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BRAZILIAN JOURNAL OF PUBLIC ADMINISTRATION

The fiscal crisis of states and the Fiscal Recovery Regime: the federative *Déjà Vu*

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This article aims to discuss the fiscal crisis of the Brazilian states and the Fiscal Recovery Regime (FRR) enacted in 2017, whose adjustment measures are considered fundamental for the balance of state public accounts. Under the federative perspective, these adjustments represent a weakening of the states since such measures affect their political and administrative autonomy. The state of Rio de Janeiro was chosen as the subject of this research because it was the only state to join the FRR since its enactment, and the study used data from the years 2008 to 2019. The findings suggest that the austerity measures adopted by the state of Rio de Janeiro were not enough to guarantee financial stability and the rebalancing of public accounts. Among the results, we highlight that the state remained financially insolvent and the indebtedness for the period grew. The only positive result within the terms of the FRR was the reduction in the state's personnel expenses. Finally, it is noted that until the penultimate quarter of 2019, the state of Rio de Janeiro did not comply with the terms of the agreement signed with the federal government.

Keywords: crisis of states; fiscal federalism; Fiscal Recovery Regime.

A crise fiscal dos estados e o Regime de Recuperação Fiscal: o *déjà vu* federativo

Discussão acerca da crise fiscal dos estados e do Regime de Recuperação Fiscal (RRF), promulgado no ano de 2017, cujas medidas de ajuste são apontadas como fundamentais para o equilíbrio das contas públicas estaduais e que representam, no entanto, sob a perspectiva federativa, um enfraquecimento dos estados brasileiros, já que tais medidas afetam a autonomia político-administrativa destes entes subnacionais. O estado do Rio de Janeiro foi objeto desta pesquisa entre os anos de 2008 e 2019, pois foi o único a aderir ao RRF desde sua promulgação. O estudo indica que as medidas de austeridade adotadas pelo estado do Rio de Janeiro não foram suficientes para garantir a estabilidade financeira e o reequilíbrio das contas públicas. Dentre os resultados, destacam-se a manutenção da insolvência financeira, bem como o crescimento do endividamento do período, sendo o único resultado positivo, no âmbito dos termos do RRF, a redução dos gastos com pessoal. Por fim, observa-se que, até o penúltimo quadrimestre de 2019, o estado do Rio de Janeiro não cumpriu integralmente o acordo firmado com a União.

Palavras-chave: crise dos estados; federalismo fiscal; Regime de Recuperação Fiscal.

La crisis fiscal de los estados brasileños y el Régimen de Recuperación Fiscal: el *déjà vu* federativo

Este artículo tiene como objetivo discutir la crisis fiscal de los estados brasileños y el Régimen de Recuperación Fiscal (RRF) promulgado en 2017, cuyas medidas de ajuste se consideran fundamentales para el saldo de las cuentas públicas estatales, pero también representan, bajo la perspectiva federativa, un debilitamiento de los estados brasileños, ya que tales medidas afectan la autonomía política y administrativa de estas entidades subnacionales. El estado de Río de Janeiro fue objeto de esta investigación entre los años 2008 y 2019 porque fue el único estado que se adhirió al RRF desde su promulgación. El estudio indica que las medidas de austeridad adoptadas por el estado de Río de Janeiro no fueron suficientes para garantizar la estabilidad financiera y el reequilibrio de las cuentas públicas. Entre los resultados, destacamos el mantenimiento de la insolvencia financiera, así como el crecimiento del endeudamiento en el período y el único resultado positivo dentro de los términos del RRF es la reducción de los gastos de personal. Finalmente, se observa que hasta el penúltimo cuatrimestre de 2019, el estado de Río de Janeiro no cumplió plenamente el acuerdo firmado con el Gobierno Federal.

Palabras clave: crisis de los estados; federalismo fiscal; Régimen de Recuperación Fiscal.

DOI: http://dx.doi.org/10.1590/0034-761220200042
Article received on January 23, 2020 and accepted July 22, 2020.
[Translated version] Note: All quotes in English translated by this article's translator.

ISSN: 1982-3134

1. INTRODUCTION

In the Brazilian federative system, state governors – except for short periods in history – have greatly influenced the nation's politics and directions. This relationship has contributed to perpetuating the power of state oligarchies, which came to be called "Barons of the Federation" (Abrúcio, 1988).

In the early 1990s, the golden times of state supremacy in the federative system began to fade along with the Union's capacity to address different state interests through fiscal mechanisms (public funds), combined with the process of re-centralizing relations between the Union and subnational units. The Brazilian states' financial crisis led to a movement of continuous tension in the pacts around institutional arrangements that coordinated the relations among the different government levels. Consequently, this dynamic imposed changes in the power relations among the entities of the federation. The diffuse federative coordination that occurred since then explains the instability present in the intergovernmental relations, strengthening apparently contradictory movements among the federal entities and promoting the rise of a kind of *federalism without a pact*.

In a context of federative crisis, low economic growth, and fall in governments' revenues, the states are again going through a critical fiscal-financial situation that jeopardizes their capacity to meet obligations. This is seen particularly in the payment of debts with suppliers and payroll and consequent impacts on active and inactive employees.

The enactment of complementary law LC159/2017, which established the states' (and Federal District) *Regime de Recuperação Fiscal*, or fiscal recovery regime (FFR), enabled the solvency of Brazilian states in the face of imbalances in public accounts and high indebtedness.

This article discusses the implications of the Brazilian states' fiscal crisis and the FRR. The FRR's measures are essential to balance public accounts. However, from the perspective of the federative relationship, they represent a weakening of the states since such measures affect political-administrative autonomy. This study focuses on the state of Rio de Janeiro for more accurate analysis and reflections, as it was the only state qualified to join the fiscal regime.

The article is organized into six sections, including this introduction. Section two discusses the decentralization process and the challenges of subnational government fiscal discipline. Section three presents considerations about the recent deterioration of the Brazilian states' finances. The fourth section offers an overview of the FRR, proposed to rebalance the accounts of insolvent and highly indebted states. The fifth section assesses the impacts of the FRR implementation in the state of Rio de Janeiro, verifying whether the measures have been sufficient to bring the state finances back to fiscal rebalancing, that is, to achieve a primary result that stabilizes the net debt. The sixth and final section presents the conclusion.

2. DECENTRALIZATION, VERTICAL IMBALANCES AND THE CHALLENGE OF THE SUBNATIONAL GOVERNMENTS' FISCAL DISCIPLINE

The progressive deterioration of the Brazilian state's finances and its macroeconomic effects have reinforced criticisms towards fiscal and political decentralization processes. These processes were disseminated with economic and political reforms carried out in the early 1980s in several countries.

The 1980s and 1990s witnessed the prominence of decentralization as a guiding principle for structural reforms to modernize the public sector. This notion gained space based on promising agendas that proposed decentralization as a way to strengthen democracy, promote greater allocative efficiency, improve accountability mechanisms, and break with the main institutional pathologies found in centralized structures (Cheema & Rondinelli, 1983; Faguet, 1997; 2004; Ligthart & van Oudheusden, 2015; Melo, 1996; Paiva, Torrezan & Paiva, 2016). The rationale was that the decentralization of public spending responsibilities could generate substantial gains in the allocative efficiency of goods and services because of local authorities' sensitivity to the heterogeneity of the local population's preferences (Musgrave, 1960; Oates, 1972; Tiebout, 1956). However, this assumption has not been empirically proven vis-à-vis the inefficiencies in providing public goods and services.

The elements that frustrated the expectation around the decentralization are a) the different levels of tax effort; b) differences in public spending effectiveness; c) local and regional socio-economic particularities; d) the overlap between the responsibilities of the different levels of government; e) the inefficiency of intergovernmental transfer mechanisms; f) the greater rigidity of subnational governments in adjusting expenditures in the face of adverse shocks in revenues. Therefore, the principle that public managers are benevolent maximizers of social welfare is not the reality of many countries.

The advances in reforms needed to implement good financial governance principles in public administration – particularly the institutional mechanisms that induce fiscal discipline to subnational entities – are inhibited. The cause of this inhibition is the rapid growth in financial autonomy and responsibilities in the provision of public goods and services by subnational governments, within the scope of the reforms and normative prescriptions of *first generation*[1] fiscal federalism, as well as the prevalence of soft budget constraints.

The precarious institutional arrangements that regulate federative relations among the different government levels in different countries contributed to stimulating interference in local budgets. This is aggravated by the difficulty of imposing rigid fiscal rules to control loans and indebtedness of subnational entities, agreed based on the constitution or infra-constitutional legislation. Not by chance, the lack of strict prudential fiscal regulation has repeatedly resulted in irresponsible chronic fiscal deficits and macroeconomic instability (Ahmad, Albino-War & Singh, 2006).

[1] According to the first generation fiscal federalism, the decentralization of the state functions in a federative arrangement divided into several levels of government and based on the transfer of fiscal competencies from the central entity to subnational governments, results in an increase in social welfare and improvements in the supply of public goods and services.

In the context of fiscal decentralization, the absence of hard budget constraints allows the fiscal operations of subnational governments to be invariably contaminated by moral hazard. That is, subnational governments start to take on excessive budget risks, under the expectation that they are too small to fail (Luc & Badia, 2013), and the central government would bail them out.

The concern with the subnational governments' fiscal discipline was an issue already present in the eighteenth century, as observed by Alexander Hamilton (1767), the first United States Treasury Secretary, in his work *The Federalist Papers*. Since then, subnational government interpretations of fiscally irresponsible behavior have been ambiguous. If fiscal appeasement has been used to politically accommodate negative results of discretionary fiscal policies promoted by subnational governments, these managers have inadequately exercised the financial autonomy granted within the federal system. They have adopted these procedures motivated by strong expectations of a bailout in situations of chronic fiscal deficits or the default of the system's public debt.

When subnational governments fail to manage public finances responsibly, they reveal a contradiction in the process of decentralization. In this case, efficiency and the maximization of social welfare, fundamental principles of first generation fiscal federalism, become seriously compromised.

Harmonizing the finances of multilevel governments has always been a major challenge for fiscal federalism. Evidence suggests that local public managers often fail to present responsible attitudes towards budgetary stability. Thus, they disregard that subnational entities' fiscal irresponsibility may spread a macroeconomic crisis throughout the federation (Rodden, Eskeland & Litvack, 2003).

In a context of soft budget constraints with the expectation of bailing out subnational entities, Luc and Badia (2013) point out that: "[...] if subnational governments expect bailouts, their response to positive and negative revenue changes should be asymmetric. In case of negative revenue change, spending is not adjusted downward (or is adjusted less than in the case of no-bailout expectation)" (Luc & Badia, 2013, p. 30).

This opportunistic behavior ultimately means denying good governance and public manager's responsibility, particularly regarding the principles of budgetary balance and accountability. Furthermore, it proves to be counterproductive in relation to one of the fundamental pillars of the decentralization process according to the first generation fiscal federalism, since chronic budgetary imbalances and unsustainable indebtedness tend to affect the allocative efficiency in the provision of public goods and services. This potentially reduces the level of well-being and leads to the central government's macroeconomic instability (Prud'Homme, 1995).

The specialized literature has pointed out significant federative conflicts due to the lack of harmonization between the central government's macroeconomic stabilization effort and the financing of the subnational governments' actions. Against this backdrop, normative prescriptions that seek to establish a rigid fiscal discipline in the federative design considering multiple government levels have been disseminated. They seek to guarantee budget management responsibility and the public debt's intertemporal sustainability (Abrúcio, 2007; Caldeira, Wilbert, Moreira & Serrano, 2016).

The insolvency of subnational governments has become a major concern in decentralized economies. Ter-Minassian and Craig (1997), Ter-Minassian (1999), and Shah (2000) systematized some factors to guarantee greater harmonization and coordination between federative entities in decentralized systems. According to the authors, to reconcile this federative problem, there must be a) a clear definition of the allocation of revenues and accountability of government expenditures; b) transfer mechanisms with precise, stable, and transparent rules; c) incentive for tax effort; and d) rules that limit the indebtedness of central and subnational governments (Ter-Minassian, 1999, pp. 56-59).

However, the existence of rules for ex-ante borrowing and indebtedness, particularly in an institutional environment with soft budget constraints, is not enough to guarantee fiscal responsibility and sound public finances for subnational governments. It is also necessary to develop mechanisms to address ex-post situations of subnational entities' insolvency, with transparency regarding the consequences and financial and social costs of fiscal adjustments the subnational entity must carry out (Ter-Minassian, 1997).

It is crucial to acknowledge the characteristics intrinsic to federative systems. The heterogeneity of subnational governments – in terms of size, level of socio-economic development, production structure, and tax competence effectiveness – is one of the elements to be considered (Abrúcio, 2005; Mora, 2016).

Thus, it is worth noting that not all subnational entities' fiscal imbalances refer to subnational governments' fiscal leniency or opportunistic behavior. Although decentralized countries are intrinsically susceptible to excessive spending in situations of soft constraints, the fiscal imbalance in these nations often reflects the mismatches between the decentralization of tax revenues and the services subnational governments' have the responsibility to deliver. Also, the fiscal imbalance reflects the inefficiency of intergovernmental transfer mechanisms to correct vertical and horizontal discrepancies.

The diffuse federative coordination of this process explains the instability present in the intergovernmental relations in decentralized systems, promoting apparently contradictory movements among federal entities. It is a continuous tensioning of the relations agreed in the institutional arrangements that regulate the coordination among the different government levels.

Based on the theoretical aspects presented above, the next sections discuss aspects of the fiscal adjustments proposed to Brazilian state governments within the scope of the negotiation of the states' debt.

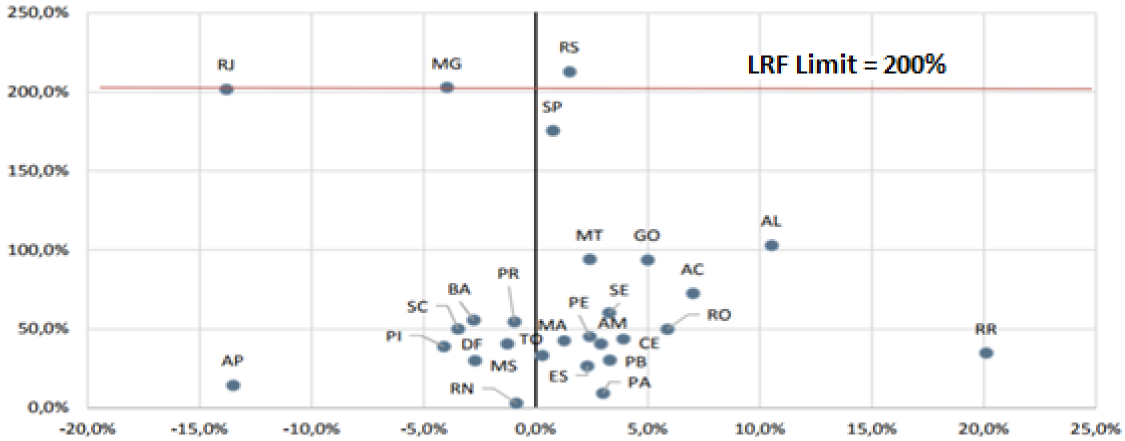
3. RECENT FISCAL DETERIORATION OF BRAZILIAN STATES AND FISCAL ADJUSTMENTS

During the 2015-2016 biennium, the deterioration of the states' finances returned to the agenda of negotiations among the Brazilian federated entities. At that time, the general belief was that such deterioration and growing liabilities accumulated on the part of subnational entities were caused by fiscal and financial interference within the federative relations. However, the real cause of such adversities was the substantial economic slowdown between 2014 and 2017.

The misunderstanding about the cause of the states' financial challenges lies in the fact that both causes and consequences should be understood from the federative perspective. Thus, the solutions should be elaborated based on cooperative federalism, not only examined under the rigor of budgetary and accounting adjustment.

The federative system crisis is observed in the analysis of the subnational entities' current fiscal and financial difficulties. The analysis of some fiscal indicators allows for the systematization of the indebted states into two groups, as shown in Graph 1. The first group consists of the states of São Paulo, Rio de Janeiro, Minas Gerais, and Rio Grande do Sul, whose characteristics are: (i) indebtedness greater than, or very close to, 200% of the state's current net revenue (CNR); (ii) primary deficit, or minor surplus. The second group, with the states of Amapá, Piauí, Santa Catarina, Bahia, Paraná, Mato Grosso do Sul, Federal District, and Rio Grande do Norte, presents a less precarious fiscal situation compared to the first group, mainly because the public debt limits are below the allowed limits stipulated in complementary law LC101/2000, known as the fiscal responsibility law (LRF). However, the states in this group demonstrated difficulties generating a primary surplus in compliance with current obligations.

GRAPH 1 PRIMARY DEFICIT (IN % OF NET REVENUES) AND CONSOLIDATED NET DEBT (IN % OF RCL) – 2016



Source: Instituto Fiscal Independente (2017).

Among the causes responsible for the deterioration of state finances is the erratic situation of public revenues, both the revenues from tax collection and the revenues from transfers received from the Union. In 2015 and 2016, there was a 9.5% reduction in tax revenues due to the economic crisis and a 2% reduction in transfers from the Union. In addition, in the 2015-2016 biennium, there was a decrease in the tax collection of 17 Brazilian states; among these, Rio de Janeiro, Rio Grande do Norte, and Espírito Santo presented a reduction in revenues above 10%. The four states of Group 1 (São Paulo, Rio de Janeiro, Minas Gerais, and Rio Grande do Sul), which concentrate the largest debt stock, presented negative tax collection results, which significantly compromised their financial stability (Graph 2).

GRAPH 2 PERCENT VARIATION OF REVENUES FROM TAX COLLECTED AND TRANSFERS RECEIVED PER BRAZILIAN STATE BETWEEN 2015 AND 2016

Source: Secretária do Tesouro Nacional (2017a, p. 19)

The scarcity of financial resources to complete the budget in all states resulted in delays in payment to suppliers, a drastic reduction in investments, and difficulties in providing public goods and services. An indicator of such scarcity is the volume of unpaid liabilities[2], which represent short-term debts. According to the data, there was an increase of 59% in states' unpaid liabilities between 2008 and 2016. This means that the accumulated expenses were carried over to the next fiscal year, indicating the lack of financial resources (Aquino & Azevedo, 2017).

The breakdowns in the states' accounts worsened in 2016 with the deterioration of the aggregate **primary result**. In 2015, the states' budgets, together, had a primary surplus result of BRL 886 million, while the fiscal result in 2016 showed a primary deficit of BRL 2.02 billion. According to the Finance Bulletin of the Subnational Entities (Secretaria do Tesouro Nacional, 2017a), this variation was due to increased costing expenses. This fiscal-financial result would be even worse, but it was mitigated by incorporating resources from assets repatriated in 2016.[3]

Faced with fiscal-financial bottlenecks and tensions in the federative relations, states sought alternatives to overcome fiscal problems. The most drastic measure was adopted by the state of Santa Catarina, which claimed in the Supreme Court (Writ of Mandate 34023/SC) the collection of simple interest on the states' debt refinanced in 1997. On April 28, 2016, the trial regarding states' debts was initiated by the Brazilian Supreme Court (STF), which should be considered a milestone in the

[2] Expenses committed and confirmed, but not paid until December 31st.

[3] Regime instituted by Federal Law 13254/2016 for the voluntary disclosure of undeclared resources, goods, or rights of lawful origin maintained abroad, which incurred an increase of BRL 50.9 billion in the governments coffers in 2016.

Brazilian federal system since the judicialization of the discussion revealed the bankruptcy of the traditional negotiation instruments among the federated entities.

In response to the fiscal crisis, complementary law LC156/2016 was enacted. The legislation allowed states to extend their payments up to another 240 months, in addition to refinancing the debts that involved resources from the Brazilian severance indemnity fund for employees (FGTS) and the Brazilian National Development Bank (BNDES). This measure's short-term effect for the states was savings of approximately BRL 18.89 billion (Secretaria Do Tesouro Nacional, 2017a) in debt service.

This new legislation had a transitory nature regarding the task of containing public expenditures. It was a kind of *fuite en avant* for subnational entities since it did not address, at any time, the structural foundations of the existing fiscal problems. It did not address the need for a new federative pact. The analysis of the evolution of states' debt stock between 2008 and 2017 shows real growth of 12%, which was not accompanied by the growth of budget revenues.

4. A NEW NEGOTIATION WITH THE STATES - THE FISCAL RECOVERY REGIME

The fiscal strangulation of the Brazilian states and its challenges led to a new mobilization in the country, reaching an apparent consensus, even though adopting different means, around the need to solve this federative conflict. However, the Union's solution in no way aligned with the federal precepts of cooperation as stated in the constitution. On the one hand, the subnational entities were financially weakened, compromised due to debts and scarce resources. On the other hand, the Union was concerned exclusively with the consequences of the states' fiscal-financial mismatch since this imbalance could compromise macroeconomic stability and generate strong economic crises, as highlighted by Ter-Minassian and Craig (1997), Ter-Minassian (1999), and Shah (2000).

In this context, FRR was instituted through complementary law LC159/2017 and regulated by Federal Decree 9109 of July 27, 2017. The legislation provided instruments to states with serious financial imbalances to adjust their accounts by implementing emergency measures and institutional reforms determined in a fiscal recovery plan the state prepares beforehand and submits to approval.

In the message accompanying the bill of the complementary law (PLP) 343/2017, which originated LC159/2017, the federal government clarifies that the rebalancing of liabilities is an indispensable condition, but not enough to eliminate the states' structural fiscal crisis:

> 5. Debt restructuring will not solve the fiscal crisis if not followed by the state's efforts to rebalance its accounts through structural and emergency measures. Therefore, obtaining the prerogatives listed above is subject to the state's commitment to a program adjusting its accounts, which has to be provided in state law and follow a recovery plan.

Article 3 of LC159/2017 clarifies that a state is considered in a severe fiscal-financial condition when it presents cumulatively three characteristics: (i) annual net current revenue (NCR) lower than the consolidated debt at the end of the previous fiscal year when applying to the FRR; (ii) the state's expenses with personnel and debt service represent more than 70% of the NCR for the year; (iii) accumulation of a total volume of contracted obligations exceeding cash on hand and cash equivalents of unrelated funds.

When the state meets the eligibility criteria for joining the FRR, it commits to adopting a series of austerity measures to ensure fiscal balance. Box 1 summarizes the obligations and restrictions imposed by LC159/2017 to solve the states' fiscal insolvency and high indebtedness.

BOX 1 OBLIGATIONS OF THE STATES ADHERING TO FRR

Obligations	Actions prohibited to the subnational entity
• Privatization of state-owned companies. • Changes in the state's social security system. • Hosting auctions to obtain discounts from creditors and process unpaid liabilities. • Adoption of a ceiling for public spending, following the variation of the inflation index IPCA.	• Creating public jobs that imply an increase in expenses. • Hiring personnel, except in case of replacement. • Conduct processes to hire tenured government employees. • Expanding or offering tax benefits. • Enter contracts involving transfer to other subnational entities.

Source: Elaborated by the authors.

The innovation proposed by the FRR in comparison with previous regulatory arrangements to correct fiscal imbalances lies in the fact that the FRR's legal framework (LC159/2017) adopts, in the public sector, the rationale and instruments of the bankruptcy law and the companies' judicial recovery applied in the private sector.

5. THE RESULTS OF THE FISCAL RECOVERY REGIME IN THE STATE OF RIO DE JANEIRO

This section aims to assess the impacts of FRR implementation in the state of Rio de Janeiro, verifying whether the agreed measures have been sufficient to bring the state's finances back to fiscal rebalancing, i.e., to a primary result to stabilize the net debt.

The analysis starts by presenting the general features of the process of adhesion to the FRR in the case of Rio de Janeiro, evaluating the three criteria the FRR adopts to certify fiscal and financial severity.

The state of Rio de Janeiro presented its Fiscal Recovery Plan in September 2017 to meet the criteria established by LC159/2017. The "*Plano de Recuperação Fiscal: 2017-2020*," had 39 items, presented a set of laws, a diagnosis of the state's fiscal-financial and budgetary situation considering the financial imbalance, and a detailed proposal of adjustment measures (both mandatory and additional measures), with the expected impacts and deadlines for their adoption (Conselho de Supervisão de Plano de Recuperação Fiscal do Estado do Rio de Janeiro, 2020).

The state of Rio de Janeiro's eligibility conditions were recognized in full compliance with the set of the three criteria of fiscal and financial unsustainability (Article 3 of LC159/2017) as detailed previously.

Within a few weeks, the agreement was concluded with the federal government. The state's commitment to executing all mandatory and additional measures and following the conditions and prohibitions in the contract was established considering the application of non-compliance sanctions. The body monitoring and pointing out non-compliance events was the FRR Supervisory Board. [4]

In return, the federal government offered tax benefits and facilities to the state of Rio de Janeiro, such as the extension of the state-funded debt, the suspension of interest charges for 36 months, and the legal requirements requested by the fiscal responsibility law (FRL) for contracting credit operations and receiving voluntary transfers.

In the words of the then Secretary of State for Finance and Planning of Rio de Janeiro, Luiz Claudio Fernandes Lourenço Gomes, there was no alternative for the recovery of the state's fiscal capacity but adherence to the FRR. In these terms, he emphatically stated that: "From the point of view of the state as a whole, there is no alternative scenario, either the state perseveres with measures to control expenditure and increase revenue, or the result will undoubtedly be return to deep financial crisis" (Secretaria de Estado de Fazenda e Planejamento do Estado do Rio de Janeiro, 2018, p. 10).

Joining the FRR was not a simple process of political negotiation. Some states, faced with the serious financial crisis and the impossibility of cumulatively meeting the three criteria, opted for the judicialization route as a *fuite en avant*. Rio de Janeiro was the only state that has adhered to the FRR since the regime's creation.

This process revealed a schizophrenic situation. The first challenge was to comply with the regime's qualification requirements – other states were in equally dramatic fiscal conditions but unable to meet, cumulatively, the three requirements. Therefore, it was necessary to show to have met such requirements, considering that Rio de Janeiro was already in a state of public calamity regarding financial management. The second challenge was the reverse, that is, to improve the indicators that qualified the state for the FRR, moving away from the three requirements, demonstrating that the economic adjustment would rebalance Rio de Janeiro's finances.

In this context, the fundamental question that emerges is: have the measures agreed under the principles of the FRR been sufficient to bring the state finances back to fiscal rebalancing?

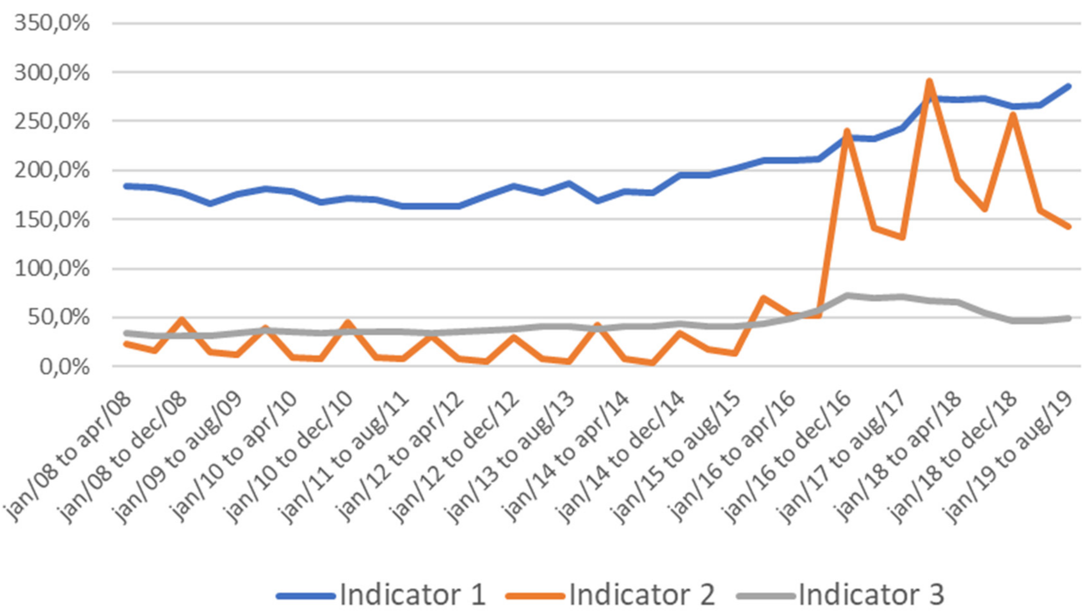
The answer must be scrutinized through the variables that make up the three FRR's criteria. The chosen methodology was for an assessment of global results and not for monitoring the effective compliance with the individual measures of the fiscal recovery plan. In effect, errors in estimating the impact of measures are minimized, resulting from insufficiencies, weaknesses, or inadequacies of accounting information vis-à-vis the criticisms pointed out in the FRR Supervisory Board monitoring

[4] The establishment of the council was provided in the LC159/2017. The members are representatives of the federal government and the state that joined the RRF, and the council is responsible for monitoring the goals established in the fiscal recovery plan presented.

reports. However, the methodology allows observing whether the economic adjustment was sufficient for the budgetary-financial rebalancing.

Based on data provided by the National Treasury Secretariat (Secretaria do Tesouro Nacional, 2017b), and information published by the Rio de Janeiro State and Finance Secretariat, through summarized budget execution reports and fiscal management reports (FMR) (SEFAZ-RJ, 2019), of the three indicators of assessment of fiscal vulnerabilities, only the relationship between personnel expenses and NCR decreased from 71.4%, from September 2017, to 48.9%, in the same period of 2019, but with non-compliance with some aspects. The other indicators (1 and 2) showed an increase over 2017 to 2019. Graph 3 shows the evolution of these indicators in the period from 2008 to 2019.

GRAPH 3 INDICATORS TO ADHERE TO THE FISCAL RECOVERY REGIME BETWEEN 2008 AND 2019, PER THIRD*



Indicator 1: percentage ratio between Net Consolidated Debt (NCD) and NCR. This indicator assesses whether the annual NCR was lower than the NCD, which was one of the criteria for adhering to the FRR.
Indicator 2: percentage ratio between the total of contracted obligations and cash on hand. This indicator assesses whether the entity had the financial capacity to pay short-term debts.
Indicator 3: percentage ratio between the sum of personnel expenses and debt service, as a numerator; and NCR, as a denominator. This indicator verifies whether the sum of such expenses reached percentages greater than 70% of the NCR.
Source: Elaborated by the authors based on data from the National Treasury Secretariat (Secretaria do Tesouro Nacional, 2017b) and SEFAZ-RJ (2019).

The results of indicators 1 and 2 suggest that the planning carried out by the state of Rio de Janeiro, based on the obligations and goals defined in the scope of the FRR's adhesion, was not fulfilled. The accumulated financial result was below that expected.

Among the factors that contributed to explain the financial crisis and the failure in the process of adjusting the finances of the state of Rio de Janeiro, stands out: (i) the non-resumption of national economic growth; (ii) political difficulties in agreeing with the Union viable; (iii) the drop in oil prices, consequently reducing the state's royalties; (iv) the crisis in the Brazilian oil sector as a result of the state-owned oil company Petrobras' corruption scandals; (v) difficulty in increasing the NCR; (vi) poor management of the state's consolidated and short-term debts; (vii) non-compliance with the prohibitions imposed by the FRL and the FRR.

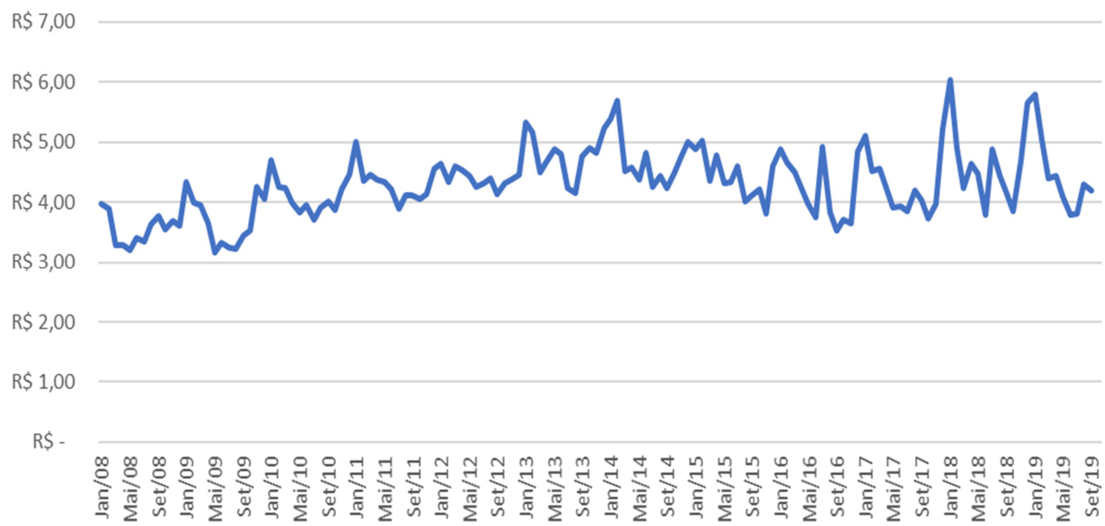
It is worth mentioning that all fiscal crises originate in the widening gap between the need for tax collection and the pro-cyclical nature of public revenues and expenditures. In a strong economic recession scenario like the one that hit the country in 2014, the fiscal and financial strangulation of subnational entities was imminent, which reveals the inefficiency in public management and reverberates its effects on social stability.

At the same time, LC159/2017 established the search for effectiveness aiming to expand and generate revenues; in this case, the increase in public revenues was one of the first steps to guarantee the solvency of the subnational entity.

Thus, a fiscal-financial plan was presented as an attachment to the National Treasury Secretariat (Secretaria do Tesouro Nacional, 2017c) and sent to formalize the agreement that can be divided into the following axes: (i) modernization of the farm management procedures; (ii) revision of the state tax ICMS; (iii) payroll sale; (iv) sale of movable and real estate assets.

Graph 4 shows that, as of 2018, the tax revenue of the state of Rio de Janeiro experienced a real increase when compared to previous years. When comparing the information for the months of January 2017 and 2018, there was an increase in tax revenues of 18.1% in real terms. This growth is attributed to the performance in the collection of ICMS, which grew approximately 12% in the period.

GRAPH 4 MONTHLY EVOLUTION OF TAX REVENUES (IN CONSTANT VALUES) OF THE STATE OF RIO DE JANEIRO BETWEEN JANUARY 2008 AND SEPTEMBER 2019 (BRL, IN BILLIONS)



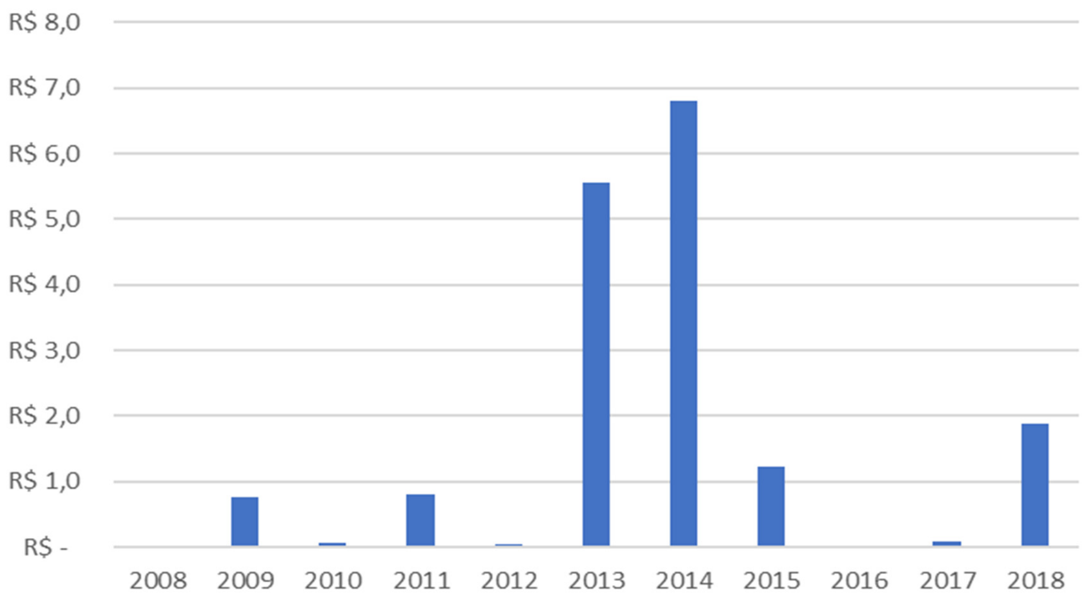
Source: Elaborated by the authors based on data from the National Treasury Secretariat (Secretaria do Tesouro Nacional, 2017b) and SEFAZ-RJ (2019).

Despite the increase in tax revenues that occurred in the 2018-2019 biennium, the time series analysis of the last 10 years indicates that tax collection is at a level lower than the amount earned in 2013 and 2014. The information presented in Annex 17 of the Rio de Janeiro Fiscal Recovery Plan (2017) showed the expectation was an increase in tax collection of 45% in 2018 and 80% in 2019. This expectation was far from reality, considering that the revenue growth in 2017 was only 1.15% and, in 2018, 8.8%.

Another central element established in the LC159/2017 for revenue generation was the sale of public assets. The annexes presented by the state of Rio de Janeiro contained privatizations and the sale of assets as fundamental elements for rebalancing state accounts. Despite having been a central element in adhering to the FRR and having state authorization (state law 7529/2017), the sale of shares in the Companhia Estadual de Águas e Esgotos do Estado do Rio de Janeiro (CEDAE) (State of Rio de Janeiro water and sewer company) became very controversial, resulting in several lawsuits. The differences increased with the enactment of state complementary law 182/2018, where Article 22 revoked Article 1 of state law 7529/2017 that disallowed the sale of shares representing the share capital of CEDAE (Tribunal de Contas do Estado do Rio de Janeiro [TCE/RJ], 2019, p. 135).

Thus, the revenues from the assets sale, as evidenced by the data presented in Graph 5, presented lower results than the years before entering the FRR. Therefore, the result was below that expected in the plan.

GRAPH 5 REVENUES FROM ASSETS SALE (IN CONSTANT VALUES) BETWEEN 2008 AND 2018 (BRL, IN BILLIONS)



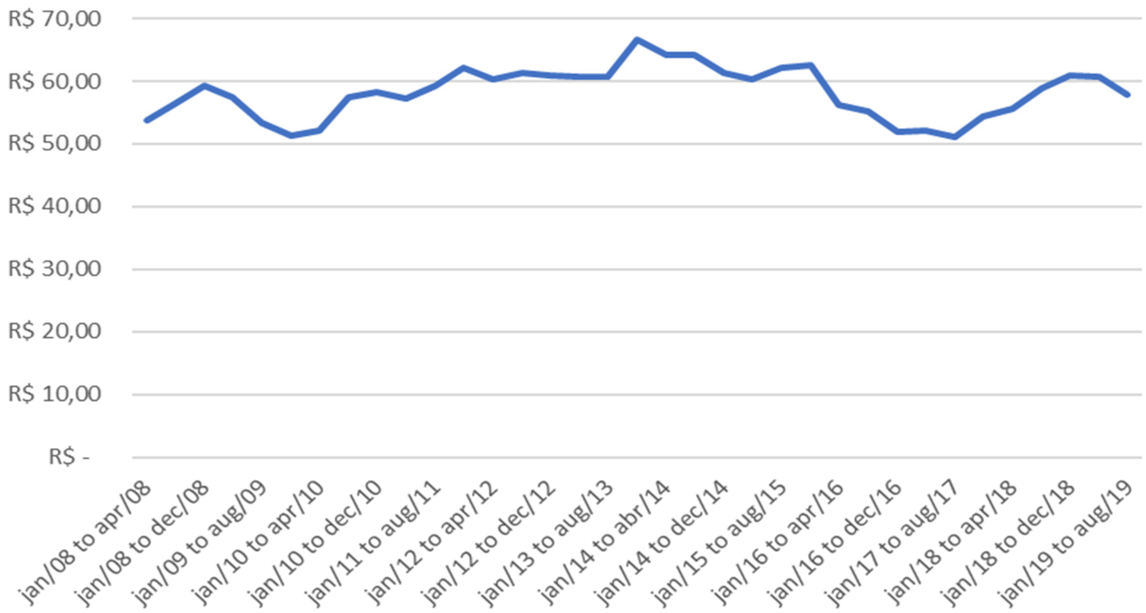
Source: Elaborated by the authors based on data from the National Treasury Secretariat (Secretaria do Tesouro Nacional, 2017b) and SEFAZ-RJ (2019).

The documents submitted to the National Treasury Secretariat indicate that the fiscal-financial mismatches of the state of Rio de Janeiro were originated from the lack of control of current expenses, mostly expenses with personnel. However, article 44 of the FRL prohibits using resources from assets sale to finance current expenses, which partly limits the scope of the intended adjustment with this measure.

However, the proceeds from the assets sale could be used, for example, to minimize the financial insufficiency of the state's social security system or to reduce the stock of the state's debt.

The result of the measures adopted was not satisfactory in the overall calculation. The NCR remained at lower values than in 2014, despite the increase in relation to 2016 and 2017, due to increased ICMS tax collection. Graph 6 shows the evolution of the NCR from 2008 to 2019.

GRAPH 6 EVOLUTION NCR (IN CONSTANT VALUES) OF THE STATE OF RIO DE JANEIRO – 2008 TO 2019 (BRL, IN BILLIONS)



Source: Elaborated by the authors based on data from the National Treasury Secretariat (Secretaria do Tesouro Nacional, 2017b) and SEFAZ-RJ (2019).

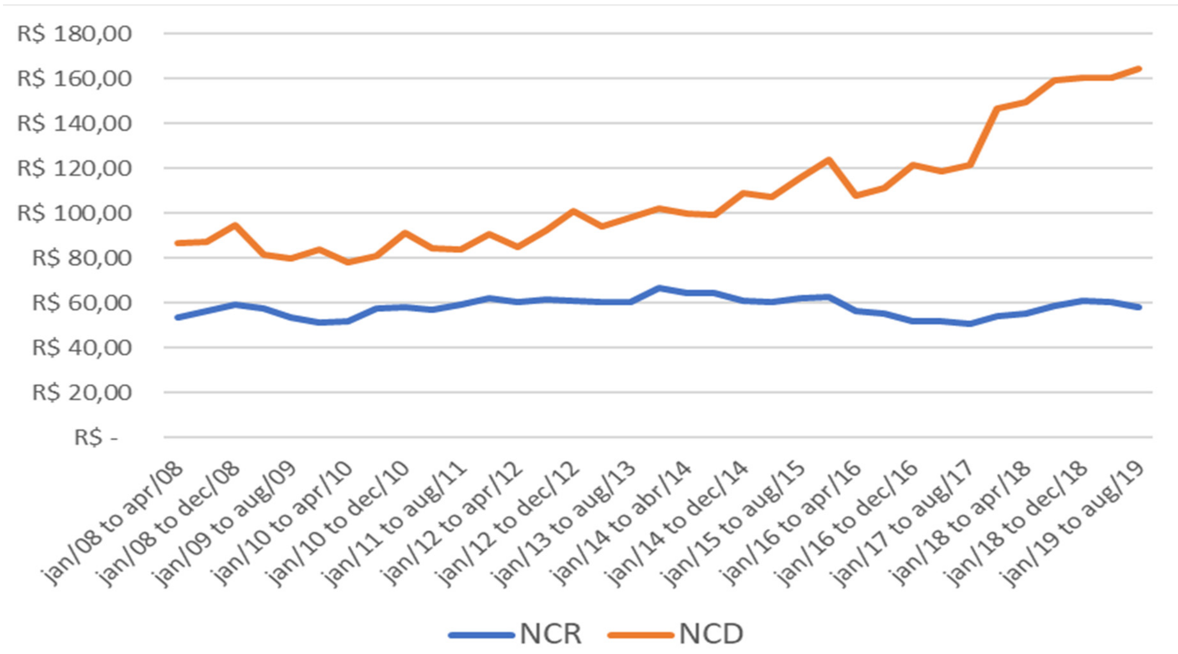
5.1 Debts of the State of Rio de Janeiro

The second turning point in the fiscal adjustment promoted by the FRR in the state is in the management of consolidated and short-term debts. The basic element for elaborating complementary law LC159/2017 focused on the thesis of debt control that would be responsible for the states' financial imbalances.

The assessment of the evolution of the state's net consolidated debt (NCD) is crucial since the balance proposed by the FRR consists of obtaining primary results that allow stabilizing net debt. Graph 7 points to a real increase of 86% in the NCD between 2008 and 2019, while the NCR continued to grow below 8% in the same period. After joining the FRR, the NCD growth was 31.7%, which is an indication that the regime was not successful in solving one of the main fiscal problems in the state of Rio de Janeiro.

The upward trajectory of long-term debt can be explained by the expansion of contractual debt, which increased 83% between 2008 and 2019. It should be noted that, of this growth, 80% is linked to debts formalized with the federal government. Graph 7 presents the trajectory of NCR and NCD in the state of Rio de Janeiro between 2008 and 2011.

GRAPH 7 EVOLUTION NCD AND NCR (IN CONSTANT VALUES) OF THE STATE OF RIO DE JANEIRO – 2008 TO 2019 (BRL, IN BILLIONS)



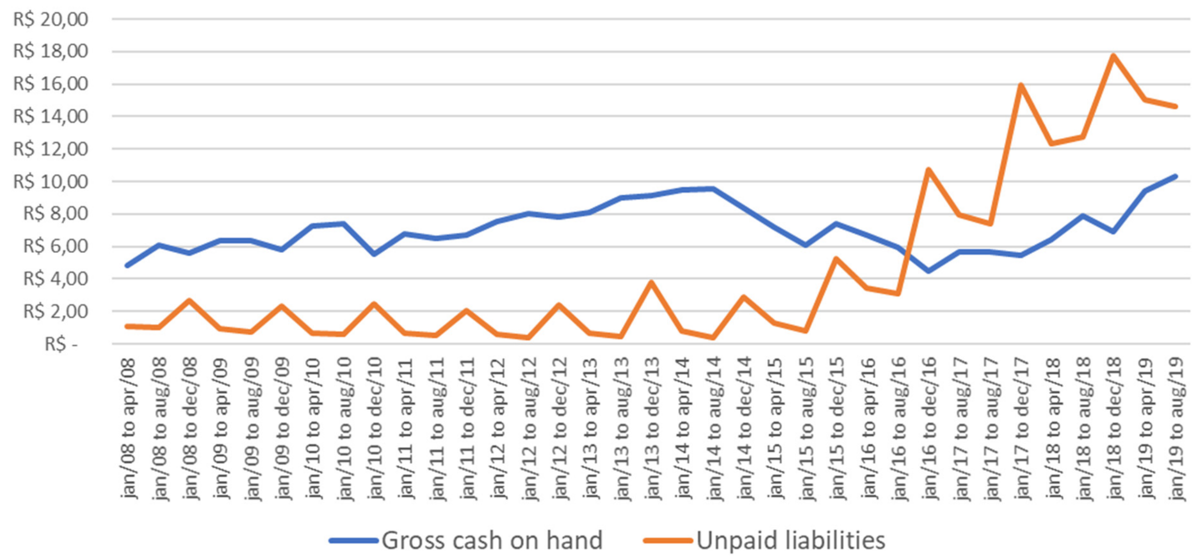
Source: Elaborated by the authors based on data from the National Treasury Secretariat (Secretaria do Tesouro Nacional, 2017b) and SEFAZ-RJ (2019).

The analysis of the short-term indebtedness of the state of Rio de Janeiro reveals that government authorities diverge from the discourse of fiscal adjustment, especially regarding the unpaid liabilities. It is important to stress that when adhering to the FRR, the agreement was zero provision for unpaid liabilities (TCE/RJ, 2019, p. 130). However, in 2018, the state of Rio de Janeiro registered BRL 18 billion in unpaid liabilities that were not paid in 2019. This amount corresponded to approximately 22% of the state's total budget.

Thus, even after signing the commitments expressed in the contract of the FRR, the state continued to go into debt and was unable to meet its short-term obligations. From 2017 to 2018, the state's unpaid liabilities grew by approximately 42%, and in 2019 they maintained an upward trend. Gross cash availability to honor these commitments has grown but still insufficient to honor short-term commitments, as shown in Graph 8.

Therefore, it is clear that the increase in unpaid liabilities cash on hand results in increasing difficulties for the termination of obligations. Indeed, there may be a rapid deterioration in the supply of public goods and services, while the absence of payment from suppliers becomes the subject of suspension of contracts.

GRAPH 8 **EVOLUTION OF UNPAID LIABILITIES AND CASH ON HAND IN CONSTANT VALUES FROM 2008 TO 2019 (BRL, IN BILLIONS)**



Source: Elaborated by the authors, based on data of the Brazilian National Secretary of the Treasury (Secretaria do Tesouro Nacional, 2017b) and SEFAZ-RJ (2019).

6. CONCLUSION

The recent economic and fiscal crisis has again hit the Brazilian federation. The financial constraint of subnational governments was observed by delays in the payment of salaries and suppliers, the lack of investments in strategic areas, such as health, education, and public security, in poor services provided, delayed works, increased public indebtedness, and challenges in the relationship with other federated entities.

In view of the imbalances in public accounts and the high indebtedness of Brazilian states, the first alternative was complementary law LC156/2016, providing on fiscal rebalancing. Subsequently, a new aid plan for the states was presented through LC159/2017, or fiscal recovery regime (FRR).

Due to the severity of the criteria to adhere to the FRR, only the state of Rio de Janeiro qualified, even though more than half of the Brazilian states were in financial calamity. This situation suggests a federative relationship that is increasingly distant from the constitutional precepts of cooperative federalism and from a coordinated and harmonious solution between the Union and subnational entities.

After more than two years of joining the FRR, the analysis of the finances of the state of Rio de Janeiro showed that the measures adopted were insufficient to resume a sustainable trajectory of rebalancing public accounts since it did not lead to a primary result capable of stabilizing the net debt.

Despite not having reached the state's financial rebalancing so far, Rio de Janeiro was greatly benefited, and the FRR cannot be qualified as a failure. It is necessary to recognize that, in a situation of non-adherence to the FRR, an unprecedented social tragedy in the state of Rio de Janeiro would have imminently occurred. Furthermore, in the first two years of the FRR, the state did not pay BRL 34.1 billion in debts, of which BRL 22.8 billion were related to debts with the federal government and BRL 11.2 billion were loans with guarantees from the national treasury, in addition to the possibility of contracting new credit operations.

As for the allegation of the state of Rio de Janeiro that the FRR's goals were unworkable and draconian, it is important to stress that they were proposed in a fiscal recovery plan prepared by the state of Rio de Janeiro itself. In addition, amid a structural crisis, the state government chose to sign agreements without politically discussing with society. Nevertheless, it imposed the burden of adjustment on the most vulnerable sections of the population, who do not have the financial conditions to access private services.

The persistence of a critical fiscal situation shows that little progress has been made in balancing the state's public finances. The evaluation of the effectiveness of the measures agreed in the plan, based on the analysis of indicators qualifying the seriousness of the fiscal crisis, especially after adhering to the FRR, reveals no significant changes on the part of the state towards achieving fiscal sustainability.

This study sought to demonstrate that the states' financial insolvency has constrained federal relations and promoted the rise of a kind of *federalism without a pact*. The repercussion of this situation requires the agreement around a new federative pact, more harmonious and cooperative since the results of the ongoing fiscal adjustments have been socially dramatic, with the return of thousands of Brazilians to the situation of extreme poverty. Thus, a critical look at the state debt negotiations and the balance of state finances reveals a future that mirrors the past and highlights the feeling of a federative *déjà vu*.

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