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BRAZIL'S STATE DEBT CRISIS: LESSONS LEARNED

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INTRODUCTION

1. The Brazil state debt crisis was one of the largest subnational debt crises ever experienced in a developing country. At its peak in 1995, states were in default on roughly US$ 8 billion in interest payments owed to the Federal Government. Even in an economy as large as Brazil's (1996 GDP of US$ 750 billion) this had macroeconomic significance, particularly because it occurred at a time when Brazil was attempting to consolidate its first successful stabilization plan in forty years. With the operational deficit of state government constituting half of the total public sector deficit in 1996, resolving the debt crisis remains a critical element in achieving macroeconomic stability.

2. This note summarizes the chronology of the state debt crisis and the efforts by the Brazilian government to resolve it. It also describes the World Bank's efforts to assist in this process through state level "adjustment" loans. It concludes with lessons. A technical appendix, detailing the loan conditionality and disbursement mechanism used in the adjustment loans, is attached.

Background

3. Brazil is politically decentralized. Its federal structure consists of 26 states, a Federal district, and 4,491 municipalities. The political autonomy of states and municipal government is protected by the Constitution. State governors and

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members of the state assembly are directly elected. The Constitution assigns to the states the highest yielding tax in Brazil--a value added tax--and requires the Federal Government to transfer 45% of the yields of its two largest non-social security taxes--the income and industrial products taxes--to subnational governments on a formula driven, unconditional basis. As a result, state and municipal governments account for roughly half of the net current revenue of the public sector and half of total public sector expenditure.

4. The Federal Constitution does restrict state autonomy in certain respects. The most important is personnel management. Under the Constitution, states cannot dismiss redundant civil servants nor can they reduce salaries in nominal terms. State employees have the right to retire after only 35 years of employment, regardless of age[1]. On retiring, they have the right to a pension equal to their exit salary plus any subsequent increases granted to their previous position. These Constitutional provisions sharply restrict states' ability to control personnel costs. By guaranteeing a lifetime salary to civil servants, the Constitution restricts states' ability to downsize or reduce benefits when fiscal conditions so require.

5. The Constitution also limits state's ability to increase revenues. The principal sources of state revenues are a value added tax (the ICMS) and federal transfers. Under the Constitution, the federal Senate has the power to set rates on the ICMS[2]. Federal transfers are formula driven, and cannot be increased on the initiative of individual states. As a result, states have as little flexibility to raise revenues.

Chronology of the Debt crisis

Precedents

6. The current state debt crisis is Brazil's third in six years. The first arose during the international debt crisis of the 1980's. Faced with foreign

1 Women may retire after thirty years of service. The threshold is reduced another five years for teachers of either sex.
2 The states have some flexibility to set the rates on intrastate sales, subject to minima and maxima set by the Senate. The Senate directly determines the rate on interstate sales.

exchange constraints (even when they had the wherewithal to pay in domestic currency) states ceased servicing their foreign debt. The Federal Government assumed this responsibility and later sought reimbursement by the states. After lengthy negotiations, an agreement was reached whereby the Federal Government agreed to transform accumulated state arrears and remaining principal into a single debt to the Federal Treasury. The refinanced debt was rescheduled for twenty years at interest rates equivalent to those specified in the original contracts, with five years grace on the payment of principal. US$ 19 billion was rescheduled under these terms.

7. The second crisis involved debt owed by the states to federal financial institutions--principally the federal housing and savings bank, Caixa Economica Federal. This was resolved in 1993 through a rescheduling of roughly US$ 28 billion of such debt. Again, the debt was transformed into debt to the Federal Treasury, with twenty years to maturity, and an interest based on the weighted average of the rates established in the original contracts. A grace period of up to 20 months (applicable to 60% of the principal) was allowed.

8. To close on this second agreement, the Federal Government conceded an escape clause. (This applied retroactively to the rescheduled foreign debt and certain other debts to the Federal Government). Under the clause, if the ratio of state debt service obligations to revenue rose above a threshold fixed by the Senate, the excess could be deferred. Deferred debt service would be capitalized into the stock of debt, to be repaid when debt service fell below the threshold amount or in the ten years after the expiration of the original twenty year repayment period.

9. These agreements substantially reduced states' debt service obligations in cash terms. With principal rescheduled and debt service subject to a ceiling, the immediate burden of servicing debt was considerably reduced. At the same time, however, they prompted expansion in the stock of state debt. With debt service subject to a ceiling, excess debt service was capitalized into the stock of debt. In addition, the agreements established two precedents that were to influence subsequent debt agreements. First, they reinforced the perception that the Federal Government was prepared to provide debt relief to any state that required it. Second, they set a precedent for providing such relief

in the form of postponement. Through the combination of grace periods, rescheduling, and debt service caps, the agreements relieved the debt service burden of sitting administrations, while leaving the fiscal consequences to their successors.

Regulatory Response

10. With each debt workout, the Federal Government made an attempt to tighten the regulations on state borrowing. State governments in Brazil borrow from a variety of sources using a variety of instruments. From the domestic private sector, states borrow from private banks, both for short term cash management purposes and for medium term financing. States also float bonds on the domestic capital market. Twenty of the 26 states (plus the Federal District) own at least one state bank, from which they borrow. (Although the practice is prohibited, states have historically managed to evade the prohibition, allowing them to mobilize savings from depositors, private banks and the Central Bank).

11. States also borrow from federal financial institutions. Long term financing is provided through 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. As a consequence of the recent debt crises, the Federal Treasury has also emerged as an important state creditor, as it holds the states' rescheduled debt. The Central Bank also became an important lender, in its role as a market-of-last resort for state bonds.

12. From the external private sector, state borrowing has traditionally taken the form of medium term contractual debt. More recently, several states (or their enterprises) have successfully floated Eurobonds. States also borrow from external multilaterals and bilateral donor agencies. The World Bank, for example, lends directly to state governments, requiring only the guarantee of the federal authorities.

13. States, finally, borrow through a variety of informal mechanisms. 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 administration. In addition, states "borrow" by taking cost cutting measures--expropriating land, for example--that are likely to be subsequently overturned by the courts. Until a judgment is issued, states can avoid payment. Under some conditions, court judgments, when finally issued, can be financed through special bonds (termed *precatorios*). The amount of such informal borrowing can be large. At the time of its recent debt agreement, Sao Paulo's outstanding debt in the form of *precatorios* and arrears to suppliers totaled US$ 9.8 billion.

14. Federal efforts to control state borrowing take several forms.

15. *Senate guidelines* Under the Brazilian Constitution, the Senate has the authority to regulate all state borrowing; i.e., any contractual arrangement involving repayment at a future date. (Bond rollovers are treated as a special category of debt). As shown in Table 1, the resolution restricts new borrowing on the basis of two factors: debt service coverage, and growth in the total stock of debt. The current resolution specifies: (a) that 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; and (b) that new borrowing, within any 12 month period, cannot exceed the level of existing debt service *or* 27% of revenue, whichever is greater[3]. The resolution is, however, merely a guideline. The Senate is free to grant exceptions, and does so.

[3] 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.

Table 1: Senate Ceilings on State Borrowing 1975-1995		
	maximum debt service	**maximum growth in stock of debt**
Resolucao 63 (1975)	15% of net revenue	20% of real growth in revenues
Resolucao 94 (1989)	100% of previous current surplus	debt service plus 10% of net revenues
Resolucao 58 (1990)	20% of net revenue or 100% of previous current surplus	debt service plus 20% of net revenues
Resolucao 11 (1994)	15% of net revenue, or 100% of current surplus whichever less	debt service *or* 27% of net revenue, whichever greater
Resolucao 69 (1995)[4]	16% of net revenue, or 100% of current surplus whichever less	debt service *or* 27% of net revenue, whichever greater

16. A variety of regulations and laws control borrowing from specific sources. Borrowing from the domestic banking sector falls under the purview of the Central Bank. 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). Central Bank regulations also prohibit a state from borrowing from its own commercial banks (although this has not always been strictly observed, as noted earlier). The issuance of domestic bonds is controlled by the Federal Constitution, which prohibits new bond issues, other than to finance *precatorios*, until the year 2000. (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 determined on a state-by-state basis by the Senate). State borrowing from external donor agencies is controlled by a multi-ministerial council (COFIEX) which must approve state requests for such loans.

17. Lending decisions by federal financial institutions vary according to the institution and the source of funding. Thus CEF imposes one set of lending criteria in its capacity as agent for FGTS-funded infrastructure lending, and a

[4] This, most recent revision, explicitly defines the amount of interest due on bonds to exclude the amount the Senate permits to be rolled over.

different set as an agent for treasury debt refinancing program. All federal lending is subject to federal legislation (Lei 8727) prohibiting any loan or guarantee by any federal institution to any state that is in arrears on any loan from the Federal Government.

The Current Crisis

18. This phalanx of federal regulations was not sufficient to forestall the current debt crisis. Most of the recent growth in debt consists not of new borrowing but of the capitalization of interest on existing debt. As such, it escaped existing controls. The remainder consists of growth of arrears, and new emergency lending not contemplated in the existing legislation.

Table 2
Trends in Inflation and Interest Rates

Year	Inflation rate	Real overnight rate
1988	993%	
1989	1863%	19%
1990	1585%	-24%
1991	475%	11%
1992	1150%	32%
1993	2488%	22%
1994	929%	22%
1995	22%	25%
1996	9%	17%

19. The stage for the current crisis was set by a high level of spending on personnel. Despite the states' two previous brushes with default, political pressures remained a important influence on state fiscal behavior. Outgoing governors granted large salary increases to bolster their campaigns for new offices and incoming governors granted increases to avoid labor problems in the first year of their administrations.

Table 3
Growth in Average Monthly Earnings 1992-1995

	1992	1993	1995
state government	594	661	710
private sector*	436	446	444

*constant reais of September 1995** workers with signed working card

20. This behavior was fiscally sustainable as long as inflation remained high. During most of the years following the 1988 Constitution, annual inflation

averaged over 1000%. (Table 2) Under these conditions, states could reduce payroll costs in real terms--without violating the Constitution--by refraining from nominal salary increases. Inflation dropped dramatically with the introduction of the Government's stabilization plan, the Plano Real. The Plano Real, introduced in mid-1994, consisted of an initial fiscal and wage adjustment, an exchange rate anchor (modified later in 1995 and made less rigid) and a tight monetary policy. The plan had remarkable success. Annual inflation fell from 929 percent in 1994 to 22 percent in 1995 and nine percent in 1996. By slashing inflation, the Real Plan sharply reduced the states' ability to reduce real salaries and pensions via inflation. As a result, state governments found themselves paying unusually high salaries in real terms. As shown in Table 3, real salaries in the public sector increased by 20% in real terms between 1992 and 1995.

21. The Plano Real also contributed to the current crisis through its impact on interest rates. Despite the two debt reschedulings, much of the existing stock of state debt was vulnerable to fluctuations in short term interest rates. The principal on rescheduled domestic debt was indexed to the average rate paid on deposits. The rate on state bonds was linked to the overnight rate on federal bonds. As shown in Table 2, domestic real interest rates had been high for several years preceding the Plano Real, due to the risks associated with inflation. While those risks were reduced by the Plan, this effect was counteracted by the Plan's tight monetary policy. The result was a continuation of high interest rates.

22. Faced with intransigent personnel costs and persistent debt service obligations, the states' response was to default. Defaults took several forms.

Capitalization of interest on bonds

23. The largest single object of default was state bonds. This mechanism requires some explanation. Although fifteen states and two municipalities issue bonds, bond financing 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 were traditionally underwritten by

the states' commercial banks, and ultimately sold to private banks and investors. Although bearing five year maturities, these bonds were routinely rolled over at maturity.

24. The states began to have difficulty marketing the bonds in the late 1980's. As state finances became increasingly precarious, the interest rates demanded by private banks rose and the maturities shortened. Ultimately, private banks declined to hold state debt even on the overnight market, at any price. Unable to liquidate the bond debt (which had reached Rs$ 31 billion by the end of 1994), the states sought relief from the Federal Government. Under the so called *troca* arrangement, the Federal Government authorized the states to exchange their bonds for more readily marketable federal bonds. State bonds would be held in the portfolio of the Central Bank, which would float a corresponding amount of Central Bank bonds, transferring them to the states. State bonds would thus be represented as assets on the Central Bank's balance sheet, and the corresponding Central Bank bonds, as liabilities.

25. Under the exchange agreement, the Senate had the authority to determine the proportion of the bonds that would have to be liquidated at maturity. The Senate used this authority liberally, authorizing 100% rollovers in all the major bond states. In addition, the Senate permitted the states to finance the interest due on the bonds, allowing it to be capitalized into the outstanding stock of bond debt at each rollover. Thus while technically avoiding default, states were able to relieve themselves of any cash obligation to service their bonds.

Table 4: Growth in Stock of Subnational Bonds
(Bn Rs of Dez 96)

Year	Stock of Bonds	Percent increase
1990	17.3	
1991	17.2	-1%
1992	23.2	35%
1993	25.9	12%
1994	31.3	21%
1995	43.2	38%
1996	51.7	20%

26. Interest charges on the exchanged bonds were based on the yield obtained by the Federal Government at periodic bond auctions. Due to the prevailing tight monetary policy, the real rate on federal bonds was 22% in 1994 and 25% in 1995. As the interest was capitalized, the stock of debt grew at a rate dictated by the interest rate on federal bonds. The result was an explosive rate of

growth. As shown in table 4, the stock of bonds grew by Rs$ 12 billion between 1994 and 1995, and another Rs.$ 8.5 billion in the following year. At the end of 1995, the total stock of state (and municipal) bond debt stood at Rs.$ 51 billion.

Defaults on revenue anticipation loans and arrears to personnel and suppliers

27. States also began to default on short term cash management debt. States had long used revenue anticipation loans (AROs) as a means of managing cash flow. Under the federal laws governing state borrowing, AROs must be repaid within 30 days after the end of the budget year in which they were contracted. As the state fiscal crisis deepened, states lacked the funds to liquidate their short term debt and appealed to their creditors to roll it over. Faced with the choice between writing off the debt or rolling it over, most private banks reluctantly took the latter course. States also resorted to more rudimentary means of borrowing, by running up arrears to suppliers and personnel.

28. As state arrears to personnel and suppliers mounted, pressure for federal relief increased. In November, 1995 the Federal Government responded. Under resolution 162 of the National Monetary Council, the government established the Program for State Restructuring and Fiscal Adjustment. This provided two lines of credit to states: the first to pay off arrears to employees and contractors; the second to refinance AROs[5]. The loans offered only brief respite. Each had to be fully amortized within the term of the current state administration. Interest rates were based on the CEF cost of funds, plus a spread. This implied, for a loan approved in early 1996, a real interest rate of 27% per year and an amortization period of slightly under 24 months[6].

29. Under the terms of the loans, the states also had to agree to a series of reform measures, covering personnel management, state enterprises, tax administration, debt reduction, and aggregate expenditure control. Typical state

[5] The program also offers a line of credit to finance severance payments. As of October 1996, Rs.$ 420 million had been disbursed for this purpose.

[6] Based on the contractual nominal rate of 2.95% per month for the first three months, and cumulative inflation February-April of 7.3%.

contracts included 35-45 specific measures and targets. In practice, the Resolution had little power to enforce these conditions. Funds were to be disbursed before any policy conditionality was imposed. The only *ex post* penalty for failing to comply with these conditions was a 3 month reduction in the maturity of the loan or mandatory prepayment of the entire amount.

Capitalization of interest owed to state banks

30. States also defaulted on debt to their state owned banks. Although this phenomenon was largely confined to a single state, it was large enough to have macro consequences. The state was Sao Paulo and the bank was BANESPA. Sao Paulo dominates Brazil's economy, accounting for 36% of national GDP and 38% of value added tax receipts. Despite Central Bank regulations, Sao Paulo had succeeded in running up considerable debt to BANESPA during the 1980s. Two-thirds of the state's debt to BANESPA originated in loans contracted directly by BANESPA from foreign banks. The other third derived from two short-term revenue anticipation bonds, borrowed from BANESPA in the late 1980s, and subsequently transformed into long term debt.

31. Sao Paulo began to default on this debt during in the early 1990's, and by 1994, had ceased servicing the debt altogether. BANESPA responded by permitting the state treasury to capitalize the unpaid debt service into the existing stock of debt. The interest rate charged on this debt was based on BANESPA's own cost of funds plus a spread of six percent--a total considerably higher than the rate on federal bonds. As market interest rates remained high after the introduction of the Plano Real, the volume of capitalized interest increased proportionately. At the end of 1993, the state's debt to BANESPA totaled US$ 5.8 billion. By December 1996, it had increased to US$ 21 billion, and was the bank's principal "asset"[7].

32. With its loans to the state generating no cash, BANESPA met its cash obligations by borrowing from the Central Bank. In December 1995,

[7] At end-1996, the state also owed US$ 5.3 billion to its two other state banks, Nossa Caixa and Nosso Banco.

viewing BANESPA's increasingly precarious situation as a threat to the financial system, the Central Bank assumed control of the bank. The bank was returned to state control in early 1996. In the interim, the state's debts remained non-performing. The Central Bank's intervention had an impact however. By assuming control and then relinquishing it to the state government, the Central Bank strengthened the perception that BANESPA's liabilities carried an implicit federal guarantee. This guarantee, together with direct liquidity support from the Central Bank, permitted BANESPA to remain in operation and continue to finance the growth in the stock of its state debt.

33. In the short term, the Federal Government's response to the emerging debt crisis--the bond exchange agreement with the Central Bank, the Resolution 162 loans from the treasury, and the ongoing Central Bank support to BANESPA-- were successful in forestalling a crisis in the financial system as a whole or a shutdown in a major state. Under the bond exchange agreement, states cash obligations on bond debt were reduced to zero. The resolution 162 program enabled the states to satisfy the demand on their creditors and staff. Support for BANESPA permitted the bank to continue operating without making cash demands on the state treasury. These were temporary solutions, however. The bond stock continued to grow through interest capitalization. Sao Paulo's debt to BANESPA grew apace. Resolution 162 debt had to be repaid within three years.

Table 5
Stock of State Debt, Dec 31, 1996
(Rs Mn)

Bonds	44,953
Contractual Debt	
rescheduled external	15,090
rescheduled domestic	32,584
Other external	2,108
Other domestic	3,235
BANESPA	27,699
Resolution 162	2,772
Total	128,440

34. More importantly, these solutions fundamentally shifted the relationship between borrower and creditor, transferring the role of creditor from the private sector onto the Federal Government. While the bonds had been held by private banks, they were now held by the Central Bank. Where the debt to BANESPA had been the concern of the bank's shareholders and depositors, it had now been implicitly assumed by the Central Bank. Where the AROs and arrears had been owed to private banks and

individuals, the restructured debt was now owed to the Federal Treasury. As of December 1996, the stock of such debt assumed by the Federal Government totaled US$ 75.4 billion.

Borrowing against state assets

35. In addition to refinancing states' bonds, arrears, AROs and state bank debt, the Federal Government provided a mechanism for states to borrow against assets. Under the program, states could transfer shares in state enterprises to the federal economic development bank, BNDES. BNDES then provided an unconditional loan, with the agreement that the loan would be liquidated when (and if) the state sold a controlling interest in the enterprise to the private sector. (BNDES and the state would share in the capital gain). As of December 1996, six states had taken advantage of the program, including Minas Gerais (Rs.$ 433 mn), Parana (Rs.$ 280 mn), Rio de Janeiro (Rs.$ 244 mn.), Rio Grande do Sul (Rs.$ 150 mn.) and Bahia (Rs.$ 135 mn) for a total of Rs.$ 1.3 billion.

36. BNDES funds were not used to retire debt. Rio de Janeiro used its BNDES funds to finance subway construction. Minas Gerais raised Rs$ 275 mn. (backed by shares in its power company) to pay interest on debts, but not to reduce principal.

Macro consequences

37. As of December 1996, the stock of state debt reached US$ 128 billion (excluding arrears). The heavy interest obligations on this growing stock of debt, combined with the states' inability to reduce personnel costs or raise revenues, resulted in operational deficits that were large enough to have macroeconomic consequences. As shown in Table 6, the state operational deficit comprised half the public sector total in 1996. In the long run, continuing high fiscal deficits financed by debt are incompatible with stabilization. As a result, there was pressure to adjust. Given the extent of Brazil's decentralization and the size of deficits at the state level, this pressure focused at the state as well as the federal, level.

Table 6 Primary and Operational Deficit (as percent GDP)						
	1991	1992	1993	1994	1995	1996
Total primary	-2.6	-2.3	-2.6	-5.2	-0.4	0.1
Federal Government and BCB	-0.8	-1.3	-1.4	-3.1	-0.6	-0.4
State and local governments	-1.2	-0.3	-0.5	-0.9	0.2	0.6
State enterprises	-0.7	-3.1	-0.7	-1.2	0.0	-0.1
Total operational	-1.3	2.2	-0.3	-1.3	4.8	3.9
Federal Government and BCB	-0.3	0.8	0.0	-1.6	1.6	1.7
State and local governments	-1.2	0.8	-0.2	0.6	2.2	1.9
State enterprises	0.1	0.6	-0.0	-0.3	0.9	0.3

Notes: (1)deficits of state enterprises owned by state governments are included in the state enterprises category, rather than under state and local governments (2) . "-" indicates surplus.

The role of the World Bank

38. The World Bank had been directly lending to Brazil states for nearly 25 years[8].Until late 1994, state finances had not been an issue in Bank lending. As all loans carried a federal guarantee, the Bank faced no direct financial risk from state defaults. State finances were only relevant to the extent they affected counterpart financing. This changed in September of 1994. At that time, the Federal authorities made two requests of the Bank. The first was to refrain from lending to states that were not creditworthy. The second was to prepare a series of state reform loans. These would support state fiscal adjustment and, as such, complement the Federal Government's effort to halt the growth of state debt. It was hoped that adjustment, combined with a satisfactory workout of state debt, would permit states to become creditworthy within a relatively short period of time.

39. Identification of the reform loans (SRLs) began immediately thereafter, with a series of visits to promising states. States were selected first and foremost on the basis of their governor's commitment to reform. (Sao Paulo was excluded from consideration from the outset due to its size). The state of

[8] This was a unusual relationship for the Bank. With few exceptions (Iran, Korea) lending to subnational governments in other countries took the form of a direct loan to the central government, with onlending arrangements established in subsidiary agreements.

Para was considered but subsequently dropped when initial proposals to sell the state bank were not pursued. After a winnowing process, five states emerged: Rio de Janeiro, Rio Grande do Sul, Minas Gerais, Mato Grosso, and Sergipe. (Sergipe was later dropped, as its reform depended critically on a Constitutional amendment on public service tenure which was delayed).

Debt Workouts

40. State adjustment was inextricably linked to a workout of the state debt. The Bank therefore quickly developed technical guidelines on the terms such a workout might take. The Bank advocated comprehensive debt workout agreements--covering all outstanding debt--with each of the major states. In the Bank's view, the agreements should have three characteristics. First, they should *permanently* reduce debt service, rather than merely postponing it. Brazil's two previous debt workouts had postponed debt service. By rescheduling the outstanding stock and permitting states to defer debt service above a fixed percentage of revenues, the agreements allowed states to increase the stock that would eventually have to be repaid. In the Bank's view, this approach would not resolve the current crisis. The size of the debt was too large, and the likelihood of commensurate turnarounds in state finances so small that postponement would merely set the stage for larger debt crises in the future.

41. Second, the Bank advocated speed. It advised to achieve creditworthiness within two to three years. This reflected a political calculation. Any feasible debt workout would require major cuts in investment and personnel spending and a virtual moratorium on new borrowing. While the sitting governors might be willing to observe these strictures, the new governors taking office in early 1999 might not. Postponing the achievement of creditworthiness would increase the likelihood that it would never be achieved at all.

42. Finally, the Bank argued that debt agreements should fundamentally change the incentives for state fiscal behavior. In the Bank's view, debt crises were inherent in the existing political and financial relationship between the Federal Government and the states. The first two debt workouts, followed by the bond exchange agreement, the Resolution 162 program, the Central Bank's

support of BANESPA and BNDES' lending program had demonstrated that the Federal Government found it hard to refuse to come to the relief of any state in financial difficulties. In the Bank's view this created a perverse incentive, encouraging states to engage in expansionary fiscal behavior, secure in the knowledge that the Federal Government would eventually come to their relief. As part of the workout package, the Bank therefore advocated terms and legal and institutional safeguards that would discourage recourse to federal relief in the future.

43. As an instrument for adjustment, the Bank advocated a "Brady-style" approach. Under a "Brady-style" approach, each state would commit itself to internal fiscal reforms: cuts in personnel, subsidies, and capital spending and increases in taxation. In return, the Federal Government would provide debt relief in the form of reductions in the stock of debt or long term interest rate subsidies. Separate agreements would be struck with each state, such that the combination of internal fiscal adjustments and federal relief would be just sufficient to permit each state to service the debt that remained.

44. From a technical perspective, a "Brady-style" approach had much to recommend it. By reducing the stock of debt up front, it would permanently reduce the burden of existing debt, rather than merely postponing it to the future. As an immediate stock reduction, it could be implemented within the required political time frame. In addition, by requiring state fiscal adjustment as a *quid pro quo* for debt relief, it would serve as a disincentive to lax fiscal behavior in the future.

Designing Tentative "Bradys"

45. Tentative "Bradys" were designed during project preparation. These were calculated for each state on the basis of (a) a maximum plausible adjustment program and (b) a corresponding amount of debt relief[9].

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[9] The spreadsheet model used to make these calculations is described in "Assessing State Creditworthiness in Brazil", LAC1 Economic Note # 8, April 1996.

46. The scale and targeting of adjustment programs varied among states. The most promising target for the state fiscal adjustment was personnel. As shown in Table 7, personnel costs (including pensions) consumed over 80% of current revenues in the three large SRL states.

Table 7
Major Categories of Expenditure, SRL States
(as % of revenue, 1995)

	RJ	MG	RS	MT
Personnel	82%	81%	82%	76%
Capital investment	8%	12%	8%	7%
Debt service [1]	45%	51%	44%	30%

[1] debt service is reported on accrual basis and thus does not reflect authorized capitalization of interest

47. At the outset, major cuts in personnel costs were predicated on reforms in the Federal Constitution. During project preparation, the federal Congress was considering a Constitutional amendment that would enable two key reforms. First, it would give states the authority to dismiss excess staff on fiscal grounds alone. This would have ended the guarantee of permanent employment. Second, it would have tightened eligibility criteria for retirement, imposing age and length of contribution criteria, and delinked pension benefits from the salaries of active workers. The amendment was not passed in the 1996 session. Any immediate prospect of major cuts in personnel costs failed along with it. Personnel nevertheless remained a principal target, with efforts now focused on measures not prohibited by the Federal Constitution.

48. Reductions in staff The most obvious were reductions in staff not protected by the Constitution. This included new staff on probation and established staff employed on a contractual basis. Attrition was also an option. By imposing hiring freezes, states could reduce the number of active staff over time. Given the generosity of the existing retirement eligibility criteria, these reductions could be fairly rapid. It was estimated that the number of active staff could be reduced by three percent annually through attrition alone. The states also undertook voluntary severance programs. All four of the states offered incentive packages to any confirmed staff willing to quit voluntarily.

49. *Reductions in real salaries and pension benefits* Reductions in real salaries were also a target. Despite the success of the Plano Real, residual inflation remained significant. In 1995, prices rose 22%; in 1996, nine percent. As the

Federal Constitution merely prohibits reductions in *nominal* salaries, this enabled states to reduce salaries in real terms. Because pension benefits are indexed to salaries paid to active workers, freezing nominal salaries produced a corresponding reduction in real pension payments. Introducing mandatory retirement contributions was also included as a means of reducing the net cost of pensions.

50. *Reductions in staff in state-owned enterprises*. Personnel costs in state enterprises (SOEs) were a third target. Staff in SOE enterprises are employed under private labor law, and can be dismissed more easily than staff in direct administration. Dismissing such staff proved to have little fiscal impact in three of the four SRL states, however, as SOE staff were paid from the revenues of their respective companies. Rio de Janeiro, however, was able to achieve considerable savings by downsizing its state-subsidized urban transport companies[10].

51. In addition to personnel, internal fiscal adjustment was to include *cuts in investment spending*. In the short term, the fiscal impact of such cuts would be limited. As shown in Table 7, states had already cut investment spending to 7-12% of revenues. It was hoped however, that a debt agreement could prevent increases in investment spending in the future. Investment spending in Brazil tends to follow the political calendar. As governors were facing elections in 1998, pressures for increased spending were expected to mount. All three of the largest debtor SRLs were proposing major investment programs in 1997 and 1998. (As shown in Table 7, much of it survived the fiscal adjustment program negotiations.)

52. Finally, adjustment was to include improvements in the *administration of the state value added tax*, the ICMS. States have little control over the *rate* of the ICMS, due to Constitutional restrictions. States are, however, positioned to increase ICMS revenues by improving the tax's administration. Under a proposed IDB-financed project, the states hoped to improve revenues by updating the taxpayer cadastre, increasing the number of tax auditors, stepping up efforts to pursue delinquent taxpayers, and upgrading the management information system used in the judicial process.

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[10] Salary reductions in SOE looked unpromising. Under the private labor law, wage disputes are ultimately settled by the Labor Court, which tends to approve increases up to the level of inflation.

Table 8 Major Components of State Fiscal Adjustment Programs			
	Rio de Janeiro	**Rio Grande do Sul**	**Minas Gerais**
cuts in # of active staff	PDV cuts 6.5% in 96; dismissal of contractual workers cuts 5% in 96; attrition cuts 3% p.a. thereafter	PDV cuts 9.5% in 96; attrition cuts 1.8% p.a. thereafter	dismissal of contractual workers cuts 12% of staff in 96; PDV cuts 4.5% in 97; attrition cuts 2% pa thereafter
cuts in avg. salary and pension	wage freeze drops avg. real salary, pension 22% in 96, 7.5% in 97, thereafter remain constant	partial wage freeze drops avg. real salary, pension benefits 7.4% in 97; remain constant in 1998; drop 5% in 1999	partial wage freeze drops avg. real salary and real salary 5% in 97, 98
cuts in # staff in SOEs	downsizing and privatization cut staff 20% in 96 ; 20% in 97;		
pension reforms	retirement tax of 5% introduced 96	retirement tax introduced at 2.5% at 1996; rises to 3% thereafter	retirement tax introduced at 3% at 1997
other recurrent costs	remains constant percent of revenue	remains constant percent of revenues	remains constant percent of revenues
capital investment	doubles in 97, 98 financed by new borrowing, privatization proceeds	increases 40% in 97,98 financed by new borrowing, privatization proceeds	increases 25% in 97,98 financed by new borrowing
tax effort	increase 2.5% annually	increases 3% in 1997, thereafter constant	increases 5% in 97, thereafter remains constant

Debt Reduction

53. Once the maximum level of adjustment was determined, the amount of debt reduction needed to render each state's total debt obligations affordable was calculated. This required short term and long term analyses of each state's

situation. The short term (defined as 2-3 years) was most immediately relevant, since the Bank advocated a resolution to the debt crisis within that time frame. Short term adjustment had to take into consideration the specific terms of individual debts and other contractual and regulatory constraints confronting each state. The long term perspective was equally important, to ensure that debt workouts would be sustainable. For the long term, immediate regulatory and contractual constraints could be relaxed, but long term trends in interest rates and debt maturities had to be projected.

54. In the short term, the debt relief requirement was defined as the amount needed to permit each state meet its annual debt and non-debt obligations from recurrent sources of revenue. (Since the states were already overindebted, financing spending by new borrowing was clearly a non-starter). This requirement was expressed in terms of the operational balance (defined as recurrent revenues, less the sum of current expenditures --including interest-- and capital expenditures--excluding amortization). By definition, a state with an operational balance would be able to meet all its expenditures, except amortization, from recurrent revenues. Any cash flow deficit would be offset by amortization, leaving the stock of debt unchanged. While a small, shrinking, operational deficit was considered consistent with a Brady-type debt workout, large or growing operational deficits were not.

55. In the long term, some of the constraints posed by federal regulations and individual debt terms could be relaxed, as states would have more flexibility to adjust over the long term and existing loans would mature and be replaced. The test of a debt workout's long term sustainability therefore focused on more fundamental determinants of debt servicing capacity: There are two. The first is the volume of resources available to service debt. A basic condition for sustainable debt is that burden of debt should not grow faster than the overall resource envelope from which it must be paid. In the Brazilian case, this meant that once a state's debt had been reduced to an affordable level, it should not grow faster than state revenues.

56. The second is the proportion of revenues that can be allocated to debt service. While in principle a state could devote all its revenues to debt service, no constituency would countenance an administration that spent most of

its revenues on intangible payments to banks. Sustainable debt principles therefore argue that the proportion of revenues allocated to debt services must be limited by the debt service tolerance of a jurisdiction's constituents. How high the limits of debt service tolerance are is difficult to determine. In OECD countries with federal structures, the threshold appears to lie between five and ten percent of revenues. State interest payments in the U.S. average four percent of revenues; in Germany, eight percent and in Canada, 12%[11]. For Brazil, the Bank adopted a threshold of 15%. This was consistent with the relatively high interest rates that have prevailed in Brazil in the past. It is also the threshold traditionally imposed by federal Senate regulations.

57. Under best-estimate projections of future interest rates and debt maturities, a 15% debt tolerance threshold implied a maximum debt:revenue ratio of 1:1[12]. Achieving this target within two to three years implied substantial cuts in state debt. As shown in Table 9, achieving this target (at the levels of debt in 1996) would have required a reduction of 60% in the debt stock in all four SRL states, as well as Sao Paulo.

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[11] Note that the regulatory ceiling in Brazil includes amortization. This does not affect its comparability to the industrial countries. As the ceiling applies only to long term debt (and bonds can be considered long term for practical purposes) amortization is only a minor component of state debt service in Brazil.

[12] This assumes that: (a) in the long run, real interest rates (combined with principal indexes) will drop to 7-10 percent per year and (b) that since the majority of future debt is likely to come from federal financial intermediaries and international lenders, maturities would be medium to long term; averaging twelve years.

Structural Reform

58. The SRL projects were designed to be underpinned by structural reforms. Here, the objective was to take advantage of the fiscal crisis and popular support for reform to put into place long sought fundamental changes in the management of public services without which the fiscal adjustment would not be sustainable. These efforts focused on two targets. The first was the closure of state banks. The banks were targets for two reasons. First, they had been a source of difficult-to-control state borrowing in the past, as witnessed by Sao Paulo's debt to BANESPA. Although Central Bank regulations prohibited the practice, there was concern that states could resume borrowing from their banks in the future. Second, the banks themselves were rapidly losing money. Although BANESPA was the only bank hurt by non-performing state debt, the state banks of Rio de Janeiro (BANERJ) and Mato Grosso (BEMAT) and the two commercial banks belonging to Minas Gerais (BMGE and Credireal) were in financial trouble. All four had been adversely affected by the Plano Real, which substantially reduced income from inflation and securities trading. These problems were compounded by a history of overstaffing and ill advised lending decisions. Three of the four banks were experiencing negative returns on assets during SRL project preparation. BANERJ and BEMAT had negative net worths. Credireal, too, had a negative net worth if unfunded pension liabilities and severance costs are included.

Table 9
Stock Reductions required to Achieve Debt:Revenue Target

	debt:revenue ratio (1996)	% cut needed to achieve 1:1
Sao Paulo	3.27	69%
Rio de Janeiro	2.71	63%
Minas Gerais	2.44	59%
Rio Grande do Sul	2.28	56%
Mato Grosso	3.26	69%

59. The other focus of structural reform was on privatization of state-owned power companies, water companies, and urban transport enterprises. This was aimed at both fiscal and efficiency objectives. As shown in the Table 10, three of the four states were to sell power companies. All four would concession water distribution. In addition, Rio de Janeiro would concession its

suburban rail and subway system and sell its bus and ferry companies. Rio Grande do Sul would sell its telephone company. Rio de Janeiro and Minas Gerais would sell their gas companies. Minas and Rio Grande do Sul would open certain highways to concessions.

Table 10: Structural Reform Components of State Reform Loans

		sell		concession	
	bank	power co.	other	water	other
Rio de Janeiro	✓	✓	ferry, bus ,	✓	rail,
R. Grande do Sul		✓	telephone	✓	port,
Minas Gerais	✓		gas	✓	highways
Mato Grosso	✓	✓		✓	

60. It was originally hoped that the fiscal and structural objectives would work in tandem. In a strictly financial sense, it was hoped that receipts from the sale of state enterprises could be used to reduce the stock of debt. These expectations were not borne out. In part this was because the assets themselves were not as valuable as expected. The liabilities of three of the state banks, for example, far exceeded the value of their assets. States had also used the BNDES program to reduce their equity holdings in state companies. More importantly, it was hoped that debt relief could be used to leverage additional structural reforms. By offering debt relief to states that privatized, and withholding it from states that did not, it was hoped that states could be induced to undertake more reforms than they would have otherwise. These expectations also failed to materialize.

61. The SRL loans were to be disbursed in two to four tranches, on the basis of pre-agreed fiscal and structural reforms. On the fiscal agenda, the SRLs had two principal requirements. The first, chronologically, was an acceptable debt agreement. This was a condition of Board presentation. The second consisted of fiscal performance targets. These would be based on the tentative "Brady" agreements discussed with each state during preparation. While the targets could not be finalized until federal-state debt negotiations were complete, it was hoped that the terms of the debt agreements, combined with fiscal adjustment at the state level, would be sufficient to yield sustainable

levels of debt. (The appendix to this paper explains how the fiscal conditions were defined).

62. On the structural agenda, disbursement-related actions established the specific enterprises to be closed or sold. First tranche conditions included the sale of state banks (Rio de Janeiro, Minas Gerais, and Mato Grosso); power companies (Rio de Janeiro and Mato Grosso) and telephone companies (Rio Grande do Sul). Subsequent tranche conditions included the concessioning of subway and suburban rail systems (Rio de Janeiro); toll highways (Rio Grande do Sul and Minas Gerais), decentralization and partial concessioning of water supply systems (Rio de Janeiro, Rio Grande do Sul, Minas Gerais, and Mato Grosso). Details of the fiscal conditions and the loan disbursement mechanism are provided in the annex.

Debt negotiations

63. The Federal Government began negotiations with the states in mid-1995, while SRLs were still in early preparation. By the end of the year, it was clear that the notion of a quick Brady-style solution was in difficulty. Opposition came from several directions. The Ministry of Finance, for one, was reluctant to grant explicit debt reductions and unsure about the legal instruments for achieving it. Wiping the state debt plate clean, in the Ministry's view, would merely present an opportunity for incoming state administrations to fill it up again. Despite the formidable array of new federal controls over new state borrowing, the Ministry was concerned that that future federal administrations might be unable to resist pressures to approve new lending operations to states. The Ministry therefore preferred to leave much of the debt stock in place, and grant just enough relief to induce the states to resume servicing the obligations on which they were in default.

64. The federal Senate also had a different perspective. Under the Brazilian Constitution, the Senate would have to approve each debt agreement. The apportionment of Senate seats weighed against the debtor states. Under the Constitution, each state has three Senate seats, regardless of population. The four major debtors (Rio de Janeiro, Rio Grande do Sul, Minas Gerais and Sao

Paulo) thus had only twelve of the 81 seats in the Senate. Differences in the views of representatives of the highly-indebted states and the less-indebted states prevented a consensus. While many Senators recognized the need for debt relief, the explicitness of a Brady approach could pose a political embarrassment. If debt was to be forgiven, a more subtle approach would have to be found.

65. Even on these terms, the Federal Government found the major debtor states reluctant to negotiate. As the major debtors were paying no interest on their bonds, their existing cash expenditures on debt service were relatively small. Not surprisingly, they were resolutely opposed to any agreement that would require them to increase their debt service payments, particularly within the sitting governors' term of office. The only position that would satisfy both constituencies--the debtor states and the non-debtor states--would be a write-off of federal debt in every state--a position opposed by the Finance Ministry.

66. Negotiations proceeded intermittently. As tentative deadlines for agreements came and went, the stock of debt continued to grow, due to the capitalization of deferred interest. Moreover, the political window of opportunity for major structural reform was beginning to close. The state governors took office in January, 1994 and faced reelection in 1998. Given the lead time required to privatize major enterprises, the deadline for initiating reforms before the onset of the political season was fast approaching.

Debt agreements signed

67. On September 20, 1996, the Federal Government signed an agreement-in-principle with Rio Grande do Sul. Two weeks later, the Government proceeded to sign a nearly identical one with Minas Gerais. In November, Sao Paulo signed, and in January, Rio de Janeiro. (Mato Grosso had signed an agreement covering its small stock of bonds and Resolution 162 debt in August, 1996).

68. The terms reflected a compromise among the various perspectives. They were concessionary enough to obtain the participation of the major debtor

states, but not so concessionary as to clear the way for a new round of state borrowing by incoming administrations, or to generate opposition from the senators from the non-debtor states.

69. Under the agreements, the entire stock of bonds and the Resolution 162 debt was transformed into a debt to the Treasury, with 30 years maturity. The interest rate on the refinanced debt is positive but concessionary. (Except in Rio, the real interest rate is 6%, comfortably below the projected long term average rate of 10%[13]). The stock of bond debt was rolled back to its March 30, 1996 value[14] The agreements also included a debt service ceiling. If debt service on the newly refinanced debt plus debt service on debt refinanced under the first and second debt agreements together exceeded 13% of net current revenues, the agreements allowed the excess to be capitalized into the stock of debt. Deferred debt service was to be repaid whenever eligible debt service dropped below 13% of net revenues, or at the end of the 30 year repayment period, whichever came first[15].

Table 11
Calculation of Implicit Debt Stock Reduction
(Rs Bn)

	SP	RJ	MG	RS	MT
total value of debt subject to refinance	42.4	12.5	9.0	6.3	0.7
value of interest rollback	3.0	0.4	0.6	0.5	0.1
value of interest subsidy	12.4	3.8	2.6	1.9	0.2
total reduction	15.4	4.2	3.3	2.3	0.3
as % of debt stock	36%	34%	36%	36%	36%

70. The agreements included no explicit debt stock reduction on the part of the Federal Government. Through the mechanism of the interest rate reduction and the rollback in the bond debt to March, they did include an implicit debt cut. As shown in Table 11, these two measures were equivalent to

[13] In Rio de Janeiro, the rate ranges from 6% to 7.5%, depending on the value of assets transferred to the Federal Government.
[14] and then recalculated on the basis of the 6% rate, rather than the federal bond rate that would otherwise apply.
[15] In first three years of the debt agreement, the states are required to pay only 11.5, 12% and 12.5% of their revenues, respectively, under a provision that permits the state to allocate part of the assets they are required to transfer to the Federal Treasury to this purpose.

a one-third reduction in the stock of debt[16]. In addition, the agreement required the *states* to reduce the debt stock by transferring assets to the Federal Government. In Rio de Janeiro, the state is required to transfer assets worth at least ten percent of the rescheduled debt. In Rio Grande do Sul, Sao Paulo and Minas Gerais, the proportion is 20%. In all cases, the assets will be credited against the stock of debt when they are actually transferred to private ownership. In the interim, the states are required to pay interest on the entire outstanding amount.

71. In principle, the agreements demand a *quid pro quo* on the states in the form of fiscal adjustment. Each state is required to gradually reduce its debt stock: revenue ratio so as to achieve a debt ratio of 1:1 in eight to ten years. The means by which this is to be achieved are not specified in the protocols, however, and the penalties for violating this provision are light. Under the protocol agreements, states failing to make steady progress toward this target will merely be denied Federal guarantees on external borrowing.

72. The debt agreements with Sao Paulo and Rio de Janeiro have additional provisions. Under the Sao Paulo agreement, the state's debt to BANESPA is included in the refinancing package, bringing the total to US$ 45 billion. The state is also required to transfer controlling interest in the bank to the Federal Government for one year. While the state has the right to repurchase the bank within that time period, the price is to be set at an independently-determined market price. (Shorn of its non-performing state assets and the corresponding liabilities, BANESPA is though to be worth about US$ 7 billion.) If the state does not exercise this option, the Federal Government would have the authority to privatize it.

73. Rio de Janeiro's debt agreement also includes a special provision for its bank. The state's debt to its bank, BANERJ, is relatively small (US$ 435 million.) The bank itself however has a large negative net worth. As part of the debt agreement, BANERJ would be sold. To render it marketable, the state is required to assume US$ 6.3 billion in BANERJ liabilities, including its

[16] Assuming that the rate on LFTs will average 10% in real terms over the next thirty years, and discounting the resulting interest savings at 10%.

liabilities to the Central Bank, pensioners, and other creditors. This will be added to the stock of debt to be refinanced[17].

74. The agreements did not fully meet the technical guidelines for success originally proposed by the Bank, although they were accepted as the best achievable compromise given the circumstances. In financial terms, the agreements clearly failed to reduce the debt burden to a sustainable level within a two-to-three year time frame. In all four SRL states, the amount of debt relief was insufficient to permit the states to meet their spending obligations from revenue. Table 12 shows a revised set of fiscal projections for each state (plus Sao Paulo), based on its debt agreement and a more modest fiscal adjustment program. As shown, all four SRL states, and Sao Paulo, are expected to run large operational deficits in 1997-1999. As a consequence, debt ratios that were unsustainable in 1996 will grow, rather than decline, in subsequent years. As shown in Table 13, projections for subsequent years show only a stabilization of debt:revenue ratios, but not a downward trend, despite optimistic projections of revenue growth[18].

Table 12
Projection of Operational Deficits

	1996	1997	1998	1999	2000
Sao Paulo	-35%	-15%	-14%	-13%	-12%
Rio de Janeiro	-30%	-32%	-27%	-18%	-19%
Minas Gerais	-44%	-31%	NA.	NA.	NA.
Rio Grande do Sul	-48%	-12%	-12%	-10	NA
Mato Grosso	-34%	-38%	-51%	-24%	-19%

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[17] Against this amount, the state will be allowed to credit up to US$ 2.48 billion in BANERJ assets, including the bank's bond portfolio and proceeds from the sale of the bank itself.

[18] These projections are themselves highly optimistic. They assume that the states will in fact transfer the required amount of assets to the Federal Government and that the Federal Government will successfully sell them during 1997. They also assume that the states will refrain from new contractual borrowing. Neither is likely to occur. It is more realistic to expect that the transfer and sale of assets will be delayed by disputes over their value. Given the scale of projected operational deficits, it is likely that the states will attempt to obtain loans, either contractually or by again defaulting on debt service to the Federal Government.

75. Whether the agreements sufficiently address the more fundamental concern--the need for change in the incentives for state fiscal behavior--depends on their future implementation. The debt agreements impose few immediate costs on the debtor states. Although debt service obligations will rise, much of the increase will only occur after the sitting governors leave office. The penalties and restrictions on new borrowing consist only of denying federal guarantees on state external lending until states' debt:revenue ratios reach 1:1. While in principle, the states are required to transfer substantial volumes of assets to the Federal Government, in practice it is not clear how effectively this will occur.

Table 13
Projection of Debt: Revenue Ratios

	1996	1997	1998	1999	2000
Sao Paulo	327%	329%	332%	333%	NA
Rio de Janeiro	271%	282%	304%	304%	303%
Minas Gerais	244%	261%	NA	NA	NA
Rio Grande do Sul	210%	228%	231%	NA	NA
Mato Grosso	326%	332%	343%	350%	NA

76. In response to the debt agreements, the Bank engaged in intensive consultations as to how to proceed with the pending loan negotiations on the first SRL, Rio Grande do Sul. After considerable discussion with the Federal authorities, the Bank ultimately decided to restructure all four loans, reducing their size and focusing solely on privatization. While fiscal performance remains a condition of tranche disbursement, its aim will be modest: merely to enable the Bank to halt tranche disbursement if the state grossly violates its adjustment goals.

Lessons learned

The need for hard budget constraints on subnational governments

77. The Brazilian experience demonstrates the importance of a imposing a hard budget constraint on subnational governments. In Brazil, as in any other multi-level democracy, subnational governments have an inherent incentive to look to the central government for increased resources, rather than increase taxes on their own constituents or cutting expenditures to fit existing budget

constraints. In many countries, the mechanism for central government support is discretionary grants. In such cases, bargaining over discretionary grants is core part of the intergovernmental political relationship. In Brazil, discretionary grants are relatively unimportant. Fiscal constraints at the federal level (due in part to the expansion of formula-driven revenue sharing) have limited the amount of Federal resources available for discretionary transfers to subnational governments.

78. This has not removed the incentive for states to seek federal relief, however. It has merely shifted the venue for bargaining from the fiscal realm to the financial one. Rather than bargain for grants, states have--wittingly or not--used the financial system to obtain Federal resources. They have done so by accumulating unsustainable levels of debt. This has prompted the federal government to intervene, providing relief in the form of debt rescheduling, interest rate subsidies, and new lending. This pattern is evident not only in the most recent debt agreement, but also in the succession of debt relief measures that preceded it: the initial debt reschedulings of 1989 and 1993, the bond exchange arrangement with the Central Bank, Resolution 162, and the BNDES arrangement.

79. Conceding such relief creates a perverse incentive. It encourages states to engage in expansionary fiscal behavior, secure in the knowledge that the Federal Government will, sooner or later, come to their relief. Although each debt crises has had its proximate exogenous cause--a sudden drop in inflation, high interest rates, foreign exchange constraints--states have consistently placed themselves at risk by overborrowing.

80. It is tempting to argue that the Federal Government could impose a hard budget constraint by simply refusing to lend to subnational governments. Private lenders, it could be argued, would refuse to lend to states in precarious fiscal circumstances. The facts of the Brazil case force a caveat. In Brazil, the debt crisis *originated* in loans made by the private sector. State bonds were initially sold to private banks. AROs, too, were extended by private banks. Private depositors and interbank lenders were the initial source of savings that financed BANESPA's lending to Sao Paulo. What was implicit in private loans to state banks, however, was a federal guarantee. While some lenders may have believed their borrowers were creditworthy, it is likely that they also assumed that the Federal

Government would make good on state obligations, once the obligations were large enough to threaten the stability of the financial system or provoke a breakdown of services in a major state. In this, they were not disappointed. The Central Bank made a market in state bonds once private banks were unwilling to hold them. The Federal Treasury refinanced the states' ARO debt. Central Bank backing kept BANESPA in operation, despite its non-performing state debt portfolio.

81. This suggests that any hard budget constraint imposed on state government must extend not only to states but to private lenders. It is not enough for a central government to refuse to lend directly to states. It also has to withdraw its implicit guarantees on private lending to states. The Brazilian Government now appears to have adopted this policy. In early 1997, the Federal Government, for the first time in recent memory, declined to intervene in a default by the state of Alagoas to a private lender.

Consistency in Federal policy

82. The Brazil experience also demonstrates the critical role of consistency in central government policies affecting subnational finances. In Brazil, federal policies concerning state debt conflicted with personnel policies embedded in the Federal Constitution. While the Federal Government was urging states to resume servicing their debt, the Constitution prevented states from taking the steps needed to do so. Throughout the debt crisis, state revenues were largely consumed by expenditures on personnel. These could not be reduced (except by gradually using inflation to erode real salaries) due to Constitutional prohibitions on dismissing staff, reducing nominal salaries, and cutting pension benefits. Had Congress approved proposed administrative reforms to the Constitution, states would have had the legal authority to carry out more extensive fiscal adjustment programs. As it was, the Federal Treasury was required to bear most of the costs of adjustment itself.

The case for a new lending instrument for state reform

83. Finally, from the parochial viewpoint of the Bank, the Brazil experience suggests the need for a less cumbersome instrument to

accomplish SRL objectives. The SRLs were intended to provide rapid budgetary support to a few critical, irreversible policy reforms in each state. In principle, two lending instruments were available: SALs and investment loans. SALs were ruled out from the beginning, as none of the natural preconditions existed. Brazil had no balance of payments deficit or IMF-monitored macro-economic program. Nor was it likely that individual state governments would be receptive to an adjustment loan passed through the Federal Government.

84. The investment loan option had drawbacks of its own. Investment loans can only disburse against items that have been procured according to Bank guidelines. The direct costs of SRL reforms--where they were not negligible--were ineligible under Bank guidelines. (Severance payments for dismissed civil servants, for example, could not be financed). As a result, considerable preparation time was devoted to identifying items of state expenditures that would be eligible under Bank guidelines but could be disbursed rapidly enough to match the time frame of an adjustment loan.

85. A new instrument--a rapidly disbursing policy based lending instrument for subnational government-- would eliminate this disbursement obstacle, permitting the Bank to provide immediate budget support for state reforms. Rapid general budgetary support to a subnational government is appropriate where the reform in question is quick, well defined, and irreversible. Privatization, for example, fits this description. Whether such loans would be appropriate for broader public sector management reform is questionable. Downsizing and salary reductions are quick but are easily reversed. More fundamental reforms in public sector management take several years to implement, a time frame too long to match the pace of a fast disbursing loan[19].

[19] see Nunberg, B; Public Sector Management Issues in Structural Adjustment Lending (World Bank Working Paper 217.

Appendix: Loan Conditions and Disbursement Mechanism for State Reform Loans

Fiscal Conditionality

86. The reform loans were to be disbursed in several tranches (referred to as "time-slices" in the legal documents.) Disbursement of each tranche would be conditioned upon satisfactory compliance with reforms. On the fiscal agenda, the SRLs had two principal fiscal requirements. The first, chronologically, was an acceptable debt agreement. This was a condition of Board presentation. Given the time required to transform an agreement in principle into an act of legislation, the Bank agreed that a signed protocol between the federal and each SRL state government, consistent with the principles defined earlier by the Bank, would satisfy this requirement.

87. The second condition was fiscal adjustment. Targets for fiscal adjustment were defined on the basis of two indicators. The first was operational balance as a percent of revenue. The minimum target for the operational balance was zero. This would indicate that the state was meeting its spending obligations without new net borrowing. As all the SRL states had unsustainable stocks of debt, a spending pattern that at least did not add to the stock of debt was considered critical to long term fiscal sustainability.

88. The second indicator was the ratio of the stock of debt to revenue. This was intended to provide a longer term measure of progress toward fiscal sustainability. The target for the debt:revenue ratio was defined as 1:1. The 1:1 ratio was justified as follows. By the end of the decade, real interest rates (combined with principal indexes) were assumed to drop to 7-10 percent per year. As the majority of debt is likely to come from federal financial intermediaries and international lenders, maturities were assumed to be medium to long term; averaging, say, twelve years. Under these assumptions, a debt stock-revenue ratio of 1:1 would result in a ratio of debt service to revenue of about 15%.

89. A timetable for achievement of these targets was to be agreed during negotiations. Satisfactory progress toward the target would then be a condition of scheduled time slice disbursements. If the state's fiscal performance proved to be substantially worse than projected, the Bank would have the option of suspending the time slice until or unless satisfactory remedial actions were undertaken.

90. On the privatization agenda, the first tranche conditions included the sale of state banks (Rio de Janeiro, Minas Gerais, and Mato Grosso); power companies (Rio de Janeiro and Mato Grosso) and telephone companies (Rio Grande do Sul). Subsequent tranche conditions included the concessioning of subway and suburban rail systems (Rio de Janeiro); toll highways (Rio Grande do Sul and Minas Gerais), decentralization and partial concessioning of water supply systems (Rio de Janeiro, Rio Grande do Sul, Minas Gerais, and Mato Grosso), and the sale of banks and power companies not included in first tranche conditions (Minas Gerais (banks), Rio Grande do Sul and Mato Grosso (power companies).

Disbursement Mechanism

91. Although the SRLs were intended to operate as SALs--disbursing in tranches against specific reforms--the Bank had no mechanism for doing so. Adjustment lending had previously been limited to national governments, where disbursements were made against imports. In the absence of a parallel mechanism for states, the SRLs were forced to follow the disbursement procedures of investment projects.

92. The reforms themselves included very little expenditure that would normally be eligible for Bank financing. Investment costs were minimal, and in any event would have been too slow to match the timetable of reform While the Bank permits financing for severance, only personnel in state enterprises are eligible. Thus the SRLs could not finance the largest single direct costs of reform: severance program for civil servants.

93. The projects instead disburse against a variety of objects, whose common denominator is the simplicity and speed with which disbursements can

be made consistent with Bank guidelines. In Rio Grande do Sul and Minas Gerais, the projects will finance (1) additions to ongoing investment projects already subject to Bank procurement (2) severance costs for employees in state enterprises, and (3) state expenditures on social assistance programs aimed at mitigating the social impact of reform. In Rio de Janeiro, the project will also disburse against salaries of the suburban railway system, on the grounds such expenses are incremental to the states normal personnel costs (as the system was only recently transferred from the Federal Government to the state).

CURRENCY EQUIVALENTS

Currency Unit: Real (Rs. $)
US$1 = Rs.$ 1.12 (January 1997)

WEIGHTS AND MEASURES

Metric System

FISCAL YEAR

January 1-December 31

PRINCIPAL ACRONYMS

BANERJ	State Bank of Rio de Janeiro
BANESPA	State Bank of Sao Paulo
BCB	Central Bank of Brazil
BEMAT	State Bank of Mato Grosso
BMGE	State Bank of Minas Gerais
BNDES	Federal Economic and Social Development Bank
CEF	Federal Housing and Savings Bank
COFIEX	Interministerial Committee on Foreign Borrowing
FGTS	Unemployment Insurance Fund
ICMS	Value added tax
PDV	Voluntary employee separation program
SRL	State reform loan