Fiscal federalism in Brazil: the importance of data disclosure of subnational governments

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1.   Introduction

The monitoring of government policies gained prominence after the outbreak of the global crisis in 2008. The evolution of public deficit and debt has received increasing attention from analysts and policy managers. Although the focus of attention is usually directed to the central government, the demand for information on subnational governments (SNGs) is on the rise because of the autonomy that these governments have achieved to manage their finances. This process has brought risks to fiscal stability, and several central governments have been asked to take on unpaid SNGs' debts. Moreover, the default of SNGs may reduce the credibility of the general government. In order to prevent these problems, several measures have been adopted, including the enactment of laws regarding fiscal responsibility that impose limits and conditions for borrowing and require greater transparency of public accounts in order to avoid fiscal mismanagement.

The aim of this work is to show that in the Brazilian institutional arrangement that followed the subnational debt-restructuring operations in the 1990s and the enactment of the Fiscal Responsibility Law (FRL) in 2000,[2] financial disclosure of SNGs acquired greater importance, increasing the demand for high-quality, detailed and trustworthy statistics. In line with these demands, the Ministry of Finance and the Central Bank, the main agencies in Brazil responsible for releasing fiscal data, have attempted to increase information on subnational level. Some challenges, however, remain, such as the timely data collection. Considering that the disclosure of subnational fiscal data is a worldwide challenge, the discussion of the Brazilian case may be helpful.

The rest of the paper is organized as follows: section 2 briefly reviews the literature on subnational debt and deficit control. Section 3 discusses the role of institutions and the evolution of subnational finances in Brazil. Section 4 discusses subnational fiscal disclosure in Brazil and section 5 concludes.

2.   Deficit and debt control in SNGs

The growth of SNGs' debt usually expresses the misallocation of tax resources between levels of government or the lack of borrowing transparency. The challenge of maintaining fiscal sustainability involves the creation of mechanisms that induce SNGs to follow responsible policies, keeping sustainable levels of indebtedness.

The control of loans to SNGs varies significantly between countries, and practices generally reflect the degree of central government control, the level of domestic financial market development and the current economic situation. Ter-Minassian and Craig (1997) distinguish four categories of subnational borrowing control: (a) administrative controls, (b) control based on cooperation between the various levels of government, (c) control based on legal rules

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(rules-based) and (d) control based on market discipline. It should be noted that these categories are usually nonexistent in pure form and there are often a mix of categories.

Administrative control is often exercised through approval of each loan request by the central government, or by setting limits on the deficit of each SNG. In the case of foreign loans, direct control of central government is more frequent, considering that there may be important implications for macroeconomic policy, especially in the foreign exchange policy, whose responsibility belongs more directly to the central government.

Cooperation between central and subnational governments approaches the previous model, but in this case all governments work together in setting goals and macroeconomic parameters, including limits on deficit and debt. It is obviously a very sensitive model, more likely to be successful in countries where there is already some fiscal discipline, and where central government is able to coordinate the various interests.

The control based on rules can include ceilings on indebtedness of SNGs, limits on the maximum amount of annual loans or repayments, or establish that loans can only be taken for specific purposes, such as investments in infrastructure projects. These rules are usually inscribed in the constitution or ordinary laws. A very common norm is the "golden rule", which prohibits loans to current expenditures, restricting it to capital expenditure, particularly investment. One of the limitations to this approach is that its rules are often circumvented by the creation of extra-budgetary entities, the use of state-owned enterprises to obtain loans, or through reclassification of current to capital expenditures. Kopits (2001) outlines that there are usually two basic approaches in subnational fiscal rules: the autonomous and the coordinated approach. Under the first approach the initiative for establishing rules arise from each individual SNG. In the coordinated approach all SNGs are subject to uniform rules under the surveillance of a central authority.

Controlling the debt level through market discipline considers that economic agents are able to assess the borrowers' risk, and are in charge of establishing debt limits and, consequently, the fiscal deficit. In order to establish effective market discipline there must be, firstly, a sufficiently developed financial market, free of regulations that require, for example, that financial institutions buy government bonds or place the government as a privileged borrower (Ahmad, 2005). Fiscal transparency, expressed by the disclosure of SNGs' accounts, allows an efficient evaluation of the borrower's risk, based on its actual ability to pay. However, this requirement is not always fulfilled, especially in developing countries, which generally have limitations in the coverage, quality and timeliness of fiscal data. It should be noted that when the central government indicates the possibility of becoming the final risk taker, assuming unpaid liabilities, market discipline ceases to be a good way to control subnational borrowing.
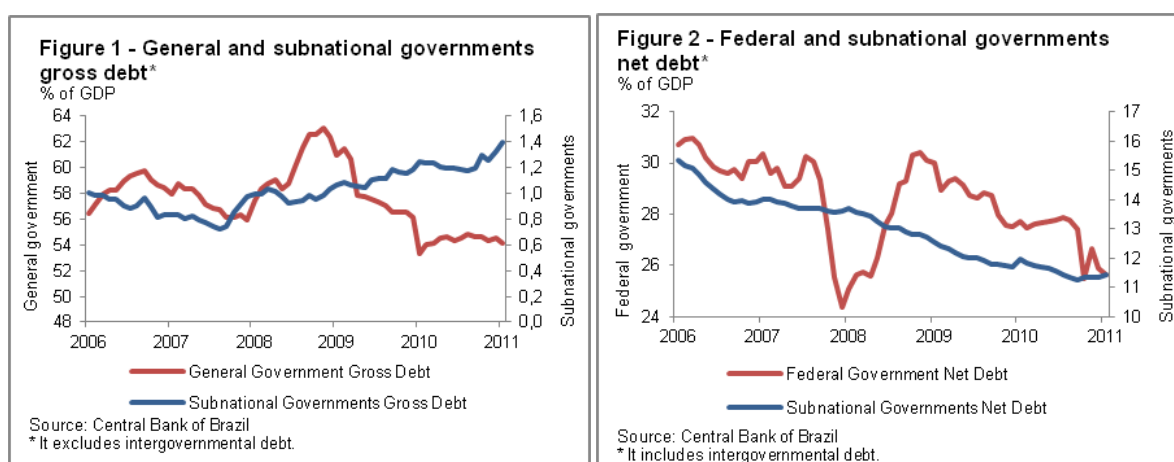
As borrowing is a joint decision between debtor and creditor, limits have also been set to creditors, although the literature on fiscal discipline has focused on the incentives and constraints set to debtors (Liu and Webb, 2011). Lenders do not always take a cautious behavior, especially if there is an expectation that borrowers will receive help in case of repayment difficulties. The controls on the creditors can take, for instance, the form of direct regulation by the central bank, with increased capital requirement to operate with some debtors, such as SNGs.

Finally, SNGs may have a role in counter-cyclical economic policy, which means that debt may increase during crisis. Despite the evidence that some SNGs, mainly in advanced economies, have adopted counter-cyclical measures since the outbreak of the financial crisis in 2008, one problem that may arise is that central governments and SNGs may take different paths when facing an adverse situation (OECD, 2010). The traditional view is that counter-cyclical policy should be carried out only by central governments because of the need to coordinate fiscal policy with other macroeconomic policies, which is usually beyond SNGs' power (Ter-Minassian and Fedelino, 2010). In this context, SNGs' data disclosure can be crucial to understand its fiscal stance and help intergovernmental policy coordination.

In sum, the disclosure of fiscal data may play a major role in controlling the SNGs' debt and deficit, especially when subnational borrowing control is market disciplined or rules-based. Also, it may help intergovernmental coordination, averting macroeconomic mismanagement.

3. The role of institutions and the importance of fiscal disclosure in Brazil's SNGs

The general government gross debt in Brazil reached 54.2% of the GDP in 2011. The central (federal) government reached 53.7%, and the SNGs, 1.4%. However, most of the SNGs' debt in Brazil is with the central government, which does not appear in consolidated data and makes it important to focus on intergovernmental debt. Actually, the main SNGs' debt with the central government reached 10.8% of the GDP in 2011. To understand why the central government is the main creditor of SNGs and why the disclosure of subnational data has become more important it is necessary to analyze the fiscal and institutional developments in recent decades.

Figure 1 - General and subnational governments gross debt*
% of GDP
General Government Gross Debt
Subnational Governments Gross Debt
Source: Central Bank of Brazil
* It excludes intergovernmental debt.

Figure 2 - Federal and subnational governments net debt*
% of GDP
Federal Government Net Debt
Subnational Governments Net Debt
Source: Central Bank of Brazil
* It includes intergovernmental debt.

Growth in subnational debt in Brazil began in the 1970s as a way to circumvent the centralization of resources (Mora, 2002). With the 1988 Constitution, SNGs got more autonomy, increasing its share in total revenue, but the indebtedness at the end of the decade was already high and in 1989 the central government assumed and refinanced states' external debts.
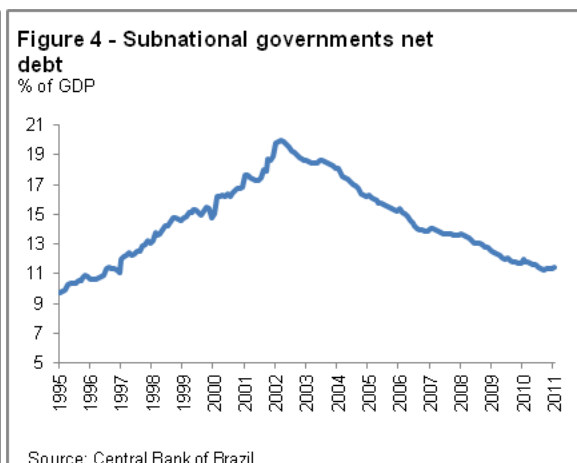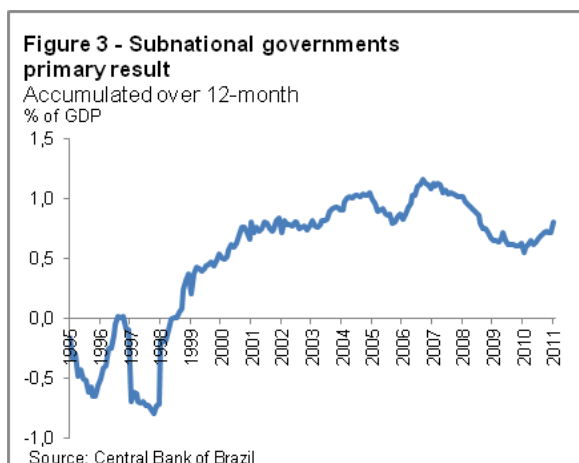
However, refinancing the states' external debt did not avoid the increase of SNGs' total debt in the early 1990s. In 1993, the debt with domestic financial institutions was accepted and refinanced by the central government, as part of negotiations that resulted in the Law 8,727. This law rescheduled loans taken until September 1991, giving a period of up to 20 years for repayment. Yet it kept unsolved the rapid growth in securities debt. Despite the ban on the issuance of new securities, except to repay the matured debt, the securities debt continued to grow due to the high interest rates that aimed at helping finance the balance of payments and maintain the parity of the Real - the new currency that was launched in 1994 - with the dollar, which was regarded essential to keep macroeconomic stability.

In the second half of the 1990s, given the growth of the SNGs' debt, a broad program of aid to state governments was drawn, demanding in return, for the first time, fiscal adjustment measures that would avoid the recurring financial crises. The negotiations resulted in the enactment of the Law 9,496 in 1997. This Law refinanced states' debt with the central

government,[3] thus permitting a reduction of financial charges. The agreements established monthly repayments over 30 years, limiting them to a portion of net revenue, and the states had to set a fiscal adjustment program with annual primary surplus targets. After the agreements, the states improved their primary results, but the debt problem was transferred to the central government (Goldfajn and Guardia, 2004).

Although the subnational debt was concentrated in the states, in 1999 the central government launched a program to take on and refinance the municipalities' debt (Provisional Law 1,811), similar to what had been signed with the states, but without the requirement to implement any fiscal adjustment plan. The debt-restructuring plan particularly benefited the city of São Paulo, the largest in the country.

The structural reforms that began after the enactment of the Law 9,496 substantially changed the path of the primary result, initiating a consistent adjustment. Most of the states signed the debt refinancing agreements in the first half of 1998, and the effect in the SNGs' fiscal result is clear-cut. The primary deficit accumulated over a 12-month period, which reached 0,7% of GDP in June 1998, changed to a surplus from May 1999 onwards. Several works have highlighted the importance of the agreements to the adjustment. For instance, Giambiagi and Ronci (2004) emphasize the increasing in subnational revenues after 1998 as a result of the improvement in fiscal administration. Mello (2008) estimated a fiscal reaction function and found out that the institutions after 1998 played a major role in the subnational fiscal adjustment.

Figure 3 - Subnational governments primary result
Accumulated over 12-month
% of GDP
Source: Central Bank of Brazil

Figure 4 - Subnational governments net debt
% of GDP
Source: Central Bank of Brazil

In 2000, after a long negotiation process, the FRL was enacted, setting limits and rules of fiscal management for the three levels of government,[4] including limits on personnel payroll and rules for budgeting. It also states that the budget laws should set annual targets for both primary and nominal results, reinforcing a measure, regarding primary results, that had been followed by SNGs since the agreements. An important novelty was the prohibition of loans between governments. Thus, SNGs' bailouts by the central government, which occurred several times before the Law was published, are no longer possible. The bailout operations that took place before the Law were kept, but they cannot be rescheduled or amended. Another novelty was the reports on fiscal disclosure, including a four monthly report on debt

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[3] Twenty-five of 27 states had their debts refinanced by the central government in accordance with the conditions set in Law 9,496/1997.

[4] Brazil is a federal republic with a central (federal) government, 27 states (including the Federal District) and around 5,600 municipalities. Each unit has its own Executive and Legislative branches. The Judiciary is found only in federal and state levels. The tax base for each government level as well as mandatory transfers is clearly defined in the Constitution.
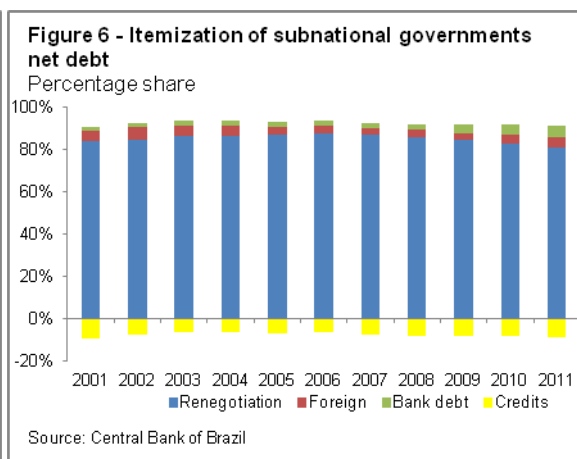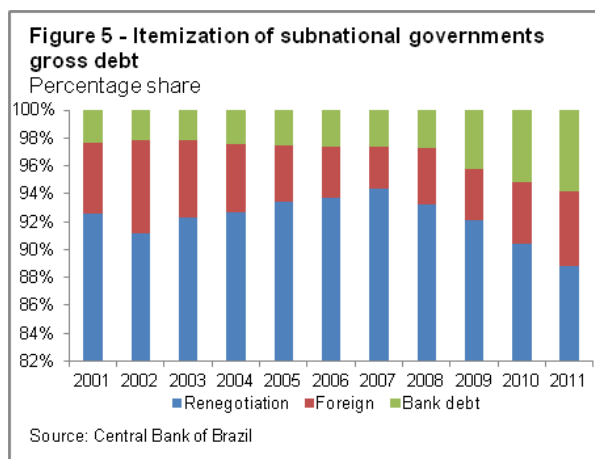
and borrowing. These reports aim to provide a comprehensive overview of fiscal situation, increasing the amount of information on SNGs.

In addition to these rules, in 2001 the Senate[5] set new limits on the amount of public indebtedness. For the states, the consolidated net debt was limited to two times the current net revenue, and in the case of municipalities, to 1.2 times (Senate Resolution 40/2001). For SNGs whose ratios were above the limits, it was given a period of fifteen years to address the issue. The Senate also set limits for the annual amount of disbursement and debt repayment (Senate Resolution 43/2001). For states and municipalities, the maximum disbursement was set at 16% of current net income, taking into account the annual schedule. On the other hand, debt repayment, including interest and other charges, was limited to 11.5% of current net income. Besides these limits, the golden rule applies to all government levels and the Central Bank cannot grant loans to any government.

When a SNG wants to take a loan, its financial situation is examined by the Ministry of Finance, according to the limits and conditions set by the Senate. Financial institutions (creditors) may perform it own analysis and are free to reject any loan request.

Finally, there are also rules limiting the supply of domestic bank credit to the public sector. These rules are set by the National Monetary Council (CMN). The CMN has limited the amount of loans that each financial institution may offer to the public sector to 45% of its net worth (Resolution 2,827, of 2001). There is also a limit for loans to the public sector altogether.[6] These limits are controlled by the Central Bank.

The new rules and adjustment measures that have been adopted are helping dealing with the debt question. Since the early 2000s subnational net debt has declined when compared to the GDP. This fall in total net indebtedness of SNGs is mostly a consequence of the reduction of debts renegotiated with the central government, compared to the GDP. On the other hand, new loans have been contracted with financial institutions, which are increasing the amount of bank debt and changing the composition of total subnational debt. The improvement in the fiscal situation has therefore increased confidence in the SNGs and allowed the growth in bank debt to finance subnational public investments.

Figure 5 - Itemization of subnational governments gross debt
Percentage share
Source: Central Bank of Brazil

Figure 6 - Itemization of subnational governments net debt
Percentage share
Source: Central Bank of Brazil

It should be noted that there are major differences in the financial position of SNGs, which makes the analysis of disaggregated data (each state and each municipality) essential. In the case of the states, for instance, data show that the ratio between consolidated net debt and net current revenue - the indicator set by the Senate to gauge the limits of indebtedness - vary widely. At the end of 2011, the State of Rio Grande do Sul had the highest ratio (2.14), and the State of Roraima, the lowest (-0.1). This shows that financial institutions and other economic agents should evaluate the status of each SNG in order to avoid biased analysis.

Figure 7 - State governments: ratio of consolidated net debt/current net revenues

Source: Ministry of Finance
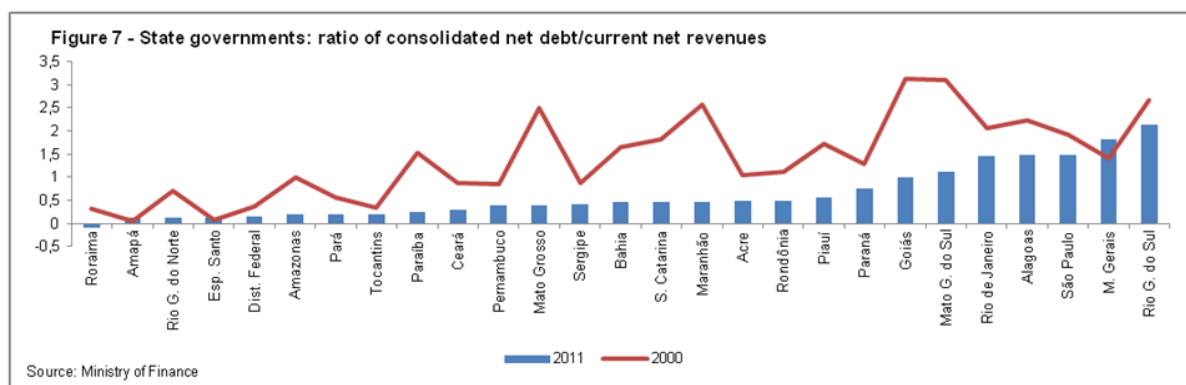
The current control of the SNGs' indebtedness in Brazil can therefore be regarded as a mixture of administrative, rules-based and market discipline models, with controls ex ante and ex post. The debt-restructuring agreements that imposed a fiscal adjustment program, along with the new Senate's Resolutions and the new rules set in the FRL, have made possible to achieve an effective and permanent fiscal adjustment in SNGs, with increased discipline and transparency. The deficit and debt rules evolved over the last decades toward a more responsible approach, which is why fiscal disclosure has become more important.

The figure that follows summarizes the main rules for debt and deficit control in SNGs.

Table 1 - Controls for subnational governments in Brasil*		
	For Borrowers	For Lenders
Ex ante controls	- Debt and deficit ceilings - Limits and restrictions on borrowing - Analysis of borrowing capacity according to Senate's rules - **Publication of detailed budget and fiscal results**	- No direct Central Bank finance - Regulations by National Monetary Council
Ex post consequences	- No bailouts from central government - Debt service witheld from transfers to SNGs - **Publication of detailed budget and fiscal results**	- Strong supervision of banks - Regulations require capital write-offs for losses from SNG debt

* Based on the model of Liu and Webb (2011).

4.   Subnational fiscal disclosure in Brazil

The Ministry of Finance and the Central Bank are the main agencies that disseminate fiscal statistics in Brazil. The Ministry of Finance regularly publishes, for each SNG, information on indebtedness and in compliance with the limits set in the FRL and the Senate's Resolutions.

The source of the information is the SNGs, and most time series begun in 2001. Another important agency that publishes fiscal data is the Brazilian Institute of Geography and Statistics (IBGE), which releases data on National Accounts, including government revenues and expenditures. Unfortunately, the IBGE's fiscal data are disclosed with a long lag, restraining its use.

More importantly, although the FRL determines that states and municipalities must disclose their accounts, there is still some uncertainty about the quality of this information because of the lack of standardization. In this sense, the data published by the Central Bank, based on internationally accepted methodology, are well regarded by the market.[7]

Fiscal statistics compiled by the Central Bank have as its main objective to measure the impact of public sector operations on aggregate demand, a fundamental information to the formulation of monetary policy. The data monthly published by the Institution include stocks and flows, displaying in detail the evolution of the country's fiscal situation. The data cover the non-financial public sector - federal government, Social Security System, SNGs, the Central Bank and the state-owned non-financial enterprises of the three government levels.

The Central Bank calculates the fiscal results by the methodology "below the line", or, in other words, through the evolution of government's assets and liabilities. This is possible because the Central Bank has access to the major sources of public sector net debt: the banking system, custody's systems of securities and the balance of payments. Getting its information primarily from government's creditors and debtors adds greater transparency and credibility to the data released by the Central Bank. Therefore, these data, whose time series begin in 1991, have served as a parameter to measure the country's fiscal targets, set in the annual Guideline Budget Law. In addition, they are widely used by public managers, analysts, international organizations and researchers, in monitoring the fiscal situation in Brazil and in carrying out works and studies on public finance.

Information about SNGs disclosed by the Central Bank by the end of 1997 did not distinguish states and municipalities, only presenting aggregated data for the SNGs altogether. In 1998, as a result of agreements with the International Monetary Fund, Brazil began to set primary surplus targets by level of government. To allow a better monitoring of targets, the Central Bank that year began the publication of disaggregated data for the set of states and the set of municipalities.

The next challenge was to disseminate information for each state and each municipality. In 2009, the Central Bank began publishing disaggregated data, separating each state, each capital and also the set of major cities in each state. The itemization outlines bank debt, foreign debt, net financial assets and debts renegotiated with the central government. There are also information on primary deficit, nominal deficit (overall balance) and accrued interest. According to the Central Bank, the data, which have a 4-month basis, will have its frequency changed to a monthly or a quarterly basis.

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[7] The methodology followed by the Central Bank is based on *Government Finance Statistics Manual - 1986*, by the International Monetary Fund, adapted to the Brazilian case.

State	2010 December Net Debt	2011 Flows accumulated in the year			Other [5/]	2011 December Net Debt [3/]
		Primary	Nominal interest	Total [4/]		
Acre	1354	-236	131	-105	21	1270
Alagoas	5 944	-261	556	295	42	6 281
Amapá	-132	122	26	149	1	17
Amazonas	1856	-666	-72	-739	103	1 220
Bahia	10 532	-1070	1110	41	-75	10 498
Ceará	1931	-390	256	-135	424	2220
Distrito Federal	1 969	-278	272	-6	-50	1 913
Espírito Santo	690	-168	184	16	-41	665
Goiás	11 355	- 473	1181	708	450	12 512
Maranhão	4 002	-1027	95	-931	29	3 099
Mato Grosso	5 091	- 911	542	-369	-95	4 626
Mato Grosso do Sul	5 651	-542	628	87	79	5 817
Minas Gerais	59 750	-3 111	7 809	4698	782	65 230
Pará	2076	-1113	216	-898	61	1 240
Paraíba	1 827	-556	48	-507	23	1 343
Paraná	14 655	-1971	1 681	-290	-218	14 146
Pernambuco	3 366	-417	320	-97	709	3 978
Piauí	1 804	-215	181	-34	17	1 787
Rio de Janeiro	58 836	-3 974	6 900	2 926	1786	63 548
Rio Grande do Norte	695	-498	132	-366	1353	1682
Rio Grande do Sul	42 326	-2 191	4 894	2703	586	45 615
Rondônia	1 546	-386	226	-161	1	1 386
Roraima	725	-68	100	32	0	757
Santa Catarina	10 466	-2616	1351	-1265	62	9 263
São Paulo	221 228	-15 488	26 714	11 226	-3 986	228 468
Sergipe	1522	36	179	216	223	1 960
Tocantins	482	-132	38	-94	30	418
Total Brazil [3/]	471 548	-38 599	55 696	17 097	2 313	490 959

Table 2 - States and municipalities[1/] net debt - Conditioning factors
Accumulated in the year

R$ million

Source: Central Bank of Brazil

1/ Includes information about the states and their major municipalities.

2/ (-) Surplus; (+) Deficit.

3/ The net debt in the period t+1 is obtained by the sum of the net debt in the period t, the nominal result and the other flows.

4/ The nominal result is obtained by the sum of the primary result and the nominal interest.

5/ Includes adjustment in the foreign exchange variation, acknowledgement of debts and privatizations.

One problem that persists in SNGs' statistics is the difference usually found between above and below the line results. An important source of this difference is the arrears. SNGs disclosure their results above the line taking accrued expenditures as reference, which include spending that should have already been paid (arrears). This methodology, based on Brazilian public account legislation, seeks to avoid underestimated expenditures, which could generate misleading results. On the other hand, below the line statistics in Brazil does not usually consider arrears as liabilities because they are debts not intermediated by financial institutions. The impact of arrears in below the line statistics occurs when they are actually paid, reducing currency and deposits.[8] Therefore, below and above the line statistics may display over-time discrepancy in their results.

Another source of discrepancy between above and below the line results in SNGs is the time on which the systems of data records are affected in each statistic. In some cases, for instance, the revenue-expenditure recording system may register a specific operation that will affect the assets-liabilities recording system afterwards (the following month or year), displaying different results in each period. Also, operations performed by a state-owned enterprise may be registered as if it was a government entity, and the results for the

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8   This is the methodology followed by the Central Bank, for instance, whose primary results are compiled on a cash basis. It should be noted that the impact of the arrears in the result is indeed considered, but only when the debt is paid.

government will be misleading. To address these issues, several programs that seek to improve and update fiscal administrations have been performed in SNGs.

The Central Bank began in 2009 a project to disseminate its below the line methodology among SNGs. According to the Institution, the SNGs are not accustomed to dealing with this methodology, and the dissemination may help them manage their finances, making it easier to budget and financial programming, as well as to the long-term planning of subnational finances. The project has also allowed to understand the differences between the data compiled by the Central Bank and by the SNGs. In 2011 the Ministry of Finance joined the project and the two agencies together have promoted meetings with SNGs' staff all over the country.

Finally, both the Ministry of Finance and the Central Bank are currently involved in activities that seek to align its methodologies with the Government Finance Statistics Manual 2001, by the International Monetary Fund. A migration plan to adopt the presentation of fiscal data in the new format was defined by Brazilian authorities and has been implemented in collaboration with the IMF. This implementation involves changes in the public account legislation and an extensive training program for technicians who work in SNGs. The challenge is tremendous, because the GFSM 2001 represents a major step forwards in the standards of fiscal statistics, and SNGs in Brazil are very diverse.

5.   Final remarks

The control of SNGs' deficit and debt in Brazil has evolved over the last decades. The 1980s and 1990s were marked by subnational indebtedness crisis that resulted in bailout operations from the central government. These operations reinforced the view that the central government would always provide debt reliefs, thus reducing SNGs' cost of borrowing and introducing a moral hazard. Moreover, permissive rules regarding debt rollover contributed to a growing indebtedness. Several measures taken since the late 1990s addressed the issue in a satisfactory way, promoting fiscal discipline and reducing the indebtedness.

The new framework that emerged after the debt-restructuring agreements, the FRL and the Senate's Resolutions was effective in restoring credibility and increasing transparency in SNGs. One consequence of this new framework is the greater importance of market discipline in controlling indebtedness, insofar the creditors are well aware that bailout operations are no longer possible, and lending to problematic SNGs may lead to losses. This has increased the demand for information on SNGs, because the analysis of each government's financial status and ability to pay has become essential.

This situation has imposed new challenges to the agencies responsible for the disclosure of fiscal data. The disclosure rules stated in the FRL represent major progress compared to the former ones, but improvements are still necessary, particularly in public accounting legislation, accounting systems and staff training.

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