limits, in exchange for a credible fiscal adjustment that restores sustainability. This requirement would reduce the expectation of ad hoc bailouts by the federal government. States would bring debt and debt service down to prudential levels in a prespecified time horizon, supported by a medium-term adjustment plan and, if needed, a debt restructuring strategy that involves all creditors (see Box 3).

45. For municipalities, a balanced budget rule could be considered. Most municipalities have debt well below the debt ceiling (120 percent of NCR). The average net debt for non-capitals during 2016–2018 was zero or negative for most states, with the exceptions of Bahia and São Paulo (Figure 14). Nevertheless, two large state capitals—Rio de Janeiro and São Paulo—had average net debt-to-revenues around 60–80 percent during this period. Still, many municipalities have faced fiscal distress and have required federal support. Consideration should be given to significantly reducing the debt limit for municipalities, possibly differentiating between large cities and smaller municipalities. Alternatively, Brazil could shift to a balanced budget rule for all municipalities. Doing this would be consistent with the reality that most municipalities do not have the capacity to borrow and have overall deficits around zero (Figure 15). These rules make special sense for local governments as the other levels of government are usually responsible for

²⁶ The debt ratio could be set to the average level of revenues (for example, over the past five years) or to a level of revenues consistent with a long-term average revenue growth (for example, over 10 years). Doing this would avoid large fluctuations in the debt ratio due to temporary volatility in revenue.

countercyclical policies. In addition, many projects are funded with transfers or grants and do not depend on local fluctuations in revenue. Nevertheless, local governments could create “rainy day funds” that would accumulate savings when revenues are higher than expected and could finance budgets when revenues fall.²⁷

Figure 14. Brazil: Net Debt: Capitals and Other Municipalities

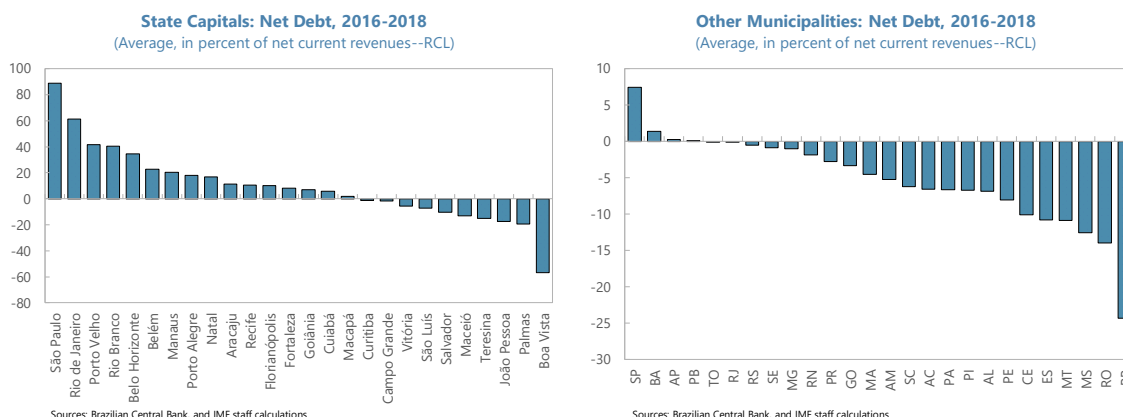
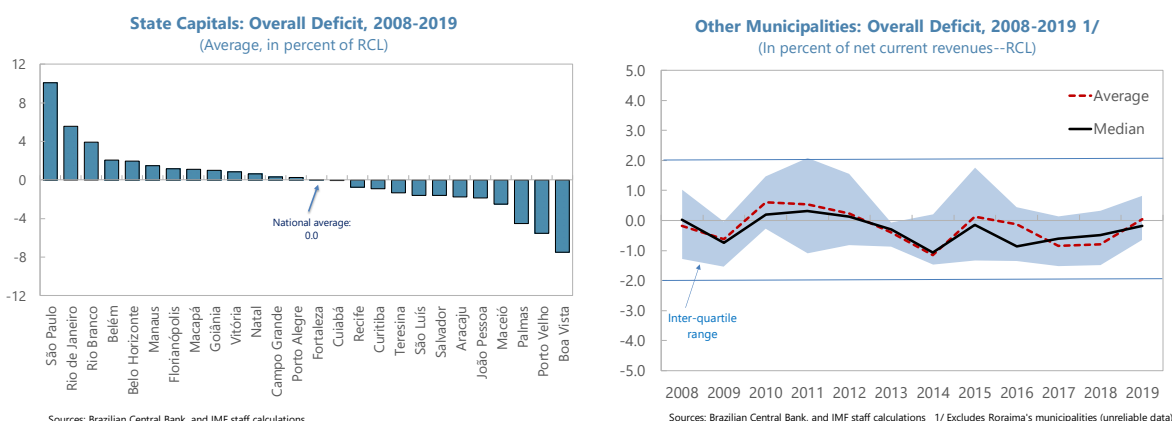


Figure 15. Brazil: Overall Balances: Capitals and Other Municipalities



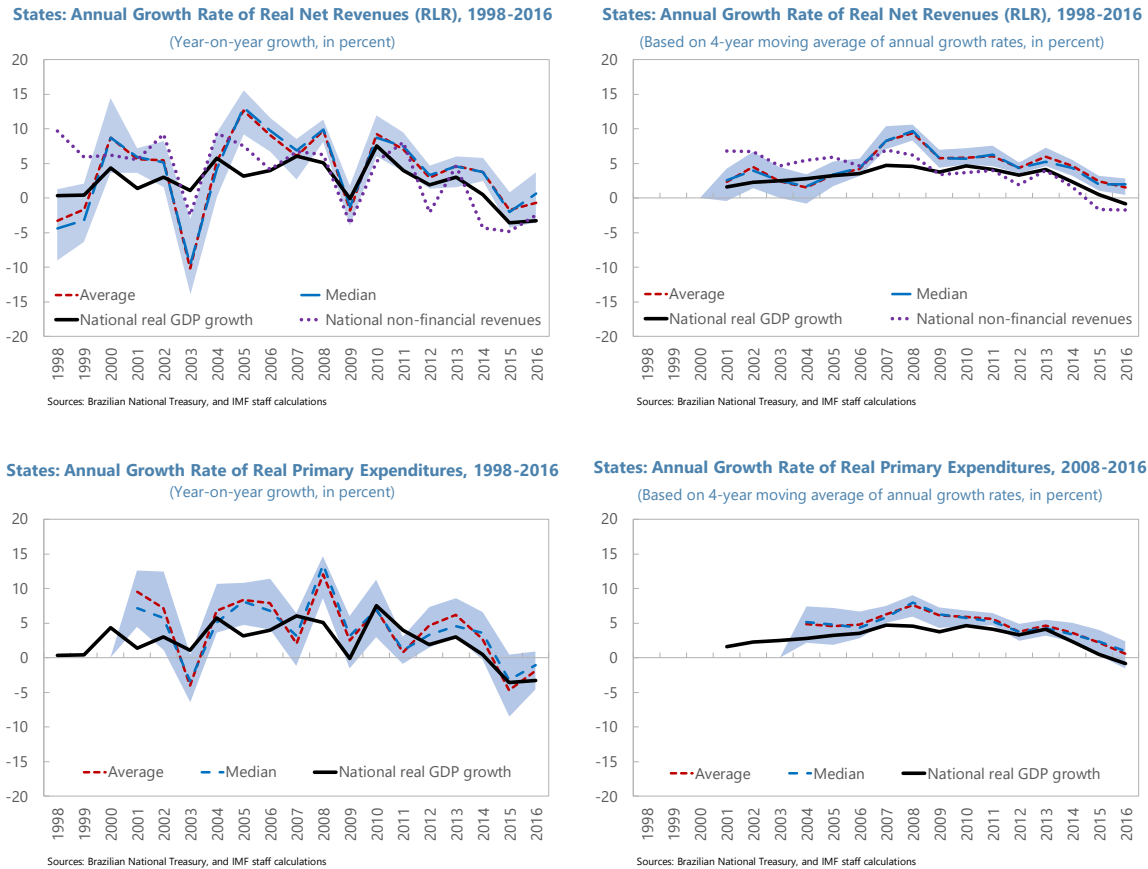
Spending limits

46. A ceiling on expenditure growth for states could help reduce the high procyclicality of expenditure. Subnational revenues are volatile in real terms (constant prices), often even more than real GDP—which tends to be reflected in volatile expenditure growth (Figure 16). As such, the existing indicators used in the FRL that rely on ratios to subnational revenues are prone to be procyclical. Introducing a cap on primary expenditures growth could help bring more stability to subnational budgets. Doing this is important not only to ensure a stable provision of

²⁷ Balanced budget rules in different forms are common in OECD countries. In practice, rainy day funds are used together with nominal budget balance rules, mainly by SNGs in federal countries. This is the case for 48 US states and state and local governments in Canada, Mexico, and Sweden.

essential public services but also to help stabilize the economy over the economic cycle because state level expenditures play a significant role in this process.

Figure 16. Brazil States: Annual Real Growth of Revenues and Primary Expenditures



47. The subnational spending cap would apply to the growth of total primary current expenditures, similar to the one in place at the federal level. The target could be set in the FRL or, alternatively, states could have the ability to set their own limits within broad guidelines established by the FRL. The spending rule would apply uniformly to all while considering the specific state circumstances. A proposal would be to set the real growth limit on total primary expenditures based on the trend growth of the state's current revenues—for example, equal to or less than the average growth of real revenues over the past decade.²⁸ The quantitative limit could be reviewed and, if necessary, revised after a number of years (for example, every four to five years). For SNGs that rely heavily on commodity revenues, it may be appropriate to have more prudent strategies because natural resources are exhaustible and more volatile. Revenue windfalls from the mining of nonrenewable resources should be saved—possibly implying more

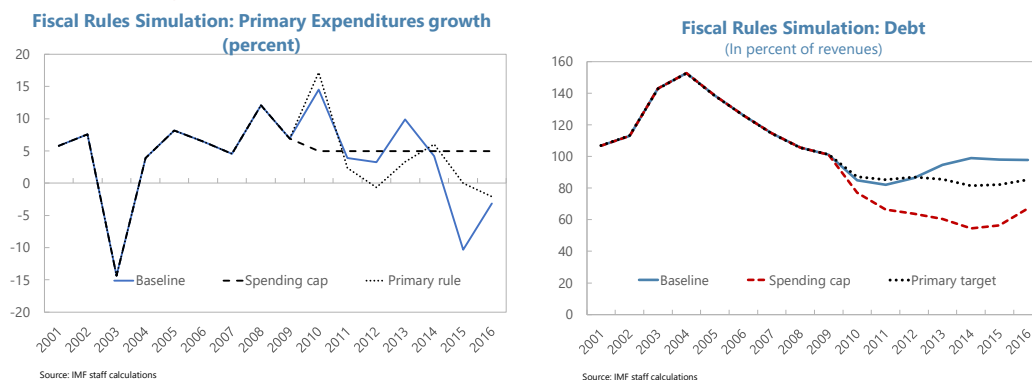
²⁸ Given the complexity of Brazil's federative system and the uneven technical capacity across states and municipalities, the latter entities could be expected to adhere to the state-specific primary spending cap rule.

conservative expenditure limits to avoid boom-bust cycles.²⁹ Doing this will primarily affect the states of Espírito Santo and Rio de Janeiro, as well as some municipalities.

48. The new rule has several advantages over the existing cap on personnel expenses, which has led to widespread creative accounting. The new limit would ensure control of total primary expenditures while giving states the flexibility to manage the composition of their spending. Also, the personnel limit is based on its relationship to volatile yearly revenue, while the expenditure growth ceiling would be more stable—thereby providing a better tool to avoid excessive spending growth during booms or the need for cuts in economic downturns. In addition, this rule would be less subject to creative accounting than the existing limit on personnel spending (or the golden rule); it would still be crucial to ensure high transparency on the reporting and monitoring. Finally, the expenditure growth limit provides more flexibility to manage the budget, but addressing the high degree of budgetary rigidities to ensure that the rule is effective over time remains a priority.

49. Economic simulations, based on historical data, highlight the benefits of the spending rule and its interaction with the debt limit. The expenditure limit is especially useful in guiding budget planning. Using historical data, we compare the effects of two alternative fiscal rules for the State of Pernambuco: (1) a spending cap, and (2) a primary balance limit. A hallmark of this state's fiscal flows is their volatility and, at times, the amplification of national shocks to the local economy. As shown in Figure 17,³⁰ the expenditure ceiling delivers a more stable expenditure path, with debt falling in years when the economy and revenue are strong and rising when revenue falls. This behavior depends on the debt being kept at safe levels to avoid reaching the debt limit.

Figure 17. Brazil: Simulation of Alternative Rules for a State, 2001–16



²⁹ That is, there should be caution with respect to linking expenditure growth to the behavior of oil prices in recent years. The analysis should focus on longer trends and take into account the fact that oil resources are nonrenewable.

³⁰ The baseline scenario reflects actual data. The spending cap scenario assumes primary expenditures growth at a constant annual growth rate of 5 percent from 2010 onward (similar to Pernambuco's own average over 2001–09). In the calibration of the primary target rule, we replace the actual primary-to-revenues ratio from 2010 onward with a constant ratio of 3 percent (similar to Pernambuco's average over the previous six years).

50. The rules should include escape clauses to provide flexibility when there are exceptional shocks. These events can include severe economic downturns, natural catastrophes (like the Brumadinho dam disaster in Minas Gerais in 2019), pandemics (such as COVID-19 in 2020), or other national emergencies. In these rare occasions, escape clauses offer a legal path for temporary deviation from the rules, and they facilitate the return to fiscal sustainability over the medium term. To be effective, escape clauses should be precise on the definition of the types of exogenous shocks that will trigger the legal deviation from the rules, as well as on the expected time for SNGs to return to compliance with the rules. It will be important that escape clauses are only used when necessary to address the specific shock and not to accommodate fiscal slippages due to other factors—adhering to this will ensure that the fiscal framework is credible and robust.³¹

Recommendations

The new framework would be based on improved fiscal rules, stronger external audits, greater transparency, and increased market discipline. Allowing SNGs to have more freedom in directly accessing debt markets, without federal guarantees, would instill greater market discipline—complemented by fiscal rules. Another core element would be an enhanced FRR as the only legal mechanism to address cases of highly indebted states in exchange for a credible fiscal adjustment. Regarding the specific design of the rules:

- Introduce subnational debt limits that ensure fiscal sustainability with high probability under adverse scenarios. Such limits could be complemented with an automatic correction mechanism.
- Introduce subnational spending caps on the growth of total primary expenditures. Doing this would help to reduce the volatility and procyclicality of public expenditures.
- For municipalities could consider introducing a balanced balance rule and rainy day funds.
- Establish well-defined escape clauses that allow temporary deviations from the rules under extraordinary circumstances and offer a legal path for resuming fiscal sustainability over the medium term.

³¹ For example, a local government may receive support from the state or the Union to deal with a natural disaster and, as such, may be able to manage the shock without the use of the escape clause.

Annex I. System of Intergovernmental Transfers

The main intergovernmental transfers are as follows:

- States and Federal District Participation Fund (FPE)
- Municipalities Participation Fund (FPM)
- Maintenance and Development of Basic Education and Education Professionals Enhancement Fund (*FUNDEB*)
- Royalties (financial compensation for natural resources exploration: oil, water, mineral resources)
- Transfers under the National Health System (SUS)
- Manufactured Products Tax Relative to Exports (*Lei Kandir*)

The FPE depends on a historic value and certain coefficients based on population and per capita income. The value was based on fixed coefficients from 1989 until 2015. The new FPE (Law nº 143/2013) established the two criteria for its evolution, in place since 2016: the amount received by each state in the same period in 2015 corrected by inflation and 75 percent of Gross Domestic Product change. Specifically, the FPE is distributed annually as follows: if the reference value (based on the 2015 level) is less than the amount of the resources (21.5 percent of IR and IPI), the reference value will be transferred to the states based on the coefficients defined in the Supplementary Law nº 62/1989; the rest will depend on the coefficients annually defined by the Brazilian Federal Court of Accounts (TCU). These coefficients are based on population and per capita income.

The transfers to municipalities depend on population and per capita income. In the case of state capitals, the distribution criteria depend on population and the inverse of per capita income (considering the state GDP). For the rest, population is the main criterion, but the coefficients for the municipalities of each state are fixed since 1989. For the group with more than 156,216 inhabitants, the distribution criteria are population and the inverse of per capita income (considering the state GDP).

States and municipalities also receive funds from Fundeb that are earmarked for education. The resources come from 20 percent of the following sources:

- FPE
- FPM
- tax on inheritance and donation of any property or right (ITCMD)
- tax circulation of goods and provision of interstate and intermunicipal transportation, services and services of communication (ICMS)
- tax on property of motor vehicles (IPVA)

- tax on rural real estate property (ITR)
- tax on manufactured products (IPI)
- transfers foreseen in the Supplementary Law nº 87/1996 (*Lei Kandir*).

The federal government supplements the resources of the funds with 10 percent of the total amount of revenues defined above. Every state and the federal district has its own fund (27 accounting funds). The criteria for distribution among municipalities are the numbers of students enrolled in infant education and in elementary and high school education; at least 60 percent of the FUNDEB expenses must be applied to improve teachers' salaries. The criteria are calculated every year, and so they reflect the changes in the variables.

There are also transfers related to the health care system that depend on several factors, including regional characteristics, such as demographics and the quantitative and qualitative characteristics of the health care network.

Finally, there are also transfers from states to municipalities: 25 percent of the main state tax (value added tax, ICMS) and 50 percent of the tax on property of motor vehicles (IPVA).

Annex II. Spain's Strategy to Control Spending Arrears

Considering the weight of small and medium enterprises in Spain, curbing late payment in public administrations has been one of the goals of Spanish economic policies in recent years and has played a fundamental role in the economic recovery.

The Spanish strategy for clearing expenditure arrears started with the reforms implemented in 2012, in the worst times of the economic crisis, within a context of severe liquidity restraint in financial markets and with public administrations whose late payments further aggravated the economic slowdown. According to the Bank of Spain, the aggregate commercial public debt grew from 57.1 billion euros (5.3 percent of GDP) to 87.3 billion euros (8.1 percent of GDP) between 2007 and 2011. Although this rise in the stock of public debt took place at all levels of administration, it was more concentrated in SNGs, autonomous communities, and local entities, whose debt accounted for 75 percent of the total in 2011.

The Spanish strategy is based on two types of measures³²: some are of a temporary nature to clear the stock of arrears at the time, and others are of a structural nature to avoid the problem in the future:

- The extraordinary funding mechanisms, such as the Payments to Suppliers Fund and the Autonomous Communities Liquidity Fund, aimed at reducing the temporary component of the arrears and clearing the stock of commercial debt. The Payment to Suppliers Fund mobilized around €30 billion from the central government to suppliers of SNGs; the total in loans from the extraordinary funds is well above €250 billion as of today. Those governments were required to sign 10-year loans with the central government. Those loans included conditionality and monitoring of the fiscal performance through the adjustment plans, which had to be in place until the loans were fully repaid.
- The transparency of the indicator average payment periods (APP) of the administrations has played a fundamental role in creating incentives for them to curb their late payments. Even though the Spanish law contains a legal definition in line with the EU Directive on late payments and therefore establishes a 30-day legal limit on payments to suppliers in the public sector, the Spanish law built a system of obligations for the administrations similar to fiscal rules, around the APP indicator. Irrespective of its size, every government must construct its APP with a common methodology established by the law. The APP is an average that considers both the stock of accounts payable and the time used in the payments made in the past month. The Basic Stability Organic Law establishes a system of sanctions similar to

³² For more information on the Spanish strategy, see Gonzalez, Fernando. 2018: *The Management of Government Expenditure Arrears in Spain* (Instituto de Estudios Fiscales): https://www.ief.es/docs/destacados/publicaciones/documentos_trabajo/2018_06.pdf.

those applying to fiscal rules of SNGs. In cases where the APP exceeds a certain limit, preventive, corrective and coercive measures apply progressively. In cases where a government is unable to reduce the APP, the central government can ultimately block payments from the regular system of transfers to SNGs, to pay that government's suppliers directly and deduct the amount from the transfers.

- One of the key elements of the system is the transparency of the APP. It is monitored by the central government and published on the Minister of Finance's website every month. These publications have an important impact on local media and force discipline on the managers. An example of a local news release is available at the following website:

<https://www.lavanguardia.com/local/murcia/20180122/44218975472/la-region-de-murcia-cumple-por-primera-vez-con-el-limite-maximo-de-pago-a-proveedores-desde-septiembre-de-2014.html>.

Annex III. Spanish Regions' Progressive Return to Financial Markets: Back to Normal

In 2012, the Spanish Central Government created a system of loans to solve the severe liquidity restraints of the subnational governments (regions and municipalities). Subnational governments had seen their revenues fall dramatically after the 2009 crisis and access to financial markets closed, leading them to accumulate important stocks of debt in arrears. The system of loans was designed to clear this stock of arrears, fund the deficit target of the subsequent years (to avoid new accumulation of arrears in a time when there was no access to financial markets), and fund the debt service of SNGs. It transferred the lower cost of borrowing of the Central Government to SNGs, which signed 10-year contracts with a grace period of two years of no interest and which were subject to strong conditionality. The system has mobilized a total amount of €277 billion.

Financial conditions have changed since the inception of the system. SNGs are in a much better situation; most municipalities are in a surplus position. Financial markets are willing to lend again to subnational governments, which would benefit from low interest rates and which are in a better position to honor their debt service.

For these reasons, the Central Government approved an agreement that established the rules governing a progressive return of the regions to financial markets, on July 5, 2018. This agreement is independent of the current regime of authorizations by the Central Government, applicable in certain cases; these cases include issuance of bonds, use of foreign currency instruments, and noncompliance with the fiscal rules as an automatic corrective measure and when debt service is high relative to current revenue. The agreement only establishes the rules applicable to the combination of borrowing from the markets and borrowing from the Central Government.

The strategy should be transparent and known by the markets.³³ The return to markets is likely to be gradual, considering the short average maturity of the debt of the regions and the accumulation of amortizations in the coming years. The regions starting this transition should be those in a better position to access a wide range of institutional investors and those with the most favorable financial conditions. For these reasons, several criteria were required to start the process. These conditions were linked to compliance with fiscal targets in previous years, presenting a low average payment to suppliers, and having a minimal credit rating of investment grade. If the region met these requirements, it had to present a three-year Multiannual Debt Plan, to be assessed by the Ministry of Finance and the Treasury to determine its feasibility.

³³ The press release on the July 5, 2018, agreement is available at the following website:

<https://www.hacienda.gob.es/Documentacion/Publico/GabineteMinistro/Notas%20Prensa/2018/S.E.%20HACIENDA/10-07-18%20CCAA%20Mercados%20Financieros.pdf>.

In the future, all of the regions are expected to gradually return to the financial markets. The transition should be monitored so that it is a one-way transition, reducing the possibility of remaining in the extraordinary funds in the medium to long terms. In this context, it is under consideration to establish a temporary transition fund with a fixed end date of, for example, three to five years; after this period, the region should obtain funds only from markets. The future of the current extraordinary mechanisms would be as a last resort instrument in cases of severe unexpected financial distress; it would be linked to strong conditionality and punitive interests and only used as a last-resort option.