



# Evolution of the fiscal situation of the Brazilian states: 2006–2015

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## Abstract

The text analyzes how the Brazilian states' fiscal position evolved between 2006 and 2015, with the data revealing a clear deterioration in state-level public finances during that period. The rating methodology developed by the Ministry of Finance is used to show that, when comparing 2006–2008 to 2013–2015, 21 of the 26 states and the Federal District saw their fiscal position deteriorate. The results suggest that after the global financial crisis the states failed to pursue a fiscal rule that would curb the growth of spending in a context of falling revenue and rising debt. The study shows that, despite shrinking revenue, the states maintained the pace of expenditure growth, particularly payroll and pension expenses. Moreover, the text shows that following the crisis, state-level revenue would have declined by even more were it not for a substantial increase in credit inflows. While additional borrowing enabled the states to maintain public investment in the short term, this policy showed to be unsustainable. The paper shows that higher debt and the lack of the adjustment in public spending have a negative impact on state-level investment in the long term.

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## 1. Introduction

After the economic stabilization in 1995, the fiscal situation of the states collapsed. In response, the federal government adopted a program to renegotiate state-level debts, which encompassed a fiscal adjustment plan and, subsequently, the establishment of the Fiscal Responsibility Law (FRL).

Ten years after those measures were adopted, Piancastelli and Boueri (2008) analyzed the evolution of the states' fiscal situation and found that state-level public finances improved between 1995 and 2006. As evidence of this, the authors noted a reduction in the ratio between the net consolidated debt and net current revenue, and improvements in the states' primary balances, which turned from negative (deficits) to consistently positive results (surplus). For example, the authors show that all Brazilian states posted primary surpluses in 2004 and 2005. The same improvement was seen in the states' nominal balance. The authors also show that tax revenue grew in the period, particularly in the case of the main state levy—the Goods and Services Sales Tax (ICMS). On the expenditure front, the authors identify a drop in payroll expenses relative to GDP. On the downside, they note that the current spending — *despesas de custeio*—which were not subject to any limit under the FRL—grew sharply. The authors also noted that the states

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met their fiscal targets in the period by slashing investment, and most of them were unable to contain the growth of the refinanced debt.

In contrast to the improvement that occurred in the first few years after the renegotiation process, 20 years later the states are again in a fragile fiscal position; and a new debt refinancing program is being designed by the federal government to alleviate their fiscal situation. The question that arises is how and why the process of improving the state's public accounts has been reversed. This study attempts to analyze these issues, focusing on the changes that occurred after 2005, which weakened the states' fiscal position.

Initially, the study analyzes the path of the states' fiscal situation by calculating the trend of their ratings, using the methodology established by the Ministry of Finance<sup>1</sup> in conjunction with the FRL indicators. This is done to make a time-series comparison of the states' fiscal situation considering a group of indicators rather than focusing on just one. The results show that, among the 26 states and Federal District, 21 federative entities saw their fiscal position deteriorate when comparing 2006–2008 to 2013–2015. The figures show that borrowing is not the main cause of the current fiscal crisis in the states. Although the federative entities' debt ratio has risen since 2012, in most states it is lower than in 2006. The same is true with respect to the debt service, which in 2014 recorded its lowest level relative to state revenue.

The data show that, in the period under study, the states did not systematically abide by a fiscal rule consistent with public debt sustainability and, hence, with the maintenance of fiscal balance. The text illustrates that, despite shrinking revenues, the states maintained continuous growth in payroll expenses, current expenditure and pensions. These two factors—the country's faltering growth and the states' failure to react to curb expenditure growth—undermined their fiscal position, resulting in a sharp fall in the primary surplus and a further rise in the debt level.

It is interesting to note the role played by the credit obtained mainly from public sector banks and multilateral organizations in the deterioration of the states' fiscal position. The text shows that both the volume and number of loans made to the states by public banks and, to a lesser extent, by multilaterals, have increased substantially since 2008. While inflows from borrowing enabled the states to cushion the impact of the fall in tax revenue, and thus avoid having to cut public investment in the short term, it also allowed expenditure growth to continue—thereby putting off the adjustment needed to maintain fiscal balance and restricting the states' future investment capacity.

The rest of this paper is organized as follows. Section 2 shows the data about the trend of the primary balance in the states, the path of states' revenue, the dynamic of state borrowing and credit and the evolution of state-level expenditure including payroll and pensions expenses. Section 3 analyzes the fiscal situation of the states through the Ministry of Finance's risk rating measure and the FRL indicators. Section 4 estimates a fiscal reaction function for the federative entities between 2006 and 2015 analyzing whether the states followed a fiscal rule compatible with the fiscal sustainability. Section 5 studies the determinants of state-level investment focusing on the role of credit and the impact of other types of expenditure on states' capital investment. Section 6 concludes with a brief discussion about the future of fiscal policy in the federative entities.

## 2. Data

The data sources used are the consolidated balance sheets published by the entities, the Budget Execution Reports (*Relatório Resumido de Execução Orçamentária* — RREO), the Fiscal Management Report (*Relatório de Gestão Fiscal* — RGF) in conjunction with information from the state accounting data collection system (*Sistema de Coleta de Dados Contábeis de Estados e Municípios* — SISTN).

The fiscal reports present information on the consolidated financial statements, the indicators regarding the budgetary execution, the execution of estimated revenue for the financial year, the compliance with the constitutional minimum expenses in the areas of health and education, together with the spending limits determined by the FRL especially with respect to spending with personal, and the limits of the net consolidated debt and credit operations, among others. The text explicitly mentions if another source of data is used. All the data covers the period between 2006 and 2015. Always when necessary nominal variables are deflated by the consumer price index (IPCA).

<sup>1</sup> Ministry of Finance: Orders (*Portaria*) MF 306/2012 and STN 543/2012.

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