Brazil
State Debt: Crisis and Reform

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ACRONYMS

BANESPA = Banco do Estado de São Paulo
CEF = Caixa Econômica Federal
ICMS = Imposto Sobre Circulação de Mercadorias e Serviços
BNDES = Banco Nacional de Desenvolvimento Econômico
FGTS = Fundo de Garantia do Tempo de Serviço
INSS = Instituto Nacional de Seguridade Social
BANERJ = Banco do Estado de Rio de Janeiro
CB = Banco Central

AVERAGE EXCHANGE RATE

December 1994 0.85 Rs$ = US$

a/ On June 30, 1994, the existing currency, the Cruzeiro Real, was converted to Reais, at an exchange rate of CR$2,750 = US$1.00

FISCAL YEAR

January 1 to December 31
FOREWORD

This study was written by Bill Dillinger, on the basis of a series of missions to Brazil from November 1994 to May 1995. Guidance and specific comments throughout the preparation of the report were provided by Homi Kharas. The report draws on background case studies written by the following:

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The report benefited from extensive comments and information provided federal and state officials and members of the Brazilian academic community, particularly Fernando Dall’Acqua, advisor to the Secretary of Finance of São Paulo, Dr. Rodolfo Tourinho, Secretary of Finance, Bahia, Carlos Augusto Dias de Carvalho, chief of DEDIP, Central Bank, and Gilton Pacheco Lacerda, of the Federal Treasury Secretary. The report also relies on recent case studies on Ceará and Goiás, provided by Jim Dinsmoor of the IDB. A review meeting on the preliminary draft was held in Brazil under the auspices of IPEA on April 4, 1995. A report on education spending was provided by Robert Hecht and Laura Rose. The report was approved for distribution by Mr. Gobind T. Nankani, Director (LA1), Mr. Homi Kharas, Lead Economist (LA1), and Mr. Paul Meo, Division Chief (LA1PS).

¹ cofinanced with the IDB
EXECUTIVE SUMMARY

State Debt: Crisis and Reform

1. The indebtedness of the Brazilian states has reached crisis proportions. Total debt now exceeds $100 billion (about the same as total Federal and Central Bank domestic debt), and states are not servicing roughly one-half of this. Since 1993, the growth of debt has accelerated, and now perhaps $1 billion per month is being added to the total. Large though they are, even these numbers do not reveal the full extent of the state debt crisis. Case studies of eight states reveal that arrears (to suppliers, wages and mandated transfers) and court-ordered payments for compensation are significant, as are unfunded liabilities to state pension schemes. The federal government now holds most of the states' contractual debt, and finances it through federal bonds, and deposits at federal banks. Unless the growth of the debt is halted, the federal government will be forced to finance it by reducing its own spending, raising taxes, or resorting to inflationary financing, threatening the Plano Real.

2. The way in which the State debt problem manifests itself differs from state to state. Some states (São Paulo and others in the south) have current debt service obligations which they cannot meet or finance, and have a major liquidity crisis on their hands. Others (Bahia and other northeastern states) have rescheduled their obligations with the Federal government, but will confront increases when grace periods expire this year, and a potential second debt crisis when deferred debt service falls due. Still others (Pará) are faced with large short term obligations in the form of arrears which they would like to capitalize into longer term debt to avoid unviable squeezing of 1995 expenditures.

3. In each of these instances, expenditures other than debt service are under enormous strain. At the same time, states' ability to respond by drastic cuts and tax increases is constrained by Brazil's new political environment. The return to democracy, coupled with the decentralization mandated by the 1988 Constitution, have raised expectations of states' ability to deliver services, and have made governors more accountable to their constituents.

4. In the past, such problems were resolved through negotiations with the Federal Government. Negotiable grants were available to finance state projects, or to cover revenue shortfalls. Debt forgiveness (either explicit or through inflation) was the norm. These actions have softened the budget constraint faced by State politicians, permitting short-term interests to dominate budget decisions, implicitly inducing financial mismanagement, and providing a safety-net for risk-taking State Governors.

5. The State debt problem is today too large for this type of remedy. A federal bail-out would undermine the fiscal discipline that is the cornerstone of the Plano Real.
Besides not being feasible, it would also not be desirable. States must be held accountable for public expenditures and financial management—indeed, many are eager to take on these responsibilities and have campaigned on, and initiated, reform and modernization programs.

6. Instead, this report recommends a three step approach. First, a package of measures is needed (involving both Federal and selected State governments) to slow the current explosive growth of state debt. Second, states should adopt reform and modernization programs, led by determined efforts at the federal level to remove constraints (on personnel management, for example) that impede states’ ability to manage their affairs. Third, the federal government must improve its ability to assess state creditworthiness, until such time as private long term financing is available to States.

CONTROLLING THE GROWTH OF INDEBTEDNESS

7. The Government has already taken important steps to rein in state borrowing. As a quid pro quo for debt rescheduling, a cap on private domestic lending to states has been imposed, and regulations prohibiting the states from borrowing from their own banks are now being enforced. The issuance of new State bonds is prohibited until the year 2000. The federal government has the authority to deduct any arrears owed under rescheduled debt (Laws 8727 and 7926) from intergovernmental transfers and state tax accounts.

8. These regulations, however, fail to deal with the problem at hand. The largest source of growth in debt arises from bonds and borrowing from state banks. Both sources were ineligible for federal rescheduling. When interest rates rose in 1993, states ceased debt service on them. The unpaid debt service is now capitalized into the stock of debt. At prevailing real interest rates (in excess of 25% per year), the stock is due to double every three years.

9. While some have argued for a federalization of this debt—consolidating it into a debt to the treasury on which federal enforcement mechanisms could be applied—this would not solve the problem. The problem is not one of enforcement, but one of scale. In the most indebted states, the debt is so large that enforcement would consume an intolerably large share of available revenues. Instead, the states and the federal government need to engage in individual workouts. This is feasible because two-thirds of the debt is concentrated in just 4 States.

10. Three general underpinnings of any work-out are important ingredients in long-term success. First, all parties—States, federal government and private creditors, such as shareholders in banks and enterprises and large contractors—must shoulder some of the burden. Second, States must put in place a significant reform program to restore their financial health over the medium-term, involving significant expenditure cuts and
privatization to retire a portion of their debt. Third, the program must not be dependent on economic variables where substantial variations are possible—the risk of program failure due to external factors should be small.

11. This last point is especially important. Part of the origin of the state debt problem is from unwise risk management—foreign debt which looked cheap in the 1970s until the exchange rate was depreciated; guarantees to state enterprises which were called when the economy stalled in the 1980s; domestic floating rate debt which bore low real interest rates until the stabilization efforts of the 1990s. Again today some proposals suggest substituting foreign for domestic debt as the former appears cheaper; perhaps, but this would also leave states exposed to exchange rate changes in an unwarranted fashion.

ADOPTION OF STATE STRUCTURAL REFORMS

12. Structural reform by states is a *sine qua non* for those requiring debt work-outs. But even for other states, reform will be necessary to deliver public services. This is recognized in many states and several reform experiments are underway. But while the earlier reforms may be driven by financial exigencies, both Brazilian and international experience suggest that the most successful reformers are those who are politically committed to redefining the role of the state to suit the new economic order.

13. A skeleton reform package would cover six elements which are common to all states, although priorities would differ considerably depending on particular State economic circumstances. First, states must develop—and regularly update—long term financial scenarios to establish boundaries on aggregate expenditure possibilities. This would include plans to deal with rapidly rising contractual obligations, such as state pensions and deferred debt. Second, states must privatize public enterprises, to generate revenues for debt reduction, as well as to achieve efficiency gains in management and to signal the determination of the state government to define its role as an overseer of economic development rather than its principal promoter. Third, the states must improve expenditure efficiency, by improving staffing productivity (shedding excess workers, and rewarding good performance), and improving the analytical content of the annual budgeting, and medium-term capital budgeting process. Fourth, states must reduce overlaps in services provided concurrently by municipal governments, by clarifying the division of functional responsibilities between the two levels of government. Fifth, the states need to tighten tax administration. Finally, states must remove the temptation to influence—however indirectly—lending from their banks, through privatization, liquidation, or arm’s-length operating autonomy.
CHANGING THE RULES OF STATE BORROWING

14. Change is also needed in the framework under which state governments borrow. Under the present structure, the Government is in effect, the ultimate guarantor of all state borrowing. Through its ownership of federal financial intermediaries, it is a major indirect creditor of the states. In its capacity as defender of the liquidity of state banks and reserve market for state bonds, it is a *de facto* guarantor of all private lending. Over time, there is a strong case for limiting the federal government’s exposure; shifting more of this risk onto private lenders reinforced by a credible federal demonstration of commitment to avoid intervention in the event of a future crisis.

15. As long as Government continues to play a dominant role in mobilizing and allocating savings for investment, it must also be more discriminating in its own lending through federal financial intermediaries. The Government’s present criteria for assessing creditworthiness are too liberal and short sighted. The Government needs to adopt more restrictive criteria, and implement them more consistently. Evidence from the eight case studies suggests that creditworthiness is not systematically related to income. Rich states such as São Paulo and Rio and poor states such as Bahia are both highly indebted. Nor is it crudely linked to reform—Minas has taken several reform initiatives but remains highly indebted, while Ceará is a case of reform resulting in creditworthiness.

16. The report develops and applies technical indicators of creditworthiness and derives a measure of affordable new debt. States which have some headroom are more creditworthy than states which exceed their affordable debt level. But these quantitative measures are only indicative of present financial positions. They must be qualified by qualitative assessments of the depth of the state reform program, which provides a view on the likelihood of a future recurrence of a debt problem and on the risk of the financial strategy being adopted, in order to evaluate creditworthiness.

HARDENING THE BUDGET CONSTRAINT

17. The best incentive framework to encourage states to reform is one where they face a budget constraint which reflects their creditworthiness. In part because of the history of previous bail-outs, private lenders behave as if they had the full protection of the federal government behind them. Along with lending by federal financial institutions, this has weakened financial discipline on states.

18. The way in which the Federal government handles any debt work-outs and the way in which it uses its loans, guarantees and collateral collection powers will heavily influence the prospects for an expanded private sector role in lending to state governments. This is why the principle of burden-sharing with the private sector and of
strict creditworthiness tests for public lending, enforced through regular bank supervision practices, are so important.

19. The federal government must also safeguard its position as principle creditor of the larger indebted states. In times of tight budgets, new devices for promoting state projects are tempting. But some of these involve sizable risk--performance guarantees on private sector contracts, use of state enterprises' borrowing capacity--which can later weaken state finances and thereby reduce the amounts the federal government is repaid. The federal government must continue to take a comprehensive view of State finances and obligations.
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1. EXISTING SITUATION

A. Overview

1.1 Brazil's public sector is highly decentralized. Approximately half of budgetary public expenditures are made by subnational governments. Democratization and constitutional revisions in the 1980s increased the degree of resources under subnational control, and the degree of local political autonomy in their allocation. Governors and mayors are now directly elected; shares of federal transfers to states and municipios—as well as shares of state transfers to municipios—have increased.

1.2 The performance of subnational governments is a source of concern for both macro and micro reasons. From a microeconomic perspective, there is concern that the large volume of resources spent by subnational governments is not spent efficiently. This concern was increased by the 1988 Constitution, which increased the resources available to state and local government by expanding the scale of federal revenue sharing and reassigning taxes to subnational governments. With over half of public sector expenditure now under the control of subnational government, there is concern that much is exhausted on unproductive staff, economically unsound capital works, and badly-designed programs.

1.3 The more immediate concern is a macroeconomic one. The indebtedness of the Brazilian states has reached crisis proportions. Brazilian states are in debt to the tune of US$110 billion, and are presently in default on roughly half of this. The debt is financed at variable rates. With the states in default, the stock of debt continues to grow in accordance with domestic interest rates. The majority of this debt is in the hands of agents of the federal government: the Central Bank and the Bank do Brazil. Most of it is owed by the most economically important states in the country.

1.4 The Government faces a difficult choice. Forcing the defaulting states into bankruptcy could have a crippling effect on the national economy and the financial system. A federal decision to cease rolling over São Paulo’s short term bonds could shut down the government of a state that produces 40% of GDP. A federal decision to cease its implicit guarantee on the deposits and interbank borrowing of São Paulo’s commercial bank—BANESPA—would prompt the collapse of one of the largest commercial banks in the country, undermining depositor confidence in the banking system as a whole.

1.5 On the other hand, refusing to halt the growth of state debt would have equally adverse consequences. Three quarters of the debt is owed to various entities of the

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1 Since the Central Bank has assumed management responsibility for BANESPA, the state bank is perceived by private banks and depositors to carry the full backing of the federal government.
federal government, which have in turn financed it through domestic borrowing. If the states do not pay down the debt, the federal government will have to. Given the volume of the debt, this would require the federal government to dramatically reduce its own spending, raise taxes, or resort to inflationary financing.

1.6 What is needed, immediately, is a package of measures that will halt the growth of the debt. Due to the capitalization of unpaid interest, the stock of bond debt is growing, in real terms, at a rate of about 20-30 percent annually. If no action is taken, it will continue to grow exponentially at this rate, raising the ultimate costs of addressing it. A workout, however, should not aim solely at defusing the present debt crisis. Brazil has undergone a series of state debt crises over the past decade, each addressed through a patchwork solution. To forestall future crises, more fundamental reforms in the institutional arrangements for state borrowing and in the management of state finances are required. The purpose of this paper is to propose a strategy to achieve these objectives. In broad terms, the strategy has two components:

1.7 Immediate Workouts. In the immediate term, it is clear that the Government needs to defuse the immediate debt crisis. This will be a selective process. In absolute terms, the state of São Paulo dominates the debt crisis, followed by Rio de Janeiro, Minas Gerais, and Rio Grande do Sul. Some of the smaller states of the west are heavily indebted—relative to their revenues—and several northeastern states have growing arrears, although this is due more to uncontrolled personnel spending than to heavy debt obligations. Individually, the smaller cases do not represent macroeconomic threats. From a macro perspective, they are only relevant to the debt crisis, first, because in Brazil’s federal structure, any solution to the problem of the largest states must take into account the interests of the smaller jurisdictions, and second, because debt—along with poor management of personnel and investment choices—contributes to the service delivery problems of these states, whose economies, in aggregate contribute significantly to GDP.

1.8 Structural and Management Reforms. To forestall a repetition of the debt crisis, fundamental structural and management reforms are required. These must target two separate problems. The first is the framework in which state governments borrow. Under the present structure, the Government is, in effect, the ultimate guarantor of all state borrowing. Through its ownership of federal financial intermediaries, it is a major direct creditor of the states. In its capacity as defender of the liquidity of state banks and reserve market for state bonds, it is a de facto guarantor of all private lending. Until the federal government can safely offload some of these roles onto the private capital market, it must become more hard-nosed in exercising them.

1.9 At the same time, internal management reform is needed within the states. The Brazilian states—particularly the major debtors—are not poor. They have diverse, robust economies and a tax instrument—the ICMS—capable of extracting revenue from it. But

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2 The total volume of state debt equaled more than half of total public sector borrowing, including operations of the central bank but excluding federal enterprises as of December 1994.
they are badly managed: budgets are exhausted in paying the salaries of a large and 
undermotivated civil service, on subsidies and on disparate capital works. It would appear 
that the majority of states could service most, if not all, their debt, if they made a more 
rational use of the resources at their command. Management reforms are needed if this potential is to be realized.

1.10 The structural reforms needed to resolve the debt crisis can have broader impacts 
on the performance of state governments. The root causes of poor state management 
appear to lie in the political economy of subnational decision making--the framework in 
which politicians make their decisions. Governors now operate in a highly competitive 
political environment, subject to non renewable quadrennial elections. They are thus under 
pressure to produce quick results using whatever resources are available, without regard 
to long term financial consequences. The federal government has often accommodated this 
behavior through large programs of negotiable grants and history of debt forgiveness. 
Recent federal administrations have taken major steps to harden the budget constraint 
confronting state governments. The Government has sharply reduced negotiable grants 
(convenios) and federal spending on functions that are nominally state responsibilities 
(e.g., urban railroads). Tougher enforcement mechanisms have reduced states' ability to 
default on loans from federal banks. Closing the remaining loopholes on state borrowing 
would largely eliminate the last remaining “softness” in the federal-state financial 
relationship. In this respect, solutions to the debt crisis can be a means of inducing 
broader reforms in state management.

B. Origins Of The Debt Crisis

1.11 State borrowing has gone through several distinct phases in the last thirty years. 
The first major boom in state borrowing dates from the establishment of the major federal 
infrastructure financing mechanisms, at the outset of the military administration (1964-1985). To provide long term financing for infrastructure investment, the military government established a variety of forced savings schemes, based on unemployment insurance and earmarked taxes, that channeled funds through federal financial intermediaries to newly created state water, power and telecommunications companies, housing companies, and transport agencies. These funding mechanisms financed the dramatic expansion of infrastructure that occurred during Brazil's economic miracle (1968-1973.)

1.12 With the first oil shock of 1973, the miracle ended; payments into the forced 
savings schemes fell, and withdrawals increased. In an attempt to prolong the boom, the 
Brazilian government turned to external borrowing, with state government following suit 
(under laws 4131 and Resolution 63.) In 1979, however, international lenders were shaken 
by the second oil price shock, followed three years later by Mexico moratorium on 
interest payments to principal commercial lenders. External loans to Brazil virtually dried up after 1982, as foreign lenders refused to even roll over state debt.
This was followed by a decade (1982-1993) of stalemate and negotiation. With deepening recession, the states ceased servicing their existing debt to federal financial intermediaries. Unable to rollover external debt, they ceased servicing external debt as well. Through most of the 1980’s, the federal government honored the state’s obligations to their respective creditors on an *ad hoc* basis. In 1989, the federal Treasury formally assumed states’ obligations on external debt, and three years later, took over states’ debt to federal financial intermediaries. Existing state debt was converted into debt to the Treasury, on rescheduled terms. In return, the states acquiesced to a tightening of federal debt service enforcement mechanisms, and freezes on borrowing from virtually all domestic private sources of savings.

**Figure 1 Trends in Real Interest Rates**

1.14 In most of the states, these workouts reduced the states’ debt service obligations to manageable proportions, albeit at high cost to federal taxpayers. The four most economically important states, however, had debt that was not included in the negotiation. The largest components consisted of bonds and debt to state owned commercial banks. Interest on this debt was manageable during most of the 1980’s when real interest rates were low or negative. In late 1991, however, real interest rates rose dramatically (as shown in the chart above) and the states began to default. Interest rates have remained high over the subsequent four years and states have continued to default, allowing the unpaid interest to capitalize into the stock of debt.
C. Current Composition Of Debt

1.15 This is essentially the present situation. The total volume of outstanding state debt, as of January 1, 1995, was over Rs 95 billion (or US$ 112 billion). As shown in the following chart, it consists of five major blocks: the debt owned to domestic banks (consisting largely of debt owed to the Treasury as a consequence of reschedulings); new (mostly external) borrowing, debt to state banks, and so-called fluctuating debt (a category that consists largely of arrears and various sub rosa borrowing techniques used by the states to evade federal controls). As the chart shows, debt to the Treasury, while large, is not growing, and debt to external banks is relatively minor. It is the bonds and debt to state banks that is ballooning. The only other source of growth in debt is in the "fluctuating debt" category.

Figure 2 Trends in Stock of Debt

1.16 Bonds The large single block of debt consists of debt financed by bonds. Although fifteen states and two municipalities issue bonds, the market is dominated by four states—São Paulo, Rio de Janeiro, Minas Gerais, and Rio Grande do Sul—and the municipalities of São Paulo and Rio. Bonds are typically underwritten by the state's commercial bank, and ultimately sold to private banks and investors. (In São Paulo’s case, the initial issues were underwritten by BANESPA, and ultimately sold to private commercial banks.) Although bearing five year maturities, these bonds were treated as perpetual, being routinely rolled over at maturity.

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3 The total level is probably considerably higher, although precise figures are not available. The figure cited here excludes arrears and other "fluctuating" debt, except in the eight case study states examined under this study, and debt owed directly to creditors by state owned enterprises. It also excludes the states’ unfunded pension liabilities.
1.17 The state banks began to have difficulty marketing the state’s bonds at the beginning of the Collor administration. With the states’ declining financial standing, the state banks were no longer able to sell the bonds at five year maturities, and ultimately resorted to “renting” them on the overnight market. Ultimately, the private market declined to hold state debt even on the overnight market. At that point, the state governments then exercised an option—agreed during a previous crisis—to temporarily exchange the unmarketable state bonds for Central Bank holdings of federal bonds (Letras do Banco Central-Serie Especial) which were more readily marketable.

1.18 This has now become the means by which the state bonds are marketed. In São Paulo, for example, out of R$8.8 billion in state bonds outstanding, R$6 billion are held by the Central Bank under the exchange program. São Paulo is presently paying no interest on these bonds. Unpaid interest is instead being capitalized into stock of debt. As a result, the state’s bonded debt is automatically growing at a level dictated by domestic interest rates.

1.19 **Debt to State Commercial Banks** The second largest block of debt consists of loans from state-owned commercial banks. In the past, the practice of borrowing from state-owned commercial banks was common. During the “miracle years” infrastructure loans from the federal housing bank (then-BNH) were normally channeled through the state banks. This debt, however, has largely been eliminated. Under the 1994 debt rescheduling (Lei 8727/94) states were permitted to transfer the debt from their banks to their treasuries, where it was then eligible for rescheduling and subject to federal debt repayment ceilings. Bahia, for example, took advantage of this opportunity to remove all state debt from BANEBE.

1.20 At present, borrowing from state commercial banks is largely confined to Sao Paulo. Most of Sao Paulo’s debt to its commercial bank—BANESPA—derives from loans contracted from non-federal creditors, and is thus ineligible for rescheduling. Two-thirds of the state’s debt to BANESPA originated in loans contracted by BANESPA from foreign banks. The other third derives from two short-term revenue anticipation bonds, borrowed from BANESPA in the last quarter of the Quercia administration, and subsequently transformed into long term debt.

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4 Initially, the amount that was exchangeable was limited to the amount the underwriter could guarantee (using cash and assets other than loans to the state as collateral.) In January of 1995, this stipulation was waived.

5 Although the Senate retains the authority the fix the percentage of bonds that may be rolled over in any year, it is liberal in exercising this power. In 1991, required São Paulo to amortize 17% of the debt that came due in that year; in 92, 16%; in 93, 13%; in first semester of 94, 10%; and in the second semester, none. Under Law 8727, any margin between a states debt service obligation subject to the 11% ceiling, and 11% of revenues must be applied to the payment of bonds. If, on the other hand, the sum of debt service on 8727 debt, plus payments to retire that part of outstanding bonds that the Senate has determined cannot be rolled over, exceed 11%, then the amount in excess is automatically rescheduled into the 10 year extended repayment period. In effect, whenever the senate decides to permit less than a 100% rollover, it automatically agrees to reschedule the amount due.
1.21 The state and its enterprises began defaulting on this debt during the early 1990's, and by 1994, had ceased servicing the debt altogether. This effectively transferred the debt problem from the Sao Paulo's treasury to BANESPA. Non-performing state debt now constitutes BANESPA's principal asset. In order to continue paying interest to its depositors, BANESPA initially relied upon interbank borrowing and increases in private deposits. As the BANESPA's financial credibility declined, private banks declined to hold its CDs. Faced with the prospects of the collapse of one of the largest commercial banks in the country, the federal government instructed federal banks--principally Banco do Brasil--to purchase the banks' bonds. The subsequent Central Bank intervention has permitted BANESPA to return to the market, but only on the basis of the guarantee implicit in the central bank's assumption of the bank's management. As of May, 1995, this continues to be the means by which Sao Paulo's debt to BANESPA is ultimately financed. The state is accumulating debt to BANESPA in the form of capitalized unpaid interest, while BANESPA continues pay interest to its depositors on the strength of the funds it is able to attract through the implicit guarantee of the federal government.

1.22 Overall, both the commercial bank debt and the bond debt have two common characteristics: First, the amount of debt is growing rapidly, due largely to the capitalization of interest onto the existing stock. Second, most of the risk of default now lies with the federal government. The central bank's intervention in BANESPA has in effect transferred the ultimate risk of Sao Paulo's default from private lenders and depositors onto the federal government. The Central Bank's exchange of state bonds for federal bonds has effectively transferred the risk of bond defaults from the private market onto the federal treasury. Together with the federalization of external debt under Law 7976 and the consolidation of debt to federal financial intermediaries under law 8727, what began as a allocation of risk among a diverse set of lenders--including external private banks, domestic banks (as holders of state bonds), and depositors in state commercial banks--has been transformed into a federal monopoly. The volume of debt is ballooning, and the federal government is holding the balloon.

1.23 **Rescheduled Debt** Rescheduled debt is the most widespread form of state debt. While bonds and debt to state commercial banks are largely confined to four large southern states, rescheduled debt is widespread. The rescheduled debt has two components. Debt to **external creditors** was restructured under Law 7976, under which the federal government agreed to assume and reschedule the existing stock of state external debt, for a period of 20 years, with five years grace on the payment of principal, at interest rates equivalent to those specified in the original contracts.

1.24 Debt to **federal financial intermediaries** was rescheduled under law 8727/93. Like the 7976/89 agreement, the new 8727/93 law rescheduled the states' outstanding obligations (both principal and arrears on interest) for 20 years, with interest based on the

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6 BNH, and its successor CEF, were the largest participants; followed by BNDES; two regional development banks (BNORDESTE, BASA) and the Banco do Brasil.
weighted average of the rates established in the original contract of each debtor. In addition, the new law provided a escape clause for states, which also applied retroactively to the 7976/89 debt and certain other debts to the federal government. Under the law, if the sum of debt service on all the eligible debt exceeds eleven percent of revenue, the amount in excess is automatically rescheduled until such time as debt service falls below that ceiling. Unpaid interest during the interim is capitalized into the stock of debt. The balance outstanding at the end of the twenty year repayment period is then amortized over another ten years.

1.25 These measures substantially reduced the immediate debt service obligations in states with high proportions of external or federal debt. Immediate arrears were eliminated, and the burden of debt service was pushed into the future. (The states will, however, face a sharp increase in amortization payments in 1995, as the grace period on the Lei 7976/89 debt expires (effective January 1, 1995) and the grace periods on the Lei 8727/93 debt expire (with the maximum grace period ending in mid 1995.) States such as Bahia and Pernambuco, which saw their immediate debt obligations fall sharply after 1993, will see them rise again.

1.26 While the rescheduling has eased the cash flow problems of the states, it has shifted the interim costs of financing this debt onto the Treasury, which will have to fund the difference between receipts from rescheduled debt, and obligations to the federal banks and external creditors, potentially for the next thirty years. The Lei 8727/93 law may also be planting the seeds of a new debt crisis in the year 2013. As long as interest rates remain high, the volume of debt service that will be automatically rescheduled under the 11% escape clause will be substantial. The interest due on this rescheduled debt will be capitalized. The amount to be amortized over the ten year period beginning 2013 may well exceed the entire revenues of many of the smaller states.

1.27 New External Debt New external debt consists of foreign debt contracted since the 1989 rescheduling agreement. It consists largely of borrowing from the offshore branches of Brazilian official banks and loans from the World Bank and IDB. Due to the perceived riskiness of lending to state governments, private external borrowing is extremely limited.

1.28 Fluctuating Debt States also borrow, less formally, through a variety of other means. Arrears on payments to suppliers, and salary payments to state employees are commonly used to finance state deficits, particularly in the last months of an outgoing

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7 A grace period on 60% the principal due was allowed. The length of the grace period is based on the proportion of debt payments in arrears between October 1991 and June 1993, with a maximum of 20 months from the signing of the rescheduling agreement. Under the legislation, the amount to be rescheduled was limited to the amount of such debt outstanding as of the first of January 1990.

8 Including arrears on federal unemployment and pension programs (FGTS and INSS) and external debt contracted before September 30, 1991.

9 This ceiling was increased from 9% to 11% effective Jan 1, 1995.
administration. Pará’s incoming administration, for example, inherited two months of unpaid salaries on taking office, and São Paulo’s arrears to suppliers increased by Rs 1.5 billion during the last year of the outgoing administration. States also borrow from commercial banks through revenue anticipation loans. To finance capital works, states borrow indirectly from private domestic and external banks, and from their own commercial banks, by guaranteeing the debt of their contractors. In addition, states also force debt on landowners, by acquiring property by eminent domain, and paying the owner a “historical” and thereby trivial price. Although the landowner inevitably sues and wins, the legal process extends over several changes in administration, essentially forcing the landowners to finance land costs until the case is finally settled. In aggregate, the stock of this so called fluctuating debt is considerable. In São Paulo, it accounts for about one-quarter of the stock; in Rio about 15%, and in Minas Gerais, seven percent. Interest rates on this debt vary. States are legally required to pay monetary correction on legal judgments and arrears, plus six- to eight percent interest, although it is not clear that these terms are always observed. Interest on revenue anticipation bonds and indirect contractor debt reflect market prices.

D. Regional Variations In Debt Structure

1.29 The severity of the debt crisis varies among the states. From a macro perspective, the states can be classified into three groups, on the basis of the size of their debt, and the proportion of it that is rapidly capitalizing. São Paulo, as shown in the chart below, is in a class by itself. The magnitude of its debt exceeds the estimated indebtedness of all other states combined, and roughly half of its debt is in bonds and bank loans—the highest cost, most rapidly growing categories of debt. Rio de Janeiro, Minas Gerais, and Rio Grande do Sul, are a second group, with proportionately less debt, but a larger share of it in the form of high cost bonds. A failure to defuse the capitalization of interest in any of these states would have implications on a macro scale.

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10 Part of these arrears can be “rolled over”, in the sense that arrears from the previous years can be liquidated and replaced by new arrears during each budget year.

11 Although, by law, revenue anticipation loans must be repaid by the end of the fiscal year, in practice states roll them over, by using the proceeds from deferred payrolls to liquidate them on December 31, and recontracting them on the first of January.

12 States use this technique to evade federal restrictions on borrowing. Under this arrangement, a contractor agrees to obtain financing for a state-sponsored work from a private lender (or the state’s own bank), and the state agrees (through a side letter) to service the debt through payments to the contractor. Contractors normally inflate their bid prices to reflect their additional risk.
1.30 The third group consists of the remaining 22 states and the federal district. Many of these states have financial problems, as indicated by persistent current account deficits, growing arrears, or more fundamental breakdowns in state services. Some have a high proportion of debt to revenue. Due to the structure of debt in these states, however, interest rates are low and the stock is not rapidly growing. Debt in these states is therefore not a macro problem, but rather part of a micro-problem: the inability of states to manage their resources effectively. Their financial problems are more attributable to overstaffing and excess capital spending, than to burden of debt service. The benefit of debt workouts in these states lies in its contribution to broader management improvements.

E. The Federal Regulatory Framework

1.31 The federal government has frequently adjusted the regulatory framework for state borrowing in response to the changing nature of state debt. The current regulatory framework has three basic components: (1) prohibitions or freezes on borrowing from particular sources; (2) omnibus Senate regulations aimed at controlling new state borrowing operations from all sources, and (3) enforcement mechanisms.
1.32 Federal legislation and central bank regulations prohibit, or freeze, borrowing from specific sources. Central bank regulations now prohibit a state from borrowing from its own commercial banks. (A general prohibition on banks' lending to major shareholders has long been on the books. What has changed is the Central Bank's policy on enforcing it as it applies to state-owned commercial banks.) To control the issuance of bonds, the Constitution (Emenda 3) prohibits any issuance of bonds by the states—other than to finance past court judgments—until December 1999. The Government has also moved to forestall new borrowing from private commercial banks. Under CB resolution 2008, private banks are prohibited from increasing their holdings of state debt, other than bonds. (They may, however, shift the composition of their state debt portfolio, as existing loans mature.) The federal government also controls access to multilateral financing, through COFEX and through its ability to withhold federal guarantees. Taken together, these prohibitions have been effective in slowing the growth of new credit operations, although it is not clear how much of this is due to regulation, and how much is due to the reluctance of lenders to resume lending to the states.

1.33 The Senate also imposes comprehensive restrictions on borrowing from all sources. Under the Brazilian Constitution, the Senate has the authority to regulate all state borrowing. The present set of guidelines, incorporated in Senate Resolution 11 (1994), is intended to apply to any contractual arrangement involving repayment at a future date, whether directly or as guarantor, including borrowing from private domestic and external banks, domestic bond issues, federal financial intermediaries, and international organizations. (Bond rollovers are treated as a special category of debt). The Resolution

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13 The amendment does not, however, prohibit states from rolling over the principal and capitalized interest on their existing bonds. The proportion of such debt that may be rolled over is instead determined on a state-by-state basis by the Senate.
essentially restricts new borrowing on the basis of two factors: debt service coverage, and growth in the total stock of debt.

(a) **debt service coverage:** Under the resolution, total debt service (i.e., service on existing and proposed debt) cannot exceed the state's current account surplus in the previous 12 months; or 15% of its revenues, whichever is less.

(b) **growth rate of stock:** New borrowing, within any 12 month period, cannot exceed the level of existing debt service or 27% of revenue, whichever is greater.\(^{14}\)

1.34 The third component of the Federal regulatory framework consists of the enforcement mechanisms. Federal regulations now forbid new federal borrowing authorizations to states that are in default on any existing obligation to the federal government (including not only debt service but payments to federal social security programs, the national power company etc.) In addition, as a *quid pro quo* for debt rescheduling, the federal government required states to authorize the federal government to deduct debt service owed to the treasury from federal transfers and from accounts in which state ICMS receipts are held. As long as they are imposed, these provisions enable the federal government to enforce debt service obligations, and may act as a break on new lending requests.

1.35 Overall, these federal regulation represent a serious effort at restraining state borrowing. Nevertheless, they do not go far enough. *First, they fail to deal with the problem at hand: the ballooning stock of debt arising from the capitalization of interest on past borrowing.* The total stock of debt continues to grow, in real terms, at an exponential rate, due to the capitalization of interest on outstanding bonds and debt to state owned commercial banks. *Second, they may not be effective in forestalling excessive new lending, once the immediate crisis is past.* As discussed in Chapter 3, the existing criteria for evaluating new lending may allow excessive levels of state debt, given the variability of economic conditions in Brazil.

\(^{14}\) The current account surplus is defined as revenues, net of Constitutional transfers to municipios, less recurrent expenditures (including interest payments). Debt service excludes that proportion of bond principal and interest that the Senate permits to be rolled over and capitalized, respectively.
2. WORKOUT OPTIONS

A. A Strategy

2.1 What is needed, immediately, is a package of measures that will halt the growth of the bonds and commercial bank debt in the most indebted states. In order to stop the ballooning of state debt, the Government must devise a plan for reducing debt service to a level that individual states are able and willing to pay.

2.2 How much of the burden should fall on the federal government, as opposed to individual debtor states is now a topic of debate in Brazil. The states have argued that the federal government bears the blame for the debt crisis; that high interest rate policies forced them to suspend payments on their debt and that the combination of capitalized interest and high real interest rates since the Plano Real have rendered their present debt service obligations completely unaffordable.

2.3 There are persuasive counterarguments, however. Given the volatility of interest rates and tax bases in Brazil, it can be argued that states should never have relied so heavily on short term, or variable interest rate, debt to finance capital investments. In an economic climate as volatile as Brazil's, any financial commitment of more than a few months subjects the borrower to dramatic swings in revenues, interest rates, or competing expenditure obligations. Under these conditions, states clearly should have regarded long term debt as something to be used sparingly.

2.4 The fact that federal macro policies may have contributed to rising interest rates does not weaken this argument. Federal macro policies are not intended for the convenience of state borrowers. It might, in fact, be argued that Government's only error was in coming to the state's assistance. If the federal government had declined to rescue the states at the time that private banks were refusing to roll over state bonds and or purchase the debt of state commercial banks, the states might have been compelled to adjust earlier. The states thus erred twice: first in borrowing heavily at the outset; second in not using the opportunity offered by federal debt reschedulings to reduce the stock of debt to manageable proportions.

2.5 If any federal debt relief is provided, it should provided at a price. It is clear that this is not Brazil's first state debt crisis. It is, in fact, likely that the state's excessive borrowing is predicated on the expectation of federal relief. Another round of federal relief only reinforces this expectation, and plants the seeds of the next round of borrowing and crisis. Where federal relief is necessary to enable a state to continue functioning, the federal government should exact a *quid pro quo*, both to ensure that significant, irreversible reforms are put in place in the defaulting state, and to reduce the temptation of other states to follow the same route in the future.
Box 2.1: The Political Economy of a Debt Workout

The politics of a debt workout involve a variety of stakeholders. The most obvious are the state governors, the President and his cabinet, and members of Congress, whose political careers may be affected by their success in defusing the crisis, and their ability to impose its costs on constituencies other than their own. But the ultimate costs of a workout will be more widely distributed. To the extent the costs of the workout are borne by the states, the ultimate costs will be distributed among (1) state taxpayers, through increased taxes and fees; (2) state service consumers, through cuts in tax-financed services (education, health, police services); (3) public employees, through job losses, salary cuts and increased pension contributions, and decreased pension benefits, and (4) contractors and construction workers, in the form of job losses in the public works construction industry.

Any burden borne by the federal government, similarly, will be distributed among federal taxpayers, the recipients of federal benefits (including social security), federal employees, and contractors. If the debt crisis is not defused quickly, there may also be pressure to finance the workout through inflation. In that case the burden will be borne directly by the price-takers in the economy—the most vulnerable economic groups—and indirectly by all Brazilians in the form of foregone economic growth.

The typical victims of a private sector bankruptcy—private creditors—are relatively invulnerable here. As noted in the text, the banks and bondholders who initially financed much of the state debt have withdrawn, leaving the federal government (including the central bank) as the primary creditor of the states. If the burden were imposed through the financial system, it would therefore take the form of a federal default, imposing the ultimate costs on the holders of federal bonds and depositors in federal banks.

How the burden should be apportioned among stakeholders is fundamentally a political decision. From a technical standpoint, one admonition emerges. Whatever the ultimate distribution of workout costs, a workout should minimize collateral damage to the economy, and avoid imposing disproportional costs on the poor. This has one clear implication: it is better to execute the workout quickly and explicitly, rather than to rely on inflation. Although inflation has often served as a genteel form of conflict resolution in Brazil, it distorts the economy and imposes its burden disproportionately on the poor.

An orderly workout, within a fixed time frame, would be better. The 1975 New York City case may be a helpful model. In New York, the newly constituted Emergency Financial Control Board (under state control) required the city to balance its budget in three years, a mandate that it enforced through its interim control over the city's finances. While bridge financing was provided by state and federal government, the costs were born by (1) the consumers of municipal services (through cutbacks in welfare benefits, increases in subway fares and tuition at the city university, and a moratorium on subsidized housing), (2) public employee unions (through the dismissal of 25,000 workers, postponement of a wage increase, and increases in pension contributions), (3) taxpayers (through a tax increase), and (4) creditors (through a requirement that current creditors roll over the city's debt.) Though the particulars will differ, the overall model of swift and explicit apportioning of costs may be a useful model for Brazil.
2.6 **State-by-State or Class-of-Debt Approaches** There are two possible ways of targeting federal debt workouts: a state-by-state approach, focusing on the major debtors; or a class-of-debt approach, focusing on the most rapidly growing, high cost categories: bonds and debt to state banks. The state by state has much to recommend it. To forestall future crises, Federal relief must be offered at a price, and the appropriate price—in terms of reform, or loss of financial independence—will vary among states. A state by state approach could follow the model used in the New York City debt crisis of 1975: establishing a control board composed of the state's major creditors, providing it with veto power over the state's spending, borrowing, and taxing decisions, and negotiating a division of the workout costs among the various interested parties: service consumers, public sector unions, taxpayers, and creditors. If the New York model were followed, the control board would remain in existence over several changes in administration. This would prevent subsequent administrations from reversing the reforms, and would reassure the financial markets of their sustainability.

2.7 The only drawback to a state by state approach is a political one: the Brazilian preference for dealing with states in a uniform manner and avoiding the appearance of favoritism. The alternative to the state by state approach would be a blanket resolution focused on the most troublesome kinds of debt. The debt crisis is essentially a crisis of bonds and debt owed to commercial banks. As described above, the other major blocks of debt—old external debt (Lei 7976) and debt to federal financial intermediaries (Lei 8727)—have already been rescheduled, at terms highly advantageous to the states. This debt is not growing rapidly. It is the bonded debt and the debt to state banks that constitute the macro threat. A workout focused on these two types of debt would be effective in addressing the crisis, but would less well-targeted that one focused on specific states.

2.8 One option that is *not* available is a mutual cancellation of the debt. Some in Brazil have argued that the ballooning state debt is simply an accounting phenomenon; an intergovernmental obligation that could be liquidated by simply erasing it from the liabilities side of the states' balance sheets and the assets side of the Treasury's. This is mistaken. The liabilities that the *Treasury* has incurred to finance its holdings of state debt are real. They are liabilities to private holders of federal bonds and to depositors in federal financial institutions. A mutual debt write-off would still leave the federal government with these obligations, which it could only "cancel" by refusing to redeem its own bonds and confiscating the deposits of its banking clientele.

2.9 The strategy proposed here therefore calls for the Government to undertake workouts aimed at reducing debt service in individual state to affordable levels, placing the bulk of the costs of the adjustment onto the individual states, preferably through state by state workouts.
B. Components Of State Workouts

2.10 Such a workout should aim at arriving at a level of debt service that is affordable. In broad terms, the affordability of debt service is a function of three factors: the level of debt service, the level of revenue (which determines the overall envelope from which debt service can be paid) and the level of rival expenditures—the non-debt recurrent and capital expenditures that compete with debt service for available revenues.

2.11 Further elaboration is required to lay out the full range of actions that could contribute to a workout and the possible contribution of each participant. Defining “who should contribute what” to a workout requires an analysis of the factors that lie under the control of each party, as well the degrees of freedom permitted by initial conditions, and the susceptibility of workout terms to likely changes in the economic environment.

1. Factors under state control

2.12 Level of Debt Service At any given time, the level of debt service would appear to be fixed. In fact, it is subject to both policy and exogenous variables. States can reduce the stock of debt by selling assets (including public enterprises) and using the proceeds to liquidate debt. All the major debtor states own a variety of state enterprises. São Paulo owns 28 enterprises, including eight banks and related financial companies, four power companies, five transportation companies (including a railroad), a water utility, and a housing corporation. Rio de Janeiro, Minas, and Rio Grande do Sul all own large commercial banks, power companies and water utilities, and are stockholders in a variety of smaller enterprises. In some cases, the sale of these enterprises could raise significant amounts of cash.

2.13 Such sales would not be unprecedented. Minas Gerais has already sold one of its banks, a large block of stock its power company, and its holdings in Fiat. São Paulo has sold its airline company, and reduced its stake in its largest power company (CESP) and its principal bank (BANESPA). Some of the major debtor states, particularly São Paulo, are resisting further privatization, however. They take the position that the current price of their enterprises would be depressed by their high level of debt (including pension liabilities) and the poor quality of their management. Instead, they have proposed plans which would enable the states to raise cash from these assets immediately, while permitting the states to make the actual transfer of ownership at a more propitious time. Under these proposals, a new state company would be created, to which the shares of existing state enterprises would be transferred. This enterprise would then sell debentures, backed by the assets of the state enterprises, and would transfer the proceeds to the state treasury to enable it pay down its debt. The company could then later sell the assets, retiring the debentures. This plan was originally proposed by the outgoing administration in São Paulo. Although the current administration has abandoned it, it is under active consideration in Minas Gerais and has been proposed for Rio Grande do Sul. While this approach may alleviate the state’s immediate liquidity problems, as a solution to the debt crisis it has little to recommend it. It is unlikely that the interest rate required to sell the debentures would be less than the rate now paid on bonds (as they bear the federal LBC
rate). Thus the financial gains to the state would be questionable. Instead, the arrangement
would simply change the locus of the liability for state debt from the Central Bank to the
holders of the debentures. From a cash standpoint, as well as from a longer term
management perspective, outright privatization would appear preferable.

2.14 States can also reduce debt service by rescheduling their debt with major creditors,
thus reducing their annual amortization payments. There is little to be gained by doing
so now, however. The debt crisis arises not from the costs of amortizing the debt, but
rather from the costs of carrying it. Debt originally owed to federal financial intermediaries
has been rescheduled to 20 year maturities, and the bonds and debt to state banks are, in
effect, automatically rolled over. Rescheduling the debt would therefore have little impact
on a state's total annual debt service obligations.

2.15 Interest rates levels are largely determined by exogenous factors. All state
borrowing is at variable rates (either through the indexation of principal or the calculation
of interest as a spread over a market-determined interest rate). It is thus subject to
monthly or even daily fluctuations. Although states cannot influence the market rate of
interest, they can attempt to reduce the spread they pay over market, by cutting the risk
premium they pay or refinancing the debt under more favorable market conditions. As
noted earlier, real\(^{15}\) domestic rates are high in Brazil, by international standards, and are
expected to remain so.

2.16 With no exogenous relief in sight, various proposals have been made to reduce
the interest rate premium paid by the states. Most of these opportunities, however, have
already been taken. States are, in fact, now benefiting from interest subsidies, rather than
paying risk premiums. The interest rate payable on state debt varies. As shown in the
table below, the interest rate charged on rescheduled external debt is a spread over
LIBOR, adjusted for changes in the exchange rate\(^{16}\). The interest rate on domestic
rescheduled debt is pegged to inflation or the rate paid by private banks on short term
domestic savings (TR), depending upon the terms of the original contract. The spreads
charged by the Treasury are, in fact, below the rate the Treasury must pay on its own debt.

2.17 The interest rates on state bonds and debt to commercial banks is considerably
higher, but is still sequestered from market forces. The exchange of state bonds for
federal bonds is, in effect, a device that allows the states to finance their bonds at a rate
that reflects the market price of federal debt. (Without this, the interest rate of some
state debt would be almost infinite.) Similarly, the interest rate paid on debt to state
commercial banks was, until recently, financed at a rate that reflected the market’s

\(^{15}\) Real, rather than nominal interest rates are a more informative indicator of the financial costs of the
debt, since the state's principal income source—the ICMS—is imposed on an ad valorem basis, and is
therefore buoyant with respect to inflation.

\(^{16}\) Since the Real Plan was introduced, the rate of interest on this debt has been negative in real terms, due
to the simultaneous appreciation of the Real against foreign currencies and its depreciation in terms
of domestic purchasing power. This anomaly is not expected to persist.
perceptions of the banks’ creditworthiness, not the state’s (as the debt was ultimately
financed through deposits and the sale of interbank CDs.) With BANESPA under Central
Bank intervention, the bank’s costs of funds now reflect the implicit backing of the Federal
government, and thus are far below what they would be if BANESPA, or the state
treasury itself, had to finance this debt on the private market. As a result, the states have
little further financial benefit to gain by reducing any domestic risk premium.\footnote{\textsuperscript{17,18}}

Table 2.1: Interest Rates

<table>
<thead>
<tr>
<th>Type of Debt</th>
<th>Formula</th>
</tr>
</thead>
<tbody>
<tr>
<td>7976</td>
<td>0.81% + LIBOR + Fx</td>
</tr>
<tr>
<td>“8727”(a)</td>
<td>6.54% + IGP or TR</td>
</tr>
<tr>
<td>New domestic</td>
<td>2% + LFT</td>
</tr>
<tr>
<td>New external</td>
<td>0.81+LIBOR+fx</td>
</tr>
<tr>
<td>State com’l bank</td>
<td>CB discount rate</td>
</tr>
<tr>
<td>Titulos</td>
<td>LFT</td>
</tr>
</tbody>
</table>

2.18 Several of the states, including São Paulo and Minas, are interested in lowering
their interest costs by refinancing their debt externally, noting that real long term
international interest rates are considerably lower than domestic rates. As the states would
still have to pay a substantial risk premium if they attempted to borrow abroad on their
own, they are seeking the guarantee of a credible borrower in this venture. São Paulo is
interested in using an international development bank. Other states are interested in using
the federal government.

2.19 The merits of doing so are questionable. The risks of transferring so much debt
onto external markets are high. The states (and the federal government, as guarantor)
would be exposed to exchange rate fluctuations and balance of payments constraints.
Externalizing the debt would also raise the cost of external borrowing to the Federal
government. Shifting so large a volume of Brazilian public debt onto international credit
markets would drive up the interest rate premium paid by all agencies of the Brazilian
public sector—including the federal Treasury.

\footnotetext{17}{Officials of the Treasury are nevertheless contemplating an official federalization of the bonded debt,
paralleling the model already adopted for the rescheduling of external and internal (federal) debt
(Laws 7976 and 8727.); i.e., the debt would officially be transferred to the Treasury, its maturity
would be extended (beyond the 30-day renewal arrangement now in effect) and states would be
required to pay interest directly to the Government. In effect this would largely formalize the
existing, de facto, situation. Treasury officials nevertheless advocate it on the strength of the
enforcement mechanisms (deduction at source) that it would make available.}

\footnotetext{18}{In principle, the states might be able to benefit from refinancing their revenue anticipation bonds
(AROs), which are now contracted at market terms. A proposal to provide funding for ARO
financing is under consideration.}
2.20 In addition, the use of the federal government as guarantor would perpetuate the moral hazard that already distorts the behavior of state governments. Relying on a federal guarantee would directly place the risk of default on the federal government. Using an international development bank would do the same (as development bank lending or guarantees require a federal guarantee.) In effect, externalizing the debt would endorse a "no-fault" approach to debt management: having gambled and lost in the short term domestic capital market, the states would be placing equally risky bets on international capital markets--and expecting the federal government to stake them.

2.21 Increasing Revenues States' ability to increase tax revenues through policy measures--increasing tax rates or reducing exemptions--is limited. The states' principal tax is the ICMS, a broad based value added tax. Under the terms of the federal Constitution, any increase in the rate of the tax requires the concurrence of all state finance secretaries. As a result, ICMS revenues tend to vary not with policy changes but with changes in GDP. This is an exogenous factor, which the states can do little to influence\textsuperscript{19}. States can, nevertheless, increase tax revenues to a limited degree by improving tax administration. Levels of evasion are high, and significant increases could be achieved by collecting more of what is due.

2.22 Rival Categories of Expenditures Cuts in rival categories of expenditures are the most promising components of a debt workout. The states could make a significant contribution to their debt service obligations by reallocating expenditures from other categories of spending. The budgets of the principal debtors are large: the combined expenditure of the four largest debtor states totaled Rs 34 billion in 1994. Not all of this could be potentially reallocated to debt service, however. States are Constitutionally required to transfer 25% of their ICMS tax revenue to the municipios. Existing debt service must obviously also be considered untouchable. The remainder however, can be considered reallocable.

2.23 There are three categories of expenditures that are obvious targets for reallocation: (1) revenue-financed capital investments (2) personnel, and (3) subsidies.

2.24 In principle, revenue-financed capital investments are the most readily reducible item in the budget. A decision to cancel or postpone such capital works requires no break in long term contractual commitments (as would be the case with personnel cuts). The level of such expenditures is large. In the eight states for which data are available, it averages about eight percent of total expenditures.

2.25 The second target for cuts are the major categories of recurrent expenditures. Personnel is the largest single economic category of recurrent expenditure, accounting for an estimated 60-80% of total expenditures (other than debt-financed capital works.)

\textsuperscript{19} One area in which the states do have ICMS policy autonomy is in the granting of fiscal concessions. This power is a disincentive to tax effort, however, as it encourages states to engage in fiscal competition in order to attract new industry.
is a perception that state governments are overstaffed, particularly at lower levels, suggesting the possibility of deep staff reductions as a means of freeing resources to pay debt service. A commonly cited constraint on layoffs, however, is a provision in the Federal Constitution that prohibits any entity of the public sector from firing staff, once the staff member has successfully completed a two year probationary period. This Constitutional constraint is not as binding as it appears however. Many of the states undertook massive hiring during the recent political campaign. As these staff have not yet completed the two year probation period, they are subject to dismissal. Personnel who are employed as contractors are also, to varying degrees, exempt from Constitutional protection, as are employees of indirect units of administration who are employed under private labor legislation (CLT) rather than as statutory public employees.

2.26 In principle, the state also has the authority to reduce salaries. Under federal law, each state has the authority to set its own salary structure. The prospects for reducing salaries are not particularly promising, however, as existing salary scales are already extremely low.

2.27 Subsidies are a third potential focus of expenditure cuts. All the states own power companies and water companies and all but two own state banks. Levels of subsidies to these enterprises are relatively small, however. It is subsidies to the transport sector that account for the majority of expenditure in this category, particularly in the case of Sao Paulo and Rio de Janeiro, where the states are responsible for both metros and train systems. 20

2.28 In the states surveyed for this report, many such reforms are already under way. These are summarized in table 2.2.

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20 Sao Paulo's subsidy includes long standing pension subsidies to the state rail company, FEPASA. Rio is scheduled to assume financial responsibility for its suburban rail system in 1996.
Table 2.2: State Reforms

<table>
<thead>
<tr>
<th>Privatization</th>
<th>São Paulo</th>
<th>Rio</th>
<th>Minas</th>
<th>Pará</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Privatizing some small empresas; but will not sell major power companies, banks, claiming market conditions unfavorable</td>
<td>Planning to sell state bank, but blocked by uncertain status of bank's non-performing assets (state bonds) and unfunded pension liabilities</td>
<td>Previous admin. sold first of 3 state banks current admin. is in process of privatizing second</td>
<td>Considering allowing private ownership of extensions to power distribution network; water supply concession</td>
</tr>
<tr>
<td>Cuts in internally financed investment</td>
<td>Cut sharply</td>
<td>Cut sharply</td>
<td>NA</td>
<td></td>
</tr>
<tr>
<td>Cuts in personnel</td>
<td>Dismissing non-confirmed staff in direct administration; claims further cuts require Constitutional amendment</td>
<td></td>
<td>NA</td>
<td>Fired temporary employees and ghost workers</td>
</tr>
<tr>
<td>Improvements in tax administration</td>
<td>Procedural reforms on vehicle tax, no major change in VAT</td>
<td>VAT: reorganizing tax office, closing loopholes in tax law; vehicle tax: computerizing enforcement</td>
<td>VAT: recadastering taxpayers, simplifying documentation</td>
<td></td>
</tr>
</tbody>
</table>

2. Changes in the Economic Environment

2.29 The impact of a workout is also sensitive to exogenous variables. Two are critical: changes in real interest rates and changes in GDP. Real interest rates are extremely variable. As shown the earlier figure, from 1987 to the first quarter of 1995, real interest rates have ranged from -49% to +39%, with a standard deviation of 28 percentage points. Changes in state GDP can also affect state financial condition, particularly in the richer states that derive most of their revenue from taxes. (As shown in the figure below, ICMS revenues are mildly correlated with changes in GDP.) The impact of workout scenarios must therefore be measured against the likely range of variation in these conditions.
C. Simulations

2.30 To test the impact of different workout packages—and their sensitivity to changes in interest rates and GDP—simulations were prepared for eight states for which reliable, comprehensive debt data was available. The simulations are based on the states’ average recurrent revenues and recurrent and capital expenditures (other than debt service) in 1993 and 1994, adjusted for inflation. Estimates of debt service were based on the level and terms of debt as at January 1, 1995, and the ceilings and grace periods in effect in 1995. “Impact” is measured in terms of net cash flow. In other words, the test of debt service affordability is whether a state can meet all of its debt service obligations, plus its other current and capital spending commitments, from projected revenues. (Capital receipts other than bond rollovers are assumed nil, as are debt-financed capital expenditures.)

2.31 The three charts below show the impact of three scenarios: (a) a base case, showing the impact of a continuation of 1994 policies and economic conditions; (b) an external case, showing the impact of improvements in the economic environment with no changes in policy, and (c) a policy case, showing the impact of policy reform without improvements in the economic environment. In the policy case, the majority of reforms are made by the individual state governments. The only federal element is the reduction in the stock of high cost debt for which both the federal government and the state government could make contributions. The specific assumptions used in making these calculations are shown below.
Table 2.3

Assumptions used in scenarios

<table>
<thead>
<tr>
<th></th>
<th>Base case</th>
<th>External case</th>
<th>Policy Case</th>
</tr>
</thead>
<tbody>
<tr>
<td>LIBOR</td>
<td>6.25%</td>
<td>6.25%</td>
<td>6.25%</td>
</tr>
<tr>
<td>LBC</td>
<td>30%</td>
<td>drops to 15%</td>
<td>30%</td>
</tr>
<tr>
<td>TR</td>
<td>12.5%</td>
<td>drops to 7.5%</td>
<td>12.5%</td>
</tr>
<tr>
<td>precatorios</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>GDP</td>
<td>grows 4.5%</td>
<td>grows 7.5%</td>
<td>grows 4.5%</td>
</tr>
<tr>
<td>debt liquidation</td>
<td>no change</td>
<td>no change</td>
<td>50% liquidated</td>
</tr>
<tr>
<td>capital spending</td>
<td>no change</td>
<td>no change</td>
<td>cut 80%</td>
</tr>
<tr>
<td>recurrent spending</td>
<td>no change</td>
<td>no change</td>
<td>cut 10%</td>
</tr>
<tr>
<td>tax effort</td>
<td>no change</td>
<td>no change</td>
<td>increase 10%</td>
</tr>
</tbody>
</table>

2.32 As shown Figure 6, all eight states would have a negative cash flow under the base case. For the states with large bonded debt, this is due to the inclusion of bond interest in the calculation of expenditures. In states with large rescheduled debt, it reflects the end of grace periods, and in some cases “unrollable” fluctuating debt. The scale of deficits varies considerably. Sao Paulo’s estimated deficit is equal to 80% of revenues. The other heavily indebted states would run deficits of 17%-36% of revenue. Deficits in the non-bond states would be considerably smaller, running from 3% to 11% of revenues.

Figure 6 Base Case Scenario

2.33 Improvements in the external environment would improve the situation somewhat, as shown in Figure 7. Nevertheless, under the assumptions shown in the preceding table, all eight states would remain in deficit.
The impact of policy reforms, on the other hand, is striking. As shown in Figure 8, six of the eight states would run positive cash flows, and Minas’ deficit would be a mere 3% of revenues--even without improvements in the economic environment. Even Sao Paulo’s negative cash flow would shrink to 30% of revenues.

These outcomes, of course, are sensitive to the mix and scale of reforms. The bond states, for example, are sensitive to changes in the proportion of high-cost debt that is forgiven or liquidated (although Rio de Janeiro and Rio Grande do Sul would achieve positive cash flows without forgiveness if tax effort increased by 20% and recurrent non-interest expenditures dropped by a similar amount.) Reforms in the non-bond states are more robust. The three combination of reforms shown in the table below all result in approximately the same net cash flow in the four non-bond states.

<table>
<thead>
<tr>
<th>Alternative Reform Scenarios</th>
<th>10%</th>
<th>25%</th>
<th>25%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase in tax revenue</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cut in recurrent expenditure</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cut in internally-financed capital expenditure</td>
<td>80%</td>
<td>80%</td>
<td>50%</td>
</tr>
</tbody>
</table>
2.36 These scenarios are intended to be illustrative. The actual impact of workouts will depend upon the specific terms and conditions of the workout, as well as the financial condition of the state and the scale of debt at the time the workout is implemented. Nevertheless the simulation suggests that the debt crisis is not an insuperable problem that can only be addressed through a complete federal assumption of the bond debt and/or dramatic drops in real interest rates. Internal reforms on a plausible scale, combined with partial debt liquidation in the most heavily indebted states, would be sufficient to reduce debt service to manageable levels.

3. REFORMING ACCESS TO CREDIT

3.1 While workouts are needed to defuse the immediate crisis, two sets of actions are needed to reduce the likelihood of its recurrence. The first is a change in the arrangements governing state access to credit, to reduce the federal government’s exposure to state financial crises. The second consists of corresponding internal reforms in individual state governments to increase the states’ ability to manage the financial risks associated with debt.

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**Defining Debt**

Debt subject to Senate regulation is defined as any financing obligation made by a state, municipio or their autarchies that represents an obligation to any creditor located within the country or overseas. The law specifically includes the concession of guarantees and contracts with delayed payment schedules. It also covers short term debt (i.e. debt with maturity of less than one year) although it is subject to a different ceiling than long term debt. Obligation to employees are not covered by the law, however. Thus unfunded pension liabilities, a growing component of state debt, are not included in the Senate calculations.

3.2 The present system uses both private and public entities to mobilize and allocate savings to state borrowers. The private role, as discussed earlier, has historically included the bond market, and the private domestic and external banks. The state bonds were originally marketed to private banks, for example, and the state commercial banks financed their holdings of state debt from private deposits and interbank CDIs. The public role is dominated by the federal government and includes a variety of forced saving schemes established in the mid-1960’s--most importantly FGTS and PIS/PASEP--whose resources are passed through federal intermediaries--CEF, BNDES-- and on-lent to states. In addition, the federal government mobilizes savings through its deposit taking commercial banks--principally the Banco do Brasil--which are then lent to states. The federal government also assists in mobilizing external resources, by acting as a guarantor of state external borrowing. Indirectly, the Central Bank also has a role in state borrowing. As guardian of the financial system, it provides liquidity for state banks, and is thus drawn
into shoring up (and ultimately taking control of) state commercial banks. In its role in assisting the states to market their bonds, the Central Bank is also drawn into financing the state’s bonded debt, taking over this role from the private capital market.

A. Problems with the Existing System

3.3 The present system for lending to states is vulnerable to several weaknesses. The prominent role of the federal government has rendered it vulnerable to the financial problems of the states. As the dominant holder of existing state debt, the federal government is subject to state defaults. As a supplier of new long term state credit, it is subject to pressures to approve loans to non-creditworthy states, laying the groundwork for defaults in the future.

3.4 Private lending has not proven an attractive alternative. While the private sector has historically been willing to lend to states, it has behaved rationally: it enters when the rewards outweigh the risks and leaves when they do not. Given the instability of real interest rates in Brazil, as well as the dramatic policy changes that accompany changes in administration, private banks prefer to confine their lending to relatively short term commitments, permitting a rapid exit when the occasion arises. This routinely provokes state liquidity crises as the states find themselves unable to pay off or refinance this debt.

3.5 The Government relies on regulation to offset these risks. The present regulatory structure, however, is insufficient to do so. At first glance, the regulatory structure would appear to be all-encompassing, with its combination of rigid creditworthiness criteria to applicable to all forms of state borrowing, prohibitions on borrowing from virtually all private sector sources, and tough federal enforcement mechanisms. (These are summarized in the chart below.) There are weaknesses in the present framework, however. First, the system used to analyze new federal lending is insufficiently sensitive to risks—and too easily overridden by the Senate. Second, the system is not effective in controlling the capitalization of interest on debt the states have already incurred. Third, the treatment of private lending—outright prohibition—while effective, is also probably unsustainable. States have a legitimate need to borrow long term, and a system that relies on a direct relationship between state governments and private lenders has much to recommend it—as long as the federal government remains firmly isolated from the associated risks. To provide a mechanism for financing long term state investment, while minimizing the federal government’s exposure to state financial crises, reforms are needed in three corresponding areas: (1) the Government’s method for evaluating creditworthiness; (2) federal regulations governing bond rollovers and exchanges; and (3) regulations on borrowing from the private sector.


Regulatory Framework

<table>
<thead>
<tr>
<th>Regulation</th>
<th>Applies to</th>
</tr>
</thead>
<tbody>
<tr>
<td>Senate ceilings on new debt</td>
<td>state borrowing from private and public lenders</td>
</tr>
<tr>
<td>Prohibition on borrowing from own state bank</td>
<td>state's own commercial banks</td>
</tr>
<tr>
<td>Ceiling on loans from pvt com'l banks**</td>
<td>private domestic banks</td>
</tr>
<tr>
<td>Prohibition on new bond issues</td>
<td>new state bond issues</td>
</tr>
<tr>
<td>Ceiling on bond rollovers *</td>
<td>outstanding bonds</td>
</tr>
<tr>
<td>Collateral requirement on CB bond exchange</td>
<td>outstanding bonds (overridden)</td>
</tr>
<tr>
<td>Prohibition on lender to defaulters</td>
<td>federal lending</td>
</tr>
<tr>
<td>Deduction at source</td>
<td>federal lending</td>
</tr>
</tbody>
</table>

* States prohibited from issuing new bonds, except rollovers, until 2000
** Regulations also prohibit any borrowing by a state from its own commercial bank

B. Reforming The Government Assessment Of Creditworthiness

3.6 The federal government needs to be able to assess the risks of lending to a particular state more effectively. The government now relies on Senate resolution 11, which applies to all borrowing by states and municipalities regardless of source. As discussed earlier, the Senate definition limits debt service to 100% of a state's current account surplus, or 15% of revenues, whichever is less. This is short-sighted and insufficiently sensitive to risks. Brazil is a country of considerable economic instability: growth rates, interest rates, foreign exchange rates and rates of inflation fluctuate greatly. Rival categories of expenditures can grow rapidly for reasons beyond a state's control. The Senate criteria does not sufficiently reflect these risks. In effect, the Senate resolution permits a state to commit the entire value of its current account surplus in its best year—the year in which the interest rates on its portfolio are lowest, exchange rates are highest, exchange rates are highest,

21 Debt service is defined as debt service on the present portfolio during the preceding twelve months, adjusted for inflation, plus the debt service that would result from new loan under consideration. As discussed earlier, other criteria are also included in the definition, but they are not binding constraints. The requirement that that new borrowing cannot exceed existing debt service or 27% of revenues, whichever is greater, places virtually no limit on the debt of states that are already heavily indebted, and "slows" the growth of debt in other states to 27% of revenues—hardly an onerous restriction. Note also that rollovers of principal and capitalized interest on state bonds are excluded from this calculation, to the extent permitted by the Senate.
and its current account surplus is largest—to servicing debt. With 100% of their surpluses leveraged to service debt, states have no margin to fall back on in case of rising real interest rates, or falling GDP. (The companion criterion—restricting debt service to 15% of revenues—merely means that states must time their borrowing to coincide with periods of high revenues and low real interest rates.) Even in the hands of a financially conservative state, these criteria are a recipe for default. If creditworthiness analysis is to deflect bad debt, it must be more forward looking and more sensitive to possible downside risks. It must be forward looking because debt will be repaid over an extended period of time. It must be more sensitive to downside risks, due to the variety of factors that will affect the state’s ability to service debt.

3.7 For the Federal government’s purposes, creditworthiness can be defined as state’s ability and willingness to meet its debt service obligations plus all other recurrent and capital expenditure commitments from projected revenues over the repayment period of the loan. The starting point for creditworthiness analysis is the state’s cash flow in the year in which debt service will begin. As a minimum condition, a state should have sufficient revenues to service its debt, along with all other spending obligations in first year of repayment. This can be calculated on the basis of revenue and expenditure patterns in the twelve months preceding the loan. As shown in Figure 9, this minimum condition may be difficult for most states to meet. None of the eight states analyzed for this study would meet this minimal criteria, given their level of debt as of December 31, 1994, assuming a continuation of interest rates prevailing in the first half of 1995, a prohibition on further capitalization of bond debt, and a continuation of the levels of spending on personnel and works that prevailed in the previous two years.

In this respect, the federal government’s perspective differs from that of a private bond investor. A private investor is ultimately concerned with getting his money back. In emerging markets, investors thus focus on the quality of collateral as a major determinant of creditworthiness. The Brazilian government has to take a broader perspective. Seizing collateral from a bankrupt state is a means of recovering funds, but it does not improve the finances of the borrower. As the federal government has an interest in the financial condition of all subnational governments, it must aim to forestall state financial crises, rather than recover from them.

This outcome is inherent in the assumptions underlying the simulation. All of the states benefited from some form of Federal relief on debt service in 1993 and 1994, including the automatic capitalization of unpaid interest on state bonds, and grace periods on the repayment of rescheduled debt. As the model recognizes the expiration of grace periods in 1995 and assumes that states will pay interest on their bonds, while continuing their level of spending on personnel and works, a negative cash flow is virtually assured.
Figure 9 Pre-Adjustment Net Cash Flow

3.8 The workouts described in the preceding chapter would substantially alter this picture. Under the “policy” package, consisting of improved tax administration, cuts in personnel, cuts in internally financed capital investment, and reductions in the stock of debt, five of the eight states would emerge with a positive cash flow in the base year, as shown in Figure 10.

Figure 10 Post-Adjustment Net Cash Flow

3.9 The existence of a positive net cash flow is not sufficient to demonstrate a state’s ability to service additional debt, however. Given the instability of economic and policy conditions in Brazil, the major risks that would affect a state’s ability or willingness to repay debt must be assessed. The future risk factors can be organized in two groups: (1) exogenous risks—particularly adverse changes in the macroeconomic or federal policy environment; (2) internal risks—the risk that the state may not have the flexibility to respond to these changes; or that the state will choose not to, even if it has the ability.
1. Exogenous Risks

3.10 Real interest rates  Changes in real interest rates (and foreign exchange rates on foreign debt) have a profound impact on state creditworthiness. Since all state debt is at variable terms, interest rate fluctuations affect the costs of existing debt, as well as new debt. Due to the volume of outstanding debt, changes in interest rates have significant impacts on overall state finances. And due to the variability of real interest rates, these changes can be large and unpredictable. In order to reflect the volatility of Brazilian economic conditions--particularly interest rates and foreign exchange rates--debt service should be defined not on the basis of the interest rates in the preceding twelve months (and the exchange rates implicit in interest rates on foreign borrowing), but on the basis of a “presumptive” interest rate, based on conservative estimates of the longer term prospects for domestic interest rates and foreign interest rates adjusted for exchange rate fluctuations. In effect, this would force states to reduce their debt to a level that would be payable through the entire range of interest rates that Brazil can expect to experience.  

3.11 State GDP  The outlook for the state economy is another important determinant of a state’s capacity to service debt, through its impact on revenues. State tax revenues are largely derived from a broad based value added tax, whose yields vary with state GDP. Rates of economic growth varied considerably among the nine case study states--from 0.5% per annum in Rio Grande do Sul, to nearly 3% per annum in Minas Gerais. Over the long term, states can prudently increase their stock of debt at the rate of revenue growth; such growth would allow the state’s debt/revenue ratio to remain roughly constant.

3.12 In the poorer Brazilian states, however, the majority of revenues are derived not from taxes but from intergovernmental transfers. The level of transfers varies with federal tax receipts, and is thus a function of national, rather than state, GDP. A more accurate indicator of a state’s debt servicing capacity would include both growth in both in local GDP and national GDP, weighted according to the respective shares of taxes and transfers in total state revenues. Under this criteria, the variation among states would closely parallel the national average.

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24 In making this calculation, it will be necessary to individually calculate the debt service on virtually every loan. The formulas used to determine interest rates vary widely among loans. Calculations of debt service obligations also have to take into account the circuit breakers that have been included in the renegotiations of state debt to the federal government. (In effect, these cap the effective rate of interest on rescheduled debt until the year 2013, after which any accumulated interest must be paid over the following decade. States with a high proportion of rescheduled debt may thus be creditworthy for debt that mature before the year 2013, after which they may be bankrupt.) Calculations should also take into account debt that are not recognized as such. Pension liabilities (including payments to retirees and survivor benefits) are by far the most important of these.

25 As noted earlier, states do not have the power to change ICMS rates unilaterally. These restrictions would be retained under the tax reform proposals now under consideration.
3.13 **Federal Debt Policy**  Federal debt policy will have a major impact on state credit worthiness. Decisions concerning the proportion of bond debt and ARO debt that federal government will assume on behalf of the states will affect the stock of outstanding state debt, and thus annual debt service obligations. Senate decisions concerning the proportion of state bonds that may be rolled over may have an immediate impact on cash flow, as the amount that cannot be rolled over will presumably have to be liquidated. At present, there is much uncertainty surrounding both factors. The federal government is now discussing possible debt relief with individual state governments. These discussions will in turn affect the proportion of bonds that the Senate permits to be rolled over. Given the uncertainty surrounding these discussions, prudent creditworthiness analysis must reflect the downside risks. It could be assumed for example, that (a) after a one-time reduction in the stock of high cost debt, no further debt relief would be granted, and that (b) although the Central Bank would continue to finance the outstanding stock of state bonds, rollovers would be limited to a small proportion of the stock, and states would be required to pay interest on an ongoing basis.

3.14 **Constitutional reforms**  Constitutional reforms have an important bearing on states’ creditworthiness through their impact on the largest non-debt item of expenditure: personnel costs. Personnel (including payment to retirees) accounts for 65%-95% of state net recurrent expenditure. At present, the Federal Constitution prohibits states from dismissing civil servants, once they have completed a two year probationary period. It also mandates their retirement after thirty years of service (regardless of age) and retirement benefits equal to full exit salary (including most gratificacoes). As a result, states are unable to downsize. Moreover, as the active labor force is growing more slowly than in the past, the ratio of active personnel to retirees is expected to grow rapidly in the near future, increasing the burden of Federally-mandated retirement benefits. Constitutional reforms that would permit states to fire staff and reduce pension benefits are now under consideration. At present it is uncertain whether these will be approved, and if so in what form. Prudent creditworthiness analysis requires a recognition of the downside risks. It could be assumed, for example, that the reforms will pass, but that the “acquired rights” of existing personnel and retirees will be protected, reducing their immediate financial impact.

2. **Internal risks and ameliorating factors**

3.15 **Revenue and expenditure flexibility**  There are other ways to deal with risk. States can adjust to changes in the economic and policy environment through their own

26 States also confront a rollover risk on their private debt. The principal risk lies with the divida flutuante—the unpaid balances owed to suppliers, contractors, personnel, and other branches of government. States normal maintain a large stock of divida flutuante, which is rolled over in the sense that the obligations from the previous year are paid off, and are then replaced by new arrears which will be liquidated in the subsequent year. This entails some risk, as the “suppliers” of this form of credit may become increasingly reluctant to do so.
budgets, by increasing revenues or reducing non-debt expenditures. How much they can adjust depends upon how much revenue and expenditure flexibility they have. As discussed earlier, states have little revenue autonomy. The rate on their principal tax can only be changed by consensus, and the level of transfer revenue is predetermined by Constitutional formula. States have somewhat more flexibility on expenditures. Although states have little control over personnel costs (other than through salary adjustments), they do control the level of internally financed capital expenditures. As these are discrete expenditures that can be postponed or canceled without breaking long term contractual commitments, these expenditures can easily be diverted to debt service in the event of a drop in revenues or an increase in costs.

3.16 In the short run, the ratio of internally financed capital investments to debt service is a good indicator of expenditure flexibility. The level of such spending is volatile, however. As a predictor of expenditure flexibility in the outer years of debt repayment, the ratio of revenue to debt service tends to be more robust. How large that ratio should be is a matter of judgment. In industrial countries, there is no hard-and-fast rule. The debt service/revenue ratio is simply one of the factors that enters into an overall judgment on a state’s credit standing. Brazil, however, may not be ready for so subjective a methodology. Access to credit is subject to intense political pressure and a more mechanical criteria may be easier to maintain. A more restrictive version of the Senate’s 15% rule may function successfully, for example. If debt service were calculated on the basis of presumptive interest rates, and “net revenues” were calculated on the basis of conservative estimate of economic growth and plausible increases in non-debt recurrent expenditures, the Government could be fairly assured that states would have the means to service their existing and proposed debt.

3.17 The 15% rule has the additional virtue of limiting growth in the stock of debt to the rate of growth in the state’s revenue base. From a macroeconomic perspective, this is an essential condition of debt sustainability. The burden of state debt—expressed as a percentage of revenue or GDP—cannot grow indefinitely. Otherwise, interest payments would eventually consume the entire economy. The sustainability of debt is normally monitored on the basis of the primary surplus (revenues minus expenditures other than debt service) and the debt/revenue ratio, as discussed in the box below.) The 15% rule conveys the same information: Limiting debt service to 15% of revenue in effect ties growth in the stock of debt to growth in the revenue base, through the debts’ interest rates and amortization schedules.
Linking Debt to Macroeconomic Conditions

Two principles underlie state creditworthiness. The first is that the burden of debt, expressed as a ratio of state revenue, should not grow systematically over time. This is a basic condition of sustainability. The second principle is that the burden of debt service should not exceed a predetermined fraction of revenue. This ensures that debt service can be paid without eliminating rival categories of expenditure. These two principles can be expressed algebraically as:

\[ \frac{d(D/R)}{dt} \leq 0 \]
\[ \frac{(r+q)D}{R} \leq 0.15 \]

where \( D = \) stock of debt, \( R = \) revenues, \( d = \) time derivative; \( r = \) long run real interest rate; \( q = \) inverse of the average debt maturity in years. Adding a budget equation completes the model:

\[ dD \leq E + iD - R \]

where \( dD = \) new net borrowing, \( E = \) non interest expenditures and \( i = \) nominal interest rate. This equation shows that debt increases as the primary deficit increases and as nominal interest rates rise. Combining the first and third equations gives the formula:

\[ \frac{(R - E)}{R} \cdot \frac{R}{D} \leq r - g \]

where \( g = \) real growth. This final equation links the state budget variables to macroeconomic conditions. When real interest rates rise or growth slows, the primary surplus must be adjusted or debt must be reduced to maintain stability in the debt/revenue ratio.

3.18 The simulations used for this report suggest that imposing risk factors would substantially reduce the amount of debt for which a state would be creditworthy. As shown in the chart below, if no risk adjustments were made—if all of the base case net cash flow were committed to servicing additional debt—six of the eight states would be “creditworthy”, with maximum new borrowing ranging from Rs250 mn to Rs2 billion. Adjusting for external risks reduces the number of creditworthy states to five, and decreases the level of maximum debt in each of them. (The impact of external risks would be greater if the base case did not already include a presumptive interest rate of 30% (LBC)). Applying more restricting definitions to the Senate’s creditworthiness criteria—limiting debt service to 15% of net revenues and requiring a current account surplus—eliminates three of the remaining states, and reduces the maximum debt in the remaining two considerably to less than Rs200 million.
3.19 **Political Risk and Collateral** Ability to pay is no guarantee that a state will actually service debt. The risk that a state will default even if it has the means to pay has ample precedent in Brazil. In some states, Governors treat debt service as merely one of many competing claims on state resources, and allocate funds according to the priorities of the moment. Judging political risk is obviously difficult. Every new administration starts with a new agenda, which often includes reneging on the commitments of its predecessors. To an extent, history (as an indicator of political culture) can be a guide: a record free of defaults, and a recent history of balanced budgets are positive indicators. Good management practices—timely and accurate financial reporting, for example—and conservative financial practices—fully funded pension liabilities, ample debt service coverage—are also indicators of a financial conservatism that may be also be associated with a commitment to servicing debt.

3.20 Certain contractual features of a loan can encourage commitment to debt service. Debt service can be withheld from intergovernmental transfers, either automatically or as a backup in case of the borrower's default. The government already requires this in the case of the rescheduled debt and it would be appropriate to extend this provision to other debt owed to the federal government—particularly the state bonds held by the Central Bank. It is not clear, however, how enforceable such collateral is. The power to garnish ICMS revenues may be useless to a Government confronted with police strikes and closed schools in a major state. Such collateral may be useful as a preventive measure—"in the
sense that it may discourage states from borrowing—but it can only be enforced selectively.

3.21 In assessing individual state creditworthiness, the Government will have to reach a judgment based on all these factors: the state's current cash flow and the likely changes imposed by shifts in the policy and economic environment, the state's expenditure flexibility and its political risks. It is important to note that these calculations must be regularly updated. While presumptive real interest rates of 30% appear appropriate now, they may be unnecessarily restrictive once Brazil achieves an extended period of economic stability.

C. Regulating Existing Debt Held by Federal Government

3.22 There is a second weakness in the framework. It is not effective in controlling the growth of state debt already in federal hands. The principal source of growth is the capitalization of interest on bonds and on the debt owed by Sao Paulo to its commercial bank, BANESPA. Although the federal government has the authority to control this growth, it has not done so effectively. The Senate has the power to limit the proportion of bonds that may be rolled over, but tends to exercise this power with restraint. The Senate can also stipulate collateral requirements for bond exchanges, but does not now do so. The Central Bank’s power to limit the capitalization of interest on bonds is limited. In effect, it is required to buy whatever bonds the Senate permits the states to roll over. In theory, the Central Bank has considerably more control over the capitalization of unpaid interest owed to state banks. Having taken over the management of BANESPA, the Central Bank is—in principle—in a position to liquidate the state’s outstanding debt, by selling what it can and using any proceeds from the sale of the BANESPA itself to pay off the remainder.

3.23 While such actions are likely to be decided in the political realm, it may be useful to strengthen the technical analysis that lies behind them. Recommendations regarding bond rollovers and state bank bailouts should to be made in a unit that has technical ability to evaluate their impacts, and the mandate to protect the long term financial interests of

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27 Isolating project funds from general treasury revenues may also increase the odds of repayment. Revenue bonds, for example, may be less risky than general obligation bonds, since they do not have to compete against other claims on general revenues of the state. The riskiness of revenue bonds will of course depend on the financial prospects of the enterprise. In practice, it also will also depend on how well the enterprise is isolated from the interference of the state. It should be noted that much of the existing state debt originated as loans to state enterprises, backed by their revenues, with the state acting only as guarantor. State interference—political manipulation of tariffs, forced overstaffing, and appointment of political supporters to senior management positions—is partly to blame for the enterprises’ default. Even enterprises that escape political manipulation run the risk that the state government will skim profits—if not operating revenues—from the enterprise during periods of fiscal distress. Risk evaluation, in the case of revenue bonds, must therefore include an evaluation of the risk that state interference will prevent enterprise from servicing the debt.
the country. The creditworthiness assessment units in the Central bank or federal Treasury—which are now responsible for calculating state's compliance with the Senate criteria for new loans—could be the basis for such a unit.

3.24 To carry out such assessment, the federal agencies responsible for credit analysis require more accurate, timely data and staff. The state balance sheets on which current calculations are based, for example, need to reveal states’ actual debt service obligations (debt service is reported on a cash, rather than an accrual basis). The staff assigned to perform creditworthiness assessments need the stature to confront state administrations with sensitive questions.

3.25 The job of resisting pressures to finance excessive debt would be made easier if the unit had readily measurable indicators; triggers that would flag problems early, and prompt pre-arranged federal responses. It would not be unreasonable to forbid bond rollovers where the resulting presumptive debt service would exceed 15% of revenue, for example, and to place time limits and collateral requirements on the amount of bonds that can be exchanged with the central bank.

3.26 To enforce such policies, the federal government would have to expand its enforcement powers. While the Government can refuse to refinance the state bonds it now holds, it has no means of forcing the states liquidate them at maturity. Recalcitrant states have the option of defaulting. To prevent this, the Government should extend its power to deduct state obligations from transfers and ICMS accounts (a power that now only applies to rescheduled debt) to state bonds held by the Central Bank.

**D. Regulating Borrowing from the Private Sector**

3.27 The imposition of tighter credit worthiness assessments, consistent enforcement, and less generous assistance with bond financing and state bank liquidity would sharply reduce the risk to the federal government of imprudent borrowing by state government. Taken together with the rest of the regulatory framework, however, it would establish a federal monopoly on lending to state governments.

3.28 The present regulatory framework restricts most forms of private lending to state governments. As states are prohibited from issuing new bonds (until 2000), the private bond market consists only of exchanges and rollovers of the existing stock. Private banks are prohibited from increasing their stock of state debt (although each bank can adjust its portfolio, as existing loans mature.) The only officially permitted source of private long term credit is the external private market.

3.29 Should the restrictions on domestic private borrowing stay in place? There are arguments pro and con. Removing the constraints, under present regulations, could easily prompt a recurrence of the present crisis: massive short term borrowing by state governments, followed by liquidity crises, and demands for federal relief. Maintaining the
existing constraints also entails certain risks, however. Federal self-regulation is a weak substitute for the discipline of the private capital market.

3.30 If private lending is re-authorized, the federal government has to limit its exposure to liquidity crises in the states. As long as this the federal government is perceived to be the de facto guarantor of all state borrowing, it will have to restrain states from borrowing from the private, as well as the public, sector. The revisions to the Senate's debt criteria proposed in the preceding section would go a long way in this direction.

3.31 The federal government needs to fortify this constraint with a credible demonstration of the financial risks facing private lenders if they ignore it. The private sector has historically lent more to states that would be justified by the states' own financial condition, in the belief that the federal government would provide relief if the state defaulted. Private bond holders were financing Sao Paulo state bonds long after it ceased being prudent, because they assumed the bonds carried a central bank guarantee. Private banks were buying BANESPA bonds, on the grounds that the Central Bank's intervention would ensure that the bonds would be honored. This ambiguity in the allocation of risk permitted states to borrow far more than a private lender would lend to them on the strength of the state's own finances. If the federal government is going to reauthorize private lending to states, the locus of risk must unambiguous; free of any implicit endorsement by the government. Judging from international experience, the implementation of this policy will require a credible demonstration. Paralleling US President Ford's response to New York's debt crisis, the federal government will have to permit a state to default, and force the state and its creditors to find resolution at the negotiating table or through the courts. The federal government could, alternatively, make the extent of its exposure explicit. It could require that state bonds carry an exchange warrant; permitting the bondholder to sell the bond to the federal government at a predetermined percentage of par value.

3.32 Overall, the result of the changes proposed here is likely to be a reduction in the aggregate level of state debt-financed capital investment. This is as it should be. In an environment of high real interest rates, it is unlikely that states would have many investment projects with rates of return sufficient to justify their interest costs. In the present economic environment, there is thus a strong case for states to financing their capital works through savings on current account, rather than through debt.

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28 Because the central bank registers state bonds on the public sector bond exchange, some private investors still assume that they carry the Central Bank's guarantee.
4. STATE MANAGEMENT REFORM

4.1 The complement to reform in the structure of lending arrangements is reform in the financial condition of borrowers. The states themselves have to become creditworthy—they have to be in a position where a prudent lender will lend to them at an interest rate that makes it worthwhile to borrow. State reform clearly has non-financial benefits as well: it would permit states to perform their role as providers of public services—education, health, transportation, and public security—more efficiently.

4.2 While most of the tools for state reform lie under the control of individual state governments, the federal government also has a critical role. As noted earlier, the federal government must continue to impose a hard budget constraint on the states, by limiting negotiated transfers and applying and enforcing strict rules on access to credit and debt repayment. It can also contribute to the creditworthiness of state governments by removing the constraints it imposes on state management. This could include, for example, the removal of Constitutional prohibitions on dismissing staff, and federal mandates on pension benefits. In the long run, it might also include changes in the tax structure, to permit individual states to set the rates of their principal tax.

1. Personnel Reforms

4.3 As noted earlier, personnel is the largest single economic category of state expenditure. Although the only actions that can be taken in the short run are dismissals, in the long run actions can be taken to improve performance of those who remain, and thus obviate the need for future staff expansion.

4.4 At present, the personnel profile of state administration is the typical "pyramid" of developing countries, with large numbers of low-skilled, often redundant, staff at the bottom, and few skilled, technically competent staff at the top. As the salary budget is exhausted in paying redundant staff at lower levels, staff at higher levels are difficult to attract and retain. Staff at all levels are unmotivated, due to legal impediments to dismissing unproductive staff, the lack of transparent criteria for promotion, and the compression of salary scales.

4.5 The Constitutional guarantee of stability is a constraint on reform, even though (as noted earlier) it can be partly evaded. It not only makes it difficult to offload redundant staff, but also demotivates those whom the state would want to retain, by eliminating any threat of dismissal. The Congress is now considering revising the Constitutional guarantee of employment stability. This would dramatically improve the states' ability to manage their personnel budget efficiently. Reform in the Constitutional
guarantee of employment stability should therefore be considered a key part of any sustainable solution to the debt crisis.

4.6 Reducing Overstaffing. Even within the constraints of the present Constitution, states have considerable latitude to improve the productivity of their labor forces. States, for example, can freeze hiring, and be selective in salary increases. In principal, these decisions as to the size of state employment rest with the Governor and the Assembly. Any new positions have to be authorized by the Assembly. In practice, these decisions do not appear to be informed by any detailed analysis of staffing shortages. In both São Paulo and Bahia, staff numbers are a residual outcome of annual salary negotiations: the overall salary bill is calculated as a percentage of tax revenues; any increase in the overall envelope is then distributed between salary increases to existing staff, and new positions, through negotiations with the interested parties.

4.7 Incentives. Staff productivity is undermined by the absence of any link between performance and pay. At present, not only is bad performance tolerated (due to the Constitutional guarantee of employment stability) but good performance goes unrewarded, due to organizational limitations on upward mobility, the lack of merit-based promotion criteria, and the absence of significant financial rewards for those who do receive promotions.

4.8 There is little scope for upward mobility within the civil service. State civil services are divided into career streams (medical workers, police, educators, etc.). Career streams are then subdivided into grades (doctor, nurse, aide). Each grade carries a range of salary levels. Promotion across grades within a career stream, however, is credential-based and is subject to arbitrary obstacles. In the São Paulo teacher corps, for example, promotion from primary to secondary school teacher requires attendance at a special training program, but the number of slots in the program is limited, and the choice of who is nominated is not entirely based on merit.

29 This is essentially a means of forestalling what would otherwise be an annual conflict with the public employees unions. In both Bahia and São Paulo, the state administrations have reached agreement with the unions on an acceptable ratio of ICMS revenues to total personnel. The federal law requiring states to spend no more than 65% of revenues on personnel is used in the same way. Although the law itself is unenforceable, it provides the state with a means of passing the blame for meager salary increases onto the federal government.

30 Wage differentials between career streams tend to reflect the relative bargaining power of different unions. In São Paulo, each union puts pressure on the relevant secretariat for a salary increase. The secretaries pass these demands along to a salary committee on which the key ministries are represented. There, various combinations of increases in salaries and additional positions are discussed, and then passed to the finance secretariat for analysis and recommendations to the governor. The governor is the ultimate arbiter, and although his decision is informed by this analysis, the pattern of increases is strongly influenced the relative power of different public employee unions.
4.9 Within a grade, promotion from one salary level to another is largely based on endurance. Both São Paulo and Bahia once had merit-based systems of performance evaluation, permitting supervisors to promote staff on the basis of individual evaluations of performance. Both states have abandoned the practice. Managers found the system too confrontational and resorted to awarding promotions by lottery or by rotation. Promotion itself carries little financial reward for outstanding performance. Within a given grade, there is little salary differentiation between the lowest and highest levels.

4.10 Reform in this agenda lies within the purview of individual states. A state has the authority to cadastre its positions and employees and derive a better match between position requirements, available skills, and new hiring. In 1987, Ceará introduced a personnel cadastre aimed at identifying ghost workers and cross checking salary benefits. The effects of purging ghosts and eliminating illegal bonuses and benefits—combined with an across-the-board salary cut—reduced the state personnel bill from Rs$ 550 million in 1986 to approximately Rs$ 450 million in 1994.

4.11 States can also rationalize staff allocation: Bahia, for example, is proposing a comprehensive review of the structure and staffing of each agency of the state, to assess whether the staffing numbers, grades and levels of responsibility are appropriate to the unit’s requirements. States can also remove barriers to cross-grade promotion, reintroduce merit criteria into in-grade promotion decisions, and de-compress their salary structures so that outstanding performance is meaningfully rewarded. While such reforms are under discussion (in São Paulo for example), no example of their implementation is available.

4.12 Defusing the Pension Bomb. In addition to these expenditure cuts, the states can also reduce an important—although unrecognized—component of their stock of debt: unfunded pension liabilities. If the states continue to fund these benefits from current income (as is now largely the practice) payments will consume an increasingly unmanageable share of their budgets. In a sense, unfunded pension liabilities threaten to become the debt crisis of the future.

4.13 The problem arises from the confluence of three factors. First, pension benefits are unaffordable. Second, pensions are unfunded. Third, the composition of the population is changing. Pension benefits are too expensive. After 35 years of service an employee is entitled to a lifetime pension based on his exit salary. (In Bahia, the pension is equal to 100% of the exit salary, in São Paulo, 70%.) Pension levels increase automatically with changes in the minimum wage. Upon the death of the pensioner, the surviving spouse

31 30 years for women; and five years less, each, for school teachers

32 Until the 1988 Constitution, any increase in the official salary of active staff had to be reflected in the pension benefits of retirees. The 1988 Constitution requires only that changes in pension benefits parallel changes in the minimum wage. States are therefore free to increase the salaries of active staff without automatically increasing the benefits of pensioners. They are, however, now forced to comply with the federally-determined minimum wage laws in setting the level of their pension benefits.
and any unmarried children are entitled to receive the pension until they die or marry. In addition, both active and retired staff and their families are entitled to medical care financed by the state. Because salaries are low, individual pension payments are not high. But because the 30-year rule permits staff to retire in their late 40's or early 50's, the duration of pension benefits is long. The lengthy payout period thus offsets the generally low levels of pensions.

4.14 These pension benefits are largely unfunded. Payments to retirees are paid directly from the general revenues of the state, without any pretense of advance funding. In theory, survivor benefits and medical benefits are paid from sequestered accounts, funded by matching contributions from the employee and the state. While the employees' share is, in fact, deducted, the states do not make a corresponding contribution. The state's annual contribution instead consists of paying the difference between the funds' outlays and the current workers' contributions.

4.15 Due to the generosity of these pension benefits, state subsidies (i.e., state expenditures net of employee contributions) already consume a significant share of the budgets of the Bahia and São Paulo state governments. (In São Paulo, the figure is 27%.) This proportion is likely to increase sharply over the next decade, due to changes in the composition of the population. As the growth of government employment slows, the ratio of retirees and survivors, relative to the number of active staff will increase. Already, in São Paulo, the ratio of retirees to active employees is 3:1.

4.16 States can begin to defuse the pension crisis, first, by reducing benefits. The most logical reform would be an extension in the date of retirement. The Congress is, in fact, now considering a proposal that would change the retirement criteria from length of service to age. The state should also begin funding the pensions, to ease the transition to the higher ratio of retirees-to-active-employees that will accompany the aging of the labor force. In São Paulo, it is estimated that an actuarially sound pension would require an 11%-of-salary contribution by both the state and the workers, each.

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33 In both Bahia and São Paulo, six percent of employees' salary is deducted and deposited to a survivor-benefit fund; and two percent of salary is deducted from wages for medical benefits.

34 Another ten percent is used to pay benefits to employees of enterprises (including those, such as VASP, that have been sold.)
Box 4.1: The Political Economy of Reform: The Case of Ceará

The political scene of the state of Ceará was dominated for 25 years by three antagonistic political leaders, who served alternating terms as governor between 1962 and 1986. Governance during this period was characterized by the clientilism typical of many poorer Brazilian states at the time: political support was obtained through an exchange of favors (that frequently included the nomination of political supporters for government jobs and directorships in state enterprises) and the use of state services to benefit supporters and punish adversaries. In the 1982 election, none of the three leaders had sufficient power to win the election outright. They therefore agreed to support a fourth candidate, with the understanding that major appointments in the new administration would be divided among their respective supporters. While the compromise candidate won the election, the political arrangement quickly produced chaos in the state administration, with agencies acting independently, and no overall control on state spending. The number of government employees increased by 43% from 1983 to 1987, causing the salary bill to rise until it consumed 87% of net revenues. With the budget exhausted on personnel costs, spending on maintenance and investment declined sharply, and the deficit (spending obligations minus total receipts) increased from 25% of revenues in 1985 to nearly 40% in 1987. The state financed these deficits through arrears. It also raised funds by borrowing from the state bank (BEC) and through revenue anticipation loans from the financial sector. This undermined the finances of BEC and resulted in an accumulating stock of high-cost debt. This increasingly chaotic situation ultimately brought the credibility of the traditional political powers in Ceará to an end.

During this period, an alternative political force had begun to emerge in the businesses community. In the late 1970’s, a group of young businessmen, seeking to improve the business climate in Ceará and obtain more power in the business community, had organized themselves as an independent chamber of commerce, the CIC. The CIC sponsored studies revealing that one of the principal obstacles to expanding the local market (by raising incomes) and attracting new investment into the state was the inefficiency of the state administration. CIC thereupon entered the political arena. The debacle of the traditional powers gave them their opportunity, and they triumphed in the election of 1986.

The new administration undertook reforms on a broad range of fronts: To reduce personnel costs, it undertook a cadastre of personnel (since updated every six months) which led to the elimination of large numbers of ghost workers and the dismissal of employees who had been contracted illegally. To reduce its interest costs and halt the capitalization of unpaid debt service, the state borrowed a total of Rs$ 885 million in its first two year of office, and used the proceeds to reduce its debt to BEC, its overdue revenue anticipation loans, and its arrears to external creditors. The state also took full advantage of the 7976/89 law, which permitted it to reschedule its external debts and obtain five years grace on repayment of principal. (The subsequent administration took advantage of the 8727/93 agreement to reschedule the state’s debt to federal financial intermediaries.) These measures allowed the state to substitute lower cost, long term debt for its high cost, short term obligations. They also permitted BEC to return to profitability. The reduction in BEC’s holdings of state debt (from 62% of loans outstanding in 1986 to 48% in 1992) combined with branch closings and the computerization of BEC operations--resulted in a profit at the bank in 1988 and subsequent years.

To increase revenues, the administration restored the principal of universal tax obligations, reviving an enforcement system that had been undermined by years of political interference. The tax system was computerized, enabling the state to track goods entering the state to their final point of sale, thus significantly increasing ICMS revenues. The state also introduced an integrated accounting system, encompassing all stages of public expenditure. In addition to providing timely financial information, this permitted the state to quickly identify temporary cash surpluses, and invest them--an important revenue source during periods of high inflation. The Ceará reforms have produced both financial and political returns. The state’s budget deficit--which had averaged 30% of revenues between 1983 and 1987--has averaged 0% in all subsequent years. Interestingly, candidates of the reform administration have won in the two subsequent gubernatorial elections.
2. Budget and spending reform

4.17 States can become more efficient in spending in general (and more agile in planning for debt obligations) by reforming the budget process. The current process by which expenditure priorities are decided within state governments has been characterized as a open-ended negotiation between the Governor and members of the state assembly, federal congressmen, important mayors, and representatives of public sector unions, all conducted in the absence of accurate, timely information, detailed analysis, or--until recently--stable prices.

4.18 Decisions on major items of state expenditure--personnel and debt service--are made by the Governor in consultation with the secretaries of finance and administration. As described earlier, the size of the personnel budget is largely determined by the predicted level of ICMS revenues. Decisions on the amount to be spent on debt service (this is treated as a policy variable, rather than a fixed obligation), are made by the Governor, acting in consultation with the secretary of finance. Consideration of the merits of increased or decreased personnel spending, or the allocation of the budget between personnel and other categories of expenditure (capital works, subsidies, etc.) thus do not enter into the discussion.

4.19 The lion's share of debate in the budget process is instead spent on a relatively small part of the total: internally financed capital investments. Negotiations over this part of the budget begin with a consultation process between the Governor, the state sectoral secretariats, and various potential beneficiary groups. The Governor then submits a proposal (as part of the overall budget package) to the Assembly. Assembly delegates have the authority to propose project amendments to the budget as long as they do not increase its total size. Most amendments are concerned with projects. To comply with the zero-sum rule, each project proposal is accompanied by a proposed reallocation from other projects in the budget. As a result, the budget process involves a complicated sorting out of competing amendments. This is carried out by a budget commission of the assembly, which then sends the proposal for the Governor's signature. Because the commission is in frequent contact with the Governor during this process, the package is virtually assured of approval. In the course of this process, little analysis of the economic merits of various proposals is made.

4.20 The financial information feeding this process appears to be reasonably timely and accurate. (Timeliness has been honed by years of inflation.) During the period in which the budget is prepared, final accounts from the preceding year are available, and monthly figures for the current year are available in aggregate. It is thus the quality of analysis, rather than the quality of information per se, that undermines the budget process. With personnel spending determined by revenues and the budget debate dominated by discussions of small capital works, the major budget issues that bear on the overall return on public expenditure appear to go unexamined.
4.21 Technically, the analytic content of the budget process can be improved by strengthening the budget analysis unit in the secretariats of planning, enhancing their ability to do economic forecasting and evaluate the effectiveness of existing and proposed state programs. There are demonstrable benefits in doing so. In primary education, for example, one of the key constraints in attracting and motivating teachers is the low level of salaries. Although primary education is one of the principal functions of state government (along with health, security, and transportation) the allocations to teachers salaries are surprisingly small. In São Paulo, out of a 1995 budget of Rs 21 Bn, only 10% is allocated to teachers salaries in the grades 1-8. Substantial increases in educational performance could therefore be achieved with only minor changes in budget allocations.

4.22 World Bank experience with budget reform suggests that the states should not attempt to introduce the comprehensive, zero based, or objective-based forms of budget analysis that were popular during the 1970's. (The states already produce budgets in a "program" format, but its use as an analytical tool has lapsed, as it has in most other countries.) Bank experience instead points to the importance of strong economic forecasting ability, and increased clarity in the budget document (along with improvement in the technical ability of the budget analysis unit.) All these suggestions are relevant to Brazil, where economic instability demands rigorous attention to the factors affecting the revenue base, and where the current budget document presented to the Assembly contains extremes of aggregation (summaries by secretariat) and disaggregation (details by budgetary unit and economic category) and little in between.

4.23 Reform in the evaluation of capital works also bears consideration, including a more realistic assessment of the amount of funds that will be available for investments and a tighter approach to formulating and implementing public investments. States are now required to prepare multi-year investment programs, and are prohibited from adding additional capital works into the annual budget. There is little evidence that the projects included in the investment budget have been subjected to a uniform evaluation system, however. A uniform system, applied to all proposed capital investments, requiring extensive analysis on high cost projects and a simple ranking system for lower cost proposals, is recommended.\textsuperscript{35}

\textsuperscript{35} The uncontrolled growth of expenditures by the non-executive organs of state government is also a threat to sound budgeting. Under the 1988 Constitution, the Assembly, Judiciary, Tribunal de Contas and Ministerio Publico are at liberty to determine their own budgets, although the Executive is required to finance them. These \textit{Outros Poderes} have used this authority to dramatically increase their salaries and benefits. The fact that Fazenda actually controls the disbursement of funds provides the executive branch with some leverage during budget discussions, but this is a tenuous solution. A proposal to amend the federal Constitution to set the proportion of state budgetary resources that must be allocated to each of the \textit{Outros Poderes} is currently under debate.
3. Restructuring State-Municipal Relations

4.24 A third means of improving state finances is to redress the imbalance in the division of revenues and responsibilities between states and municipal governments. The 1988 Constitutional revised the allocation of revenues between the three levels of government, increasing the volume of federal transfers to states, and volume of both federal and state revenue transfers to municipios. (Several minor taxes were also decentralized.) The municipios were the principal net beneficiaries of the change—their share of total government revenues (excluding social security) nearly doubled. In contrast, the states’ gain from increased federal transfers was offset by the increased portion of their own taxes that they were required to share with the municipios. The state’s share of total government revenues thus remained virtually unchanged. The federal share dropped by about 20%.

4.25 The 1988 Constitution made no attempt to accompany the transfer of revenues with a transfer of functional responsibilities. After the political failure of the Operação Desmonte—an initiative of the Collor administration to define specific federal programs that would be transferred to subnational governments—the federal government resorted to an ad hoc approach, cutting federal negotiated transfers, and offloading loss-making enterprises. Both states and municipios felt the impact of these cuts. The municipios, however, had the revenues to adjust to them; the states did not. It is the states that are suffering the financial consequences of the 1988 Constitutional reforms.

4.26 To redress this imbalance between the revenues and functions assigned to each level of government, some reallocation of functions between state and municipalities bears consideration. This could take the form of a state version of Operação Desmonte: identifying state functions that would be shifted, without funding, to the municipios. States might also expand on the example offered by Parana’s reform in primary education. Until recently, Parana (like most states) had parallel systems of state and municipal primary education. The state is now in the process transferring its state schools to the municipios. Under the Parana plan, physical assets will be transferred to the municipios, and the state will continue to pay the salaries of existing teaching staff only until they retire. Municipios will be expected to pay for new teachers, and for the replacement of retirees. To assist poorer municipios, the state has established a grant program that permits municipios to finance education spending up to a standard state level. At present, the program is voluntary, and poorer municipios have been more inclined to participate than richer ones. Nevertheless, as an approach to a more rationale division of primary schooling responsibilities between states and municipios, it bears consideration in other states.
4. Increased role of private sector

4.27 Privatization can also improve the efficiency of state service delivery, even where it does not raise much cash for the liquidation of state debt. There are four priority sectors for privatization: electric power, banks, transportation, and manufacturing.

4.28 Power companies are generally the largest enterprise owed by the states, in terms of assets and revenues. International experience suggests that competition in the power sector can increase efficiency. Due to the natural monopoly characteristics of transmission, generation and distribution are the most promising components of the sector for privatization. Many countries, including the United States, Argentina, Chile and Colombia have recently passed legislation requiring power monopolies to purchase power from private producers if prices are competitive. Brazil's new concessions law permits state power companies to do the same. Power distribution can also be privatized, if an appropriate regulatory and pricing structure is in place. Two federal distribution systems--in Rio de Janeiro and Espirito Santo--have recently been privatized.

4.29 Twenty four of the 26 states own one or more banks. While their financial performance varies, several are in trouble. In the cases of BANESPA, this is largely due to holdings of non performing state loans. Elsewhere it is due to overstaffing and overextended branch networks. Although state banks are now prohibited from lending to their respective governments, their existence presents a temptation. (The fact that the prohibition was in place but unenforced for many years, and that states now evade it by borrowing through their contractors, suggests that the temptation is not always resisted.) Privatization would end states' ability to borrow by force majeure. Rio de Janeiro is in the process of privatizing its bank, a measure that should be considered in other states.

4.30 State ownership of transportation and manufacturing enterprises has a long and generally costly history in Brazil. States have owned (in whole or in part) car manufacturing companies, airlines, railroads, and bus companies. Many states have already begun to divest. São Paulo has sold its airline, VASP. Minas has liquidated its 25% stake in FIAT-Brasil. One of the largest remaining transport enterprises in state hands is FEPASA, the São Paulo state railroad. Several options for privatizing FEPASA bear consideration, including unbundling (maintaining state ownership of the right of way, but charging private operators for the use of it); or offering both track and operating rights on a concession basis.

5. Increasing revenue

4.31 There may be some longer term potential for increasing revenues. Although--as noted earlier--the potential for increasing tax rates is limited, the long term prospects for

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36 See for example, World Bank, World Development Report 1994
increasing revenues through improved administration may be fairly substantial. In São Paulo, although the cadastre of taxpayers is fairly complete, underassessment is rife, due to the widespread practices of failing to issue receipts and crediting tax payments by non-existent suppliers. Lengthy disputes over assessments are also common, due in part to financial incentives. The process of appeals is lengthy, and as the taxpayer is not required to deposit the amount in dispute and pays an interest penalty of only 1% percent per month (with monetary correction) once a judgment is issued, the financial rewards of delinquency can be attractive. In the view of the São Paulo finance secretariat, the problem of underreporting could be addressed through more extensive computerization—permitting the tax officials do cross checks on suspected evaders. Legal changes—requiring up-front deposits of disputed amounts, or market rates of interest on delinquent accounts—would reduce the financial incentives for delinquency.

6. Concluding Note

4.32 In addressing the debt crisis, the Government’s highest priority must be to halt the ballooning of capitalized interest on state bonds and debts to commercial banks. The growth in this debt will dwarf any effort to improve expenditure allocation or increase tax revenues. The specific package of actions will vary according to the widely differing circumstances of individual states. The magnitude of debt varies, as does its composition. But for all states, there is a bigger payoff to state reform than simply defusing the debt crisis. Many of the measures needed to address the debt crisis will also improve the efficiency of state expenditure. Thus state reform can not only remove a immediate threat to the stability of the economy, but also provide long term direct benefits to taxpayers.

37 The penalty is 100% of amount due, but even that is often insufficient to offset the other financial incentives.
5. ANNEX STATE CASE STUDIES

A. Sao Paulo

5.1 Sao Paulo dominates the debt crisis. While the structure of its debt is similar to the other three major debtors, in absolute terms its debt constitutes nearly half the total state debt in Brazil. Sao Paulo’s outstanding debt totaled Rs 40 billion as of December 31, 1994. About twenty percent of this consists of rescheduled (7976 and 8727) debt. The largest components, comprising half the total, consist of debt owed to the state commercial banks (BANESPA and Nossa Caixa) and state bonds. As of December 30, the state was servicing the rescheduled debt to the federal government, and the new external loans, but had ceased paying interest or principal on debt to BANESPA and bonds. (It was also acquiring new arrears to landowners, contractors, and suppliers at a faster rate than it was paying them off.)

5.2 Based on the assumptions discussed in the text, and the stock of debt as at the end of 1994, the annual interest obligations of Sao Paulo are estimated at Rs 8 billion, about ten times the amount the state is current spending on interest and amortization combined.

1. Reducing the stock of debt

5.3 Selling Assets Some of the stock of debt can be reduced by selling assets, particularly state enterprises. The state owns 28 enterprises, including 8 financial institutions, 4 power companies, 5 transportation companies, a water utility and a housing corporation. The largest of these (in terms of operating revenues) are BANESPA/bank, BANESPA brokerage, and Nossa Caixa (banking); Electropaulo, CESP and CPFL, (power) and SABESP (water) Of the utilities, only CESP and CPFL are profitable, and although both the banks are nominally profitable, this reflects an overestimation of value of their portfolios.

5.4 Of the companies that might be sold, most attention has focused on CESP and Electropaulo (the state and metropolitan power companies, respectively). (A minority share of CESP stock is already in private hands.) Estimates of the current market value of these enterprises vary. In the opinion of the former state finance secretary, the sale of the state’s shares of CESP would be sufficient to pay off the entire state debt to BANESPA. The present administration believes that the market value of CESP and ElectroPaulo

38 excluding roll-overs of existing bonds.

39 The accuracy of the published accounts was not investigated under this study.
combined would not exceed Rs 5 billion, an amount sufficient to pay only half of the anticipated growth in the stock of debt in 1995.

**Figure 12 Major State Enterprises**

<table>
<thead>
<tr>
<th>Revenue and Profit of Major State Enterprises (1994, RS mn)</th>
<th>operating revenue</th>
<th>operating profit</th>
<th>company</th>
<th>profit</th>
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<td>335</td>
<td>CESP</td>
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<td>BANESER 233</td>
<td>-8</td>
<td></td>
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</tr>
</tbody>
</table>

5.5 There is agreement in both camps that the current price of both power companies would be depressed by their high level of debt (Rs 13 billion, combined) and the poor quality of their management. The previous (Fleury) administration was considering a plan which would have enabled the state to raise cash from these assets immediately, while permitting the state to make the actual transfer of ownership at a more propitious time. Under the Fleury proposal, a new state company would be created, to which the shares of existing state enterprises would be transferred. This enterprise would then sell debentures, backed by the assets of the state enterprises, and would transfer the proceeds to the state to enable it pay down the debt. The company could then later sell the assets themselves, retiring the debentures.

5.6 This plan has, in effect, been abandoned by the present administration. In fact, privatization in general is not seen as a solution to the debt problem, on the grounds that present prices do not reflect underlying values, and that restoring the companies to a marketable condition would take so long that any increase in price would be offset by the increase in the stock of debt.

2. Reducing risk premia on interest rates

5.7 As noted earlier, real domestic rates are high in Brazil, by international standards, and are expected to remain so. Over the last three years, the real rate of interest on federal bonds has not dropped below 20% and is not expected to do so for several years. With no exogenous relief in sight, various proposals have been to made to reduce the interest rate premium paid by the state.
5.8 Most of these opportunities, however, have already been taken. The present interest rates paid by the state do not reflect the market’s evaluation of the state’s creditworthiness. The swap of state bonds for LFTs is, in effect, a device that allows Sao Paulo to finance its bonds at a rate that reflects the market price of federal debt. (Without this, the interest rate of Sao Paulo debt would be almost infinite.) Similarly, the interest rate paid on BANESPA debt reflects the CB discount rate, a rate that reflects the price at which the central bank is willing to lend to financially sound banks, rather than financially shaky state governments. The state’s debt to BANESPA was, until recently, financed at a rate that reflected the market’s perceptions of BANESPA’s creditworthiness, not the state’s (as the debt was ultimately financed though the sale of BANESPA CDIs.) When BANESPA’s own credibility collapsed and the Government forced Banco do Brazil to hold BANESPA’s CDIs, the risk premium was in effect transferred to the Treasury, as the majority shareholder in Banco do Brazil, with the interest rate charged to Sao Paulo continuing to reflect the federal government’s cost of funds. As a result, Sao Paulo has little further financial benefit to gain by reducing any domestic risk premium.

5.9 Another proposal, put forth by the present administration, is to reduce the costs of carrying the debt by refinancing it externally. The state (as represented by Secretary Nakano) notes that real long term international interest rates are considerably lower than domestic rates. In the first six months of the Plano Real, the rate on federal bonds (LFTs) was running 32 percentage points higher than LIBOR. As the state government would still have to pay a substantial risk premium if it attempted to borrow abroad on its own, it is seeking the guarantee of a credible borrower in this venture.

5.10 The merits of doing so are questionable. The risks carrying so much debt onto external markets are high. The states (and the federal government, as guarantor) would be exposed to exchange rate fluctuations and balance of payments constraints. In effect, this would permit a Las Vegas approach to debt management: having gambled and lost in the short term domestic capital market, the states would be placing equally risky bets on international capital markets--and expecting the federal government to stake them.

5.11 Externalizing the debt would also raise the cost of external borrowing to the Federal government. Shifting so large a volume of Brazilian public debt on international credit markets would drive up the interest rate premium paid by all agencies of the Brazilian public sector agencies—including the federal treasury.

40 Officials of the treasury are nevertheless contemplating an official federalization of the bonded debt, paralleling the model already adopted for the rescheduling of external and internal (federal) debt (Laws 7976 and 8727.); i.e., the debt would officially be transferred to the Treasury, its maturity would be extended (beyond the 30-day renewal arrangement now in effect) and states would be required to pay interest directly to the Government. In effect this would largely formalize the existing, de facto, situation. Treasury officials nevertheless advocate it on the strength of the enforcement mechanisms (deduction at source) that it would make available.

41 Refers to the period August 1994 through February 1995. LFT rate adjusted for inflation; LIBOR rate adjusted for exchange rate fluctuations.
5.12 In addition, the use of the federal government as guarantor would continue the moral hazard problem that the federal government already confronts. Relying on a federal guarantee would directly place the risk of default on the federal government. Using an international development bank would do the same (as development bank lending or guarantees require a federal guarantee.) Given the record, it is not inconceivable that the states would again default, forcing a repetition of the default--workout--default cycle.

5.13 Would rescheduling help? Very little. Debt service would not be reduced by rescheduling, unless interest rates dropped substantially very quickly. The existing rescheduled debt already carries a twenty year maturity. The bonds and CDIs, although both short term, are routinely rolled over. Rescheduling would only remove the uncertainty associated with rolling over the debt each time it comes due.

5.14 Overall, there appears to be little the state can do--beyond what it has already done--to reduce the interest rate on its debt. Federal interventions have eliminated most of the risk premium that Sao Paulo would otherwise pay. Refinancing some of the debt on external markets would dramatically lower the interest bill, but only if the Government (or a multilateral lender) were willing to guarantee the debt.

3. Cutting rival expenditures

5.15 The state could make a significant contribution to its debt service obligations by reallocating expenditures from rival categories of expenditure. Sao Paulo's budget is large. The state had recurrent revenues of Rs 14.2 billion in 1994--including Rs 13.2 billion from taxes and interest on taxes, and Rs 1 billion from transfers--or an average of US$530 per capita. Not all of this could be potentially reallocated to debt service, however. The state is Constitutionally required to transfer 25% of its ICMS tax revenue to the municipios, an expense that cost the state Rs3.1 billion in 1994. Existing debt service, of Rs900 million, must obviously also be considered untouchable. The remainder--Rs 10 billion-- could however be considered fungible.

**Figure 13 Income and Expenditure of Sao Paulo State, 1994**

(Rs Bn, adjusted)

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5.16 There are three categories of expenditures that are obvious targets for reallocation: (1) revenue-financed capital investments (2) personnel, and (3) subsidies.

5.17 Revenue financed capital investments: In principle, revenue-financed capital investment is the most readily reducible item in the budget. A decision to cancel or postpone such capital works requires no break in long term contractual commitments (as would be the case with personnel cuts). The level of such expenditures in Sao Paulo is very large. The state spent nearly 20% of its 1994 budget on internally financed capital works or nearly half of what would be required to service its debt. (In 1993, the state spent a total of US$ 4.1 billion on capital works although part of this was financed through borrowing, and therefore is not fungible for purposes of paying debt service). In sectoral terms, such a cut would fall most heavily on transport (largely highways and tollroads) which accounted for 42% of capital investment in 1993. Housing (including construction grants to the state housing company) and urban transport (including metro construction) together account for 15% of capital investment and would also be affected, as would education and health (12%) and flood control (8%).

5.18 Cutting recurrent expenditures The second target for cuts are major categories of recurrent expenditures. Recurrent expenditures (excluding interest payments) accounted for an average of 75% of total fungible expenditures (i.e., excluding Constitutional transfers and debt service) in 1994 and thus presents a large target for potential cuts.

5.19 Personnel is the largest single economic category of recurrent expenditure, consuming between 66% and 90% of fungible recurrent expenditure. There is a widespread perception that the Sao Paulo government is overstaffed, particularly at lower levels, suggesting the possibility of deep staff reductions as a means of freeing resources to pay debt service. A commonly cited constraint on such layoffs is a provision in the Federal Constitution that prohibits any entity of the public sector from firing staff, once the staff has successfully completed a two year probationary period. (Exceptions are made for egregious crimes, as interpreted by the courts.) This Constitutional constraint is not as binding as it appears however. The state reports that it has 200,000 employees on probationary status (of whom 100,000 are primary school teachers), and these could in principle, be laid off immediately. Personnel who are employed as contractors are also, to varying degrees, exempt from Constitutional protection, as are employees of indirect units of administration who are employed under private labor legislation (CLT) rather than as statutory public employees.

5.20 In principle, the state also has the authority to reduce salaries. Under federal law, each state has the authority to set its own public sector salary. The prospects for reducing

42 The precise level of personnel expenditure cannot be determined from available data, as salary payments appear not only under the personnel category of the budget, but also in the terceiros (contractors) and intragovernmental transfers categories.
salaries are not particularly promising however, as existing salary scales are already extremely low. With the data at hand, no accurate estimate of the cost savings of staff reductions can be made. Given the low level of salaries prevailing in Sao Paulo, reductions in the quantity of staff would have to be considerable in order to have a significant financial impact.

5.21 Subsidies and program cuts The third focus of expenditure cuts are specific expenditure programs. Sectorally, the state budget is dominated by four functions: public security (19%), education (16%) infrastructure (15%), and health (8%). Another 15% is spent on administration (including the legislature, the Governor’s office and the secretaries of finance and planning). As this study was not intended as a public expenditure review, no detailed analysis of specific expenditure programs was undertaken. (Subsectoral analysis, should, however, accompany any debt workout.)

5.22 The study did focus on subsidies within the various sectoral categories, however. According to the accounts, subsidies account for nearly 35% of Sao Paulo’s total fungible expenditures. In practice, however, the figure is exaggerated, if subsidies are understood to mean transfers to agencies that, in principle, could be self financing. In Sao Paulo’s organizational structure, the departments responsible for highways (DER) and flood control (DAEE) are both considered indirect units of administration. Transfers to these two agencies accounted for 55% of intergovernmental subsidies in 1993. As cuts in these transfers would leave these agencies without funds, this is not a promising target for reallocations.

5.23 Of the remaining subsidies, the largest are transfers to the university system and subsidies to public companies. Sao Paulo operates the only major state university system in Brazil (all other public universities are federal.) Although their enrollment largely consists of students from middle and upper income households, no tuition (other than miscellaneous fees) is charged. The university is thus dependent upon transfers from the treasury. In 1994, state subsidies to the university system totaled approximately Rs 1 billion. A strong argument can be made for imposing tuition at the universities (and providing means-tested scholarships for students unable to afford it.) Substituting tuition income for 50% of the state’s annual subsidy to the universities would save about Rs500 million.

5.24 Operating subsidies to enterprises totaled Rs 710 million in 1994. Of this, one-third consisted of obligatory pension payments to retirees of the state railroad (FEPASA) and CESP. Of the remainder, the largest recipient was FEPASA, followed by the environmental agency, the housing company, the toll road company, and the state

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43 Intragovernmental subsidies are defined as the sum of intragovernmental recurrent subsidies, financial investments, and capital transfers net of amortization. Figures for 1994 are not yet available.

44 See Brazil Public Expenditure Study: the Education Sector

45 CETESB, like DAEE and DER, might better be classified as a unit of central administration, as it has no independent revenue source.
housing company. Although the official total of operating subsidies (other than pension payments) totaled only Rs 475 million, this figure may understate the potential revenues to be derived from cutting operating subsidies. The discrepancy between these figures and losses shown in the various enterprises income statements (although partly explained by depreciation) suggests that operating subsidies may have been delayed in 1994, and thus understated.

Figure 14 Operating Subsidies to Companies

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4. Raising Revenues

5.25 The final measure the state could take to fund a higher level of debt service would be to increase its tax revenues. The state’s principal tax is the ICMS, a broad based value added tax. Sao Paulo’s ability to increase ICMS revenues through policy measures--increasing tax rates or reducing exemptions--is limited. Under the terms of federal legislation, any increase in the rate of the tax requires the concurrence of all state finance secretaries. There is some room for increasing ICMS revenues by improving the tax’s administration, however. According to the state director of ICMS administration, evasion is widespread, due largely to the practices of crediting tax payments by non-existent suppliers, and selling goods to consumers without demanding a receipt. While the tax department has several proposals for improving the tax’s administration, it is not optimistic about the prospects for improvement in the short term.
B. Minas Gerais, Rio de Janeiro and Rio Grande do Sul

5.26 The debt of the other three large states is not as great as Sao Paulo’s in absolute terms. The stock of debt ranges between Rs 5-7 Bn in the three states, equal to 13% of GDP in Rio, 16% in Minas Gerais, and 22% in Rio Grande do Sul (as opposed to 35% in Sao Paulo). The cost of this debt, however, is relatively high. These are states whose primary long term debt is in the form of bonds. The interest obligations of the three states are therefore high, equal to 33% of revenues in Rio, 41% in Minas Gerais, and 53% in Rio Grande do Sul.

5.27 In addition to its unpaid contractual interest obligations, one of the states—Rio—also has a considerable “fluctuating” deficit, equal to nearly 20% of revenues. Taking the two groups of unpaid obligations together, the current deficit totaled 37% of revenue in Rio, 40% in Minas Gerais, and about 25% in Rio Grande do Sul. The situation in these states, nevertheless, is not as extreme as in Sao Paulo.

1. Selling enterprises

5.28 All three states own power companies, water utilities, and banks, which are potential targets for privatization. At present, several approaches are in the works. Both Minas and Rio have announced their intention to sell their commercial banks (CrediReal and BANERJ respectively.46) The pace and price of these transactions is uncertain, however. Although Credireal was marginally profitable in 1994 (after-tax profits of Rs 1.53 Mn, on assets of Rs 5.75 Bn.) privatization has been delayed by disputes over the bank’s pension liabilities. BANERJ’s privatization is also delayed by pension issues, and doubts about the quality of its assets.

5.29 In an effort to raise money from its industrial enterprises, Minas is now pursuing a Fleury-type plan. Like the previous administration in Sao Paulo, it intends to establish a company to which its shares in major enterprises would be transferred. The company would sell debentures backed by these assets, allowing the state to use the proceeds to liquidate some of the debt. Minas has been successful in borrowing against its enterprises in other contexts. The state recently floated a Eurobond issue, backed not by the revenues of the state, but by the revenues of its power company. It is not clear that this solution constitutes a long term solution to the state’s financial problem. In effect the plan

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46 Minas would retain its ownership of a second commercial bank, BEMGE.
merely permits the current administration to hollow out the companies without actually privatizing them, transferring debt, rather than equity, to its successor.47

2. Cutting interest rate premia

5.30 All three states have already benefited from federal financial concessions: all three have taken advantage of the 7976 and 8727 reschedulings. In addition, the Federal government recently agreed to take over Rio’s debt obligations for METRO construction. Few additional means of reducing the states’ interest rate premia would appear to be available.

3. Cutting expenditure

5.31 All three of states have large, internally funded, capital works programs. Rio’s capital budget (net of amortization and borrowing) is equal to 64% of its annual deficit; Minas’ equals 44%, and Rio Grande do Sul’s, 19%. Although the size of Rio’s capital spending is exaggerated by inflation--much is financed from profits from its bond brokerage--cuts in internally financed investment could significantly reduce the deficit in all three states.

5.32 There are also opportunities to cut personnel costs. In Rio, the administration is planning to review the wage increases made in the last months of the outgoing administration (first made as bonuses and later incorporated into salaries, thus becoming permanent obligations of the state.) The state has also imposed a salary freeze on current staff, except those in public enterprises.

47 This plan may not be advantageous to the state even in the short run. Because the state has to pay interest on the debentures, borrowing to pay down the bonded debt is only advantageous if the interest rate on debentures is less than the rate now paid on bonds. While the bond rate is high, it essentially reflects the creditworthiness of the federal government (due to the exchange arrangement with the Central Bank.) It is not clear that the rate on Minas debentures would be any lower. To lower its risk premium, the state intends to (1) give purchasers to the right to resell their debentures to the state at the end of the current administration, and (2) to use debentures to pay ICMS taxes. These assurances may not, however, be sufficient.
4. Raising revenue

5.33 All three states are proposing to rely largely on improved tax administration to solve their financial problems. To improve enforcement, Rio plans to contract-out for additional prosecutors, and improve coordination with the police. The state also plans to close its exemption for small and medium enterprises (which has prompted larger firms to legally subdivide themselves for ICMS purposes.) Minas is planning a comprehensive survey of ICMS taxpayers, and a simplification of tax documents. Rio Grande do Sul is making efforts to reduce the delays in tax collection.

5.34 As all three states derive at least three-quarters of their revenues from taxes, these measures can have a significant impact on the states’ respective deficits. A 50% cut in internally financed capital investments, combined with a ten percent increase in tax effort, would reduce Rio’s deficit by nearly half, and Minas’ by about one-quarter. It would have little impact in Rio Grande do Sul, however, due to the predominance of personnel costs in the state’s budget.

C. Smaller States

5.35 Brazil’s remaining 22 states account for about half the national population. Although they range in population from 215,000 (Roraima) to 11 million (Bahia) most (15) fall in the range of 2-9 million population. The debt levels of the states vary. Among
the states for which reliable data is available, the ratio of debt to GDP ranges from 5% (Bahia) to 35% (Goias.) What is important about the debt is not so much its level, as its terms. Over 80% of the debt in the five sample states consists of rescheduled debt owed to the Federal Treasury: 7976 and 8727 debt. It is therefore eligible for the 11% ceiling on debt service--the federal government’s agreement that any debt service in excess of eleven percent of revenue will be rescheduled over 30 years, with a twenty year, interest free grace period. In effect, these states have already had their workout. The federal government has agreed to assume the financial costs of most of their debt, temporarily shifting the burden off the states and on to the federal taxpayers.

5.36 The debt situation in the smaller states is thus the opposite of that of the four large states. Whereas the stock of debt is ballooning in the states dominated by bonds and debt to state banks, the growth rate of debt in the smaller states is relatively slow. Because debt service obligations are low--and because debt service can be deducted from intergovernmental transfers--levels of default are low, and there is therefore little unpaid interest to be capitalized. The stock is therefore cheap to service, and is not growing quickly. While these states will confront a one-time increase when the grace period on 7976 debt ends in 1995, the level will not rise to more than nine percent.

5.37 These states do have financial problems, nevertheless. As shown in the table below four of the five states ran persistent overall deficits in recent years. While all five states had current account surpluses, the level of capital expenditure in four of them exceeded their receipts from current savings and official borrowing, requiring the state to finance their budgets by delaying payments to staff, suppliers, and municipal governments. (In Para, for example, the incoming administration inherited a Rs 350 unfunded debt, comprised of two months of unpaid salaries, unpaid Constitutional transfers to the municipios, and unpaid budget transfers to the legislative and judicial branches of government. The source of this problem lies not in excessive debt, but in excessive spending on salaries and capital works.

5.38 While the financial situation of these states does not constitute a macroeconomic threat, it is nevertheless of concern. From a lenders perspective, the arrears indicate lack of creditworthiness. And from a broader developmental perspective, these deficits are symptomatic of fundamental management problems in these states; the inability to transform scarce tax resources into efficient state services.

48 As the smaller states are more dependent upon intergovernmental transfers, the federal government has more room to use deduction from transfers as a means of enforcing debt service.
5.39 How far from credit worthy are these states? From a strictly mechanical standpoint—the ability to cover additional debt service without running unfunded deficits, only one has achieved it: Ceara. Yet all of these states are in a relatively good position to make themselves creditworthy. Levels of debt service are controlled, and the amount of fungible resources relative to debt service is high. Even in states with relatively large deficits (Bahia, Goias) a cut of ten percent in rival expenditure would be sufficient to produce balanced budgets. What matters in these states are not the givens—the existing stock of debt, changes in market interest rates—but rather the political commitment to use the various factors under the control of the state, to balance the budget.
D. Statistical Appendix

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(Rs Mn of Dec 31, 1994)

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