

FISCAL FEDERALISM IN BRAZIL

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CERTIFICATE

This Dissertation entitled "**Fiscal Federalism in Brazil**" submitted by **Prakash Chandra Jha**, Centre for American & West European Studies, Jawaharlal Nehru University, New Delhi, for the award of the degree of Master of Philosophy is an original work and has not been submitted so far in part or in full for any other degree or diploma of any other University.

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PREFACE

Over the last two decades a clear world-wide trend has emerged towards decentralisation of fiscal power. This trend is not only witnessed in federal but also in countries with unitary type of government. The view that fiscal decentralisation can entail substantial gains in terms of efficiency and welfare has long been held in the literature on fiscal federalism. The recent trends towards fiscal decentralisation, as largely part of the process of economic liberalisation and globalisation, have been necessitated by a rethinking of the roles and responsibilities of various levels of government in relation to the conventional salient policy objectives of resource allocation, economic stabilisation and income redistribution. The renewal of interest in the study of multi-level finance has, in short, resulted in the emergence of fiscal federalism as an important subject of study in its own right.

Fiscal federalism is an area of study in which the principles of economics are applied to the functioning of the broadly understood public sector in a multi-level decision-making framework. The basic issues of fiscal federalism are : (i) assignment of functions and sources of finance among different levels of government; and (ii) evolving mechanisms and policy instruments to resolve fiscal imbalances and foster harmonious and yet competitive inter-governmental relationship. Such an arrangement ostensibly ensures cost-efficient provision of public services corresponding to the preferences of population residing in different jurisdictions.

In developing countries, many recent fiscal decentralisation schemes have been undertaken in response to economic and political difficulties, commonly under the pressure from the international financial agencies. The perceived urgency has resulted in programmes that are often hastily designed and initiated without developing a minimum enabling framework. Therefore, fiscal federalism in developing countries is more often facing a number of constraints. Brazil among the developing countries is one of the most fiscally decentralised federalism; and here fiscal decentralisation has admittedly led to serious challenges. Hence, study of fiscal federalism in Brazil assumes some special significance.

The issues of fiscal federalism have arguably been more thoughtfully addressed in Brazil than in any other countries. The Constitution of 1988 has made clear assignment of expenditure and revenue responsibilities among the different levels of government which is broadly consistent with theoretical consideration of fiscal federalism. The Constitution also provides for a rule-based inter-governmental transfers.

Theoretically, Brazil's fiscal federal arrangement is broadly consistent with the theoretical consideration of fiscal federalism. However, theoretical consideration can guide the assignment of various functions among the different levels of government only up to a point; in shaping inter-governmental relationship in actual practice, often historical, social, economic and political factors play an important role. Thus fiscal federalism in Brazil even after more than one decade of the promulgation of the Constitution of

1988 has not been able to reduce Brazil's deep-rooted regional economic disparities. Rather, it has increased the regional disparities, states' debt crisis, and macro-economic instabilities. In recent times, federal government has been trying to establish a comprehensive framework of discipline and transparency in fiscal affairs that aims at sustained, long-term financial stability and fiscal sustainability at all three levels of government--federal, states and municipal. Despite the limitations, in the recent times, municipal governments have become an important element in Brazilian federation. Local governments have progressively taken up the functions assigned to them by the Constitution.

Studies of fiscal federalism in Brazil so far is confined to the economists in this area. Economists do acknowledge the fact that political factors play an important role in inter-governmental economic relations; and their studies have therefore, tended to concentrate on problems of allocative efficiency and the system of inter-governmental transfers without modeling how politics and economics interact in institutional setting of Brazil's federalism.

The present study is a modest effort to study how decentralised policy making is motivated by the political factors in Brazilian fiscal federalism. Divided into five Chapters, the introductory Chapter aims to examine the factors behind recent fiscal decentralisation process witnessed in several countries; and it also studies theoretical aspects of fiscal federalism. Finally, challenges faced by different countries with their experiences with fiscal

decentralisation have been examined. The second Chapter deals with federalism in Brazil. Federalism in Brazil not only assumed different federal arrangements throughout its republican history but also has survived the authoritarian regime of 1964-1985. The Constitution of 1988 marks a landmark which has led to the reconstruction of federation in Brazil. Multiple power centres, as a result of political and economic decentralisation have led to tension areas in Brazilian federalism. The third Chapter, examines the fiscal federalism in Brazil as envisaged in and after the promulgation of 1988 Constitution. It studies the assignment of expenditure responsibilities and tax responsibilities, and various mechanisms of inter-governmental transfers in order to examine how far inter-governmental fiscal relations in Brazil are consistent with the theoretical consideration of fiscal federalism.

The fourth Chapter examines the working of fiscal federalism in Brazil. By focusing on both political and economic constraints in inter-governmental relation in Brazil, it also highlights some positive gains and innovative policy measures. The final Chapter presents the summary and conclusions based on the discussion and description of the preceding four Chapters.

LIST OF ACRONYMS

BNDES	National Bank of Economic and Social Development
FPE	States Participation Fund
FPM	Municipalities Participation Fund Regional Fund
GDP	Gross Domestic Product
IC	Excise Tax
ICM	Tax on Goods Circulation and Services (Turnover Tax)
ICMS	Tax on Goods Circulation and Services (Turnover Tax)
IDB	The Interamerican Development Bank
IMF	International Monetary Fund
IPI	Tax on Manufactured Products
IR	Income Tax
ITBI	Property Transfer Tax
ITR	Land Tax
IVC	Tax on Sales and Consignments
IVV-CL	Retail Sales Tax on Fuels
PASEP	Assistance Program for Public Workers
PIS	Social Integration Program
VAT	Value Added Tax

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CHAPTER 1

FISCAL FEDERALISM

Theoretical exposition of what is called fiscal federalism assumes that there are substantial gains to be made from fiscal decentralisation. The assumption that the allocation of some revenue-raising and spending responsibilities at the local level, consistent with the wishes of citizens, lead to both efficiency and gains, has most importantly of all the other reasons led to the growing trend among very diverse countries to decentralise their public sectors. Theoretically, the case for fiscal decentralisation is strong. However, its varied practices under very varied contexts in different countries, more specifically in the developing ones, have raised some serious challenges as well. The Chapter aims to examine some of the key factors behind the recent decentralisation process witnessed in several countries. A separate section surveys different theoretical aspects of fiscal federalism in order to see, how far the justification given for fiscal decentralisation is valid? Finally, the chapter examines the challenges that different countries are facing in their experiences with fiscal decentralisation.

Trends Towards Fiscal Decentralisation

Until recently, the issue of fiscal federalism used to receive fairly little attention in economics; and practically none in the disciplines of political science and public administration. Interest was also confined mainly to specialists of the subject in US. However, in the recent decades, the subject has begun to attract more and more attention both at the academic and policy-planning levels; and professional interest in the subject has also transgressed US borders.¹

The recent trends towards fiscal decentralisation, as part of the process of economic globalisation and liberalisation, have been necessitated by a rethinking of the roles and responsibilities of various levels of government in relation to the conventional salient policy objectives of resource allocation, economic stabilisation and income redistribution. The renewal of interest in the study of multilevel finance has, in short, resulted in the emergence of fiscal federalism as an important subject of study in its own right.

Many factors account for the interest in fiscal federalism and some certainly merit a brief discussion. Developments in the European Union is one of these factors. The process of creating a central entity that will transcend the responsibilities of European member-states in some

¹ Vito Tanzi, "Fiscal Federalism and Decentralisation: A Review of Some Efficiency and Macroeconomic Aspects", in Michael Bruno and Boris Pleskovic, eds., *Annual World Bank Conference on Development Economies* (Washington, D.C., 1995), p.295.

important economic spheres, opened up the question of how much economic power should be transferred to the European Union. The issues in the debate are similar to those in discussions of the *pros* and *cons* of fiscal federalism and fiscal decentralisation. Who would be responsible for economic redistribution and stabilisation? And which resource allocation functions should be performed by the European Union? The European debate has forced many economists to look at the existing literature on fiscal federalism in order to measure its relevance.

Another contributing factor has been the growing disenchantment with the role of public sector especially in developing countries. The explosive growth of the public sectors in many countries after the Second World War which was associated with the expansion of the central government's role in income maintenance, income redistribution and stabilisation of economy has recently led to a strong reaction. The recent liberal or neo-liberal view that greater reliance should be placed on the market has been accompanied by the parallel view that less power should remain in the hands of the central government. Some influential economists have questioned the effectiveness of the central government's action in stabilising the economy and improving the distribution of income, thus reducing poverty and unemployment. This challenge has reduced the legitimacy of the central government's action, and has created a presumption in favour of reducing the size of the public sector while giving more power to both the market and local jurisdictions.

As part of the public sector reforms, many countries are now considering a devolution of some functions to local governments. In terms of resource allocation, various arguments have been advanced to support the view that privatisation and decentralisation would lead to greater efficiency.

Development in specific countries such as Canada, China and some new states of the former Soviet Union have forced a reassessment of multilevel finance. In Canada, developments have been mainly because of political considerations with some provinces demanding more autonomy. In China, they are driven by the need to re-establish some control over national public finance. In the states that emerged with the break-up of the former Soviet Union, there is a felt-need to create some arrangement that gave some significant responsibilities to sub-national governments especially in Russia because of its economic, ethnic and cultural diversities.

During the 1980s, a host of developing countries including importantly Argentina, Brazil, India and Nigeria experienced major macroeconomic problems that required major adjustments in their inter-governmental fiscal relations. Subsequent policies favouring economic liberalisation have also led to re-assessment of the role of central governments in these countries. Besides, literature on fiscal federalism which emphasises an important gain from fiscal decentralisation has also contributed to the present trend. Whatever may be the other causes, the

debate on fiscal decentralisation raises some serious questions about its potential impacts, and its merits and demerits. However, before discussing the challenges of fiscal federalism, it is imperative to understand the various aspects and issues involved in the fiscal federalism.

Theoretical Aspects of Fiscal Federalism

Fiscal federalism deals essentially with the functions and roles of public sector. Generally understood, the function of a public sector is to ensure an efficient use of resources to establish an equitable distribution of income and to maintain the economy at high level of employment with reasonable price stability. The concern of fiscal federalism here is the organisation of public sector that will best allow the government to perform these tasks. Literature on fiscal federalism recognises the fact that both decentralised and centralised forms of government have advantages and disadvantages in performing mainly the three functions: allocation of resources, redistribution of income, and stabilisation of the economy. Theoretical approaches to fiscal federalism explain which functions should be placed at the level of central government and which should be assigned to the decentralised levels of government. Fiscal federalism thus seeks to combine the advantages of both the centralised and decentralised forms of government.

Federalism, for an economist, represents in one sense, a compromise between centralised and decentralised forms of government. In the federal system, there exists both a central government and sub-central governments, each making decisions concerning the provision of certain public services in their respective areas. Thus, from an economic viewpoint, the obvious attraction of the federal form of government is that it combines the strength of centralised form of government with those of a decentralised one.²

However, the main concern for an economist in a federation is the allocation of resources and distribution of income. Therefore, the economic use of the term "federalism" is somewhat different from its standard usage in political science. For an economist, all the public sectors are more or less federal because they have different levels that provide different services.³ Thus, federal government for an economist is a public sector, with both centralised and decentralised levels of decision-making in which choices made at each level concerning the provision of

² Wallace E. Oates, "An Economist's Perspective on Fiscal Federalism", in Wallace E. Oates, ed., *The Political Economy of Fiscal Federalism* (Toronto, 1977), pp. 9-10.

³ In Political Science, federalism refers to a political system with a constitution that guarantees some range of autonomy and power to both central and decentralised levels of government. Therefore, it is different from a unitary form of government where power is merely delegated from central government to its sub-units and constitutional guarantee to their autonomy is also absent. But for an economist, even unitary form of government is federal. See, Wallace E. Oates, "An Essay on Fiscal Federalism", *Journal of Economic Literature*, vol. 37, September 1999, p.1120.

public services are determined largely by the demands for these services by residents of the respective jurisdictions.⁴

The theory of fiscal federation lays out a general normative framework for the assignment of fiscal-related functions to different levels of government and suggests appropriate instruments for carrying out these functions. At the most general level, theoretical considerations contend that the central government should have the basic responsibilities for the stabilisation of economy and income redistribution. This is because central government always possesses a far greater capability to maintain high levels of employment with stable prices than a sub-national level government. Similarly, the scope of redistributive programmes is limited by the potential mobility of residents, which tends to be greater, the smaller is the jurisdiction. This suggests that since mobility across national boundaries is generally much less than within a nation, policy of income redistribution has a much greater success if carried out at the national level.⁵

Theory, however, strongly favours the decentralisation of allocative functions. The main proponent of the theory, Wallace E. Oates justifies the fiscal decentralisation on following grounds:⁶

⁴ Wallace E. Oates, *Fiscal Federalism* (New York, 1972), p.14.

⁵ *Ibid.*, pp.4-7.

⁶ *Ibid.*, pp.11-13.

(i) The provision of public goods and services by central government leads to uniform level of consumption of goods across all communities and regions. Such uniform consumption though may not be efficient; more often in reality, it leads to inefficiencies in consumption of public goods and utilisation of services.

(ii) It is argued that the possibilities of welfare gains through decentralisation are further enhanced by the phenomenon of consumer mobility. This implies that a consumer can to some extent select his place of residence that provides a fiscal package best suited to his preferences.

(iii) Decentralisation may also result in greater experimentation and innovation in the production of public goods. With a large number of independent producers of public goods, one may expect a variety of approaches that, in the long run, promise greater progress in the modes of production of such goods and services.

(iv) Inter-jurisdictional competition as a result of decentralisation should also lead to efficiency in the provision of public goods and services. This means that if one jurisdiction, for example, discovers a particularly effective way of providing a certain service, the governments of other jurisdictions are also likely to adopt similar techniques, or even better techniques and methods.

(v) Finally, it is argued that decentralisation of allocative functions may lead to more efficient levels of public output because expenditure

decisions are tied more closely to real resource cost. If a community is required to finance its own public programme through local taxation, its members are more likely to weigh the benefits of the programme against its actual cost. Broadly, there are some major arguments put forth as a justification for the assignment of expenditure and tax responsibilities to sub-national levels of government. The next two sub-sections describe them in some details.

(i) The Assignment of Expenditure and Tax Responsibilities

Allocation of expenditure and tax functions to different levels of government is the most fundamental issue in any federation. Literature on fiscal federalism reasons that expenditure assignment must precede tax assignment. This is because tax assignment is, in general, guided by the expenditure requirements at different levels; and these cannot be worked in advance of expenditure assignment.

As has been discussed in preceding pages, there is case that federal government should be given exclusive authority in carrying out services such as stabilisation of the economy and redistribution of income. National goods whose benefits are national in scope should be provided by the central government. Besides the central government should take responsibilities for certain services which require service area larger than a local jurisdiction for cost-effective provision. These include, for example, transportation services, water and sewage, etc. The federal

government should also be given a role in providing compensatory grants for spill-out of benefits from state level provision of services. A similar role for each state is in order for spill-out of benefits from local provision of services within their jurisdiction. All other services could and should best be provided by the local governments with federal and state governments having some role in defining minimum standard. Table 1 indicates the broad theoretical guidelines in expenditure assignment .

Table 1: Conceptual Basis of Expenditure Assignment

Expenditure Category	Service Responsibility	Provision of Service	Comment
Defence	F	F	Benefits/costs national in scope
Foreign Affairs	F	F	"
International Trade	F	F	"
Environment	F	S,L	"
Currency, banking	F	F	"
Interstate commerce	F	F	"
Immigration	F	F	"
Unemployment Insurance	F	F	"
Airlines/Railways	F	F	"
Industry and Agriculture	F,S,L	S,L	Significant interstate spillovers
Education	F,S,L	S,L	Transfers in kind
Health	F,S,L	S,L	Transfers in kind
Social Welfare	F,S,L	S,L	Transfers in kind
Police	S,L	S,L	Primarily local benefits
Highways	F,S,L	S,L	Some roads with significant interstate spillovers, others primarily local
Natural Resources	F,S,L	S,L	Promotes a common market

Source: Anwar Shah, *New Fiscal Federalism in Brazil*, World Bank Discussion Paper no. 124, (Washington D.C., 1991), p.7.

The division of revenue sources among different levels of government is generally referred to as tax assignment. Once expenditure assignment is agreed upon, tax assignment and revenue sharing become critical elements in providing reasonable matching of expenditure needs with revenue means for various levels of government.

Richard Musgrave uses equity (consistency of revenue means with expenditure needs) and efficiency (minimising resource cost) criteria; and suggests the following broad principles in tax assignment:

- (i) Taxes suitable for economic stabilisation should be at the central level.
- (ii) Progressive redistributive tax should also be centralised.
- (iii) Taxes on mobile factors of production are best administered at the central level.
- (iv) Tax bases highly unequally distributed between different jurisdictions should be centralised.
- (v) Taxes on completely immobile factors are best suited for local levels.
- (vi) Residence based taxes such as sales of consumption goods to consumers or excises are suitable for states.
- (vii) Benefit taxes and user charges might be appropriately used at all levels.⁷

Table 2 further elaborates the above arguments.

⁷ As cited in Anwar Shah, *New Fiscal Federalism in Brazil*, World Bank Discussion Paper, no. 124 (Washington D.C., 1991), p.10.

Table 2: Conceptual Basis of Tax Assignment

Tax	Determination of		Tax Collection & Administration	Comments
	Base	Rate		
Customs	F	F	F	International Trade
Income Tax	F	F,S	F	Redistributive, mobile factor
Estimates and gifts	F	F,S	F	Redistributive
Corporate tax	F	F,S	F	Mobile factor
Resource tax	F	F,S	F	Unequally distributed
Retail sales	F	S	S	Higher compliance cost
	F	S	F	Harmonized, lower compliance cost
VAT	F	F,S	F,SC	Border tax adjustments possible
Excises	S	S	S	Residence based taxes
Property tax	S	L	L	Completely immobile factor, benefit tax
User charges	F,S,L	F,S,L	F,S,L	Payment for service received

Notes: F – Federal, S – State/Province, L – Municipal/Local, SC – The Council of States

Source: Anwar Shah, *The New Fiscal Federation in Brazil*, World Bank Discussion Papers no.124 (Washington, D.C., 1991), p.11.

Some degree of imbalance between revenue means and expenditure needs at various levels is common to all federations. Thus, after expenditure and tax assignment, revenue sharing and transfers are used to correct any imbalances.

(ii) Inter-governmental Transfers

A critical component of fiscal federalism is inter-governmental transfers. Inter-governmental transfers are employed to fulfill a variety of objectives, and the design of a given transfer scheme depends invariably on the purpose for which it is given. In the literature on fiscal federalism, federal

transfers are recommended for correcting vertical and horizontal imbalances⁸. Vertical fiscal imbalance refers to the mis-match between revenue means and expenditure needs at various levels; whereas the horizontal imbalance refers to inconsistency between revenue raising ability and fiscal needs of government at the same level in a federation. Besides, transfers are also done in order to correct spill-overs.⁹

The inter-governmental transfers are of two types: conditional and unconditional transfers. In the case of conditional transfers, grantor places some kind of restrictions on the recipient over the use of grants. For example, grantor government may require that the recipient government use the fund for education in a specific way such as for school books or teachers' salaries. A conditional transfer may be provided with either a matching or non-matching formulae. Under matching conditional transfer, the recipient government must meet from its own funds some proportion of funds given by the grantor. Under a non-matching conditional grants, no such matching is required.

Just as the title suggest, an unconditional grant is characterized by the absence of restrictions. Unconditional grants are typically the appropriate vehicles for the purpose of fiscal equalisation. The purpose of these grants is to channel funds from relatively wealthy jurisdictions to

⁸ Oates, n.3, pp.1126-30; Bernard P. Herber, *Modern Public Finance* (Delhi, 1999), pp. 339-41.

⁹ Spillover occur because the benefits of a locally provided good or service itself spill beyond the local jurisdiction to benefit those not contributing to the costs. For instance, benefit from the control of air and water pollution etc.

poorer ones. Such transfers are often based on equalisation formulae that measure the fiscal needs and fiscal capacity of each state and locality. These formulae result in a disproportionate share of transfers going to those jurisdictions with greater fiscal needs and least fiscal capacity.

In sum, fiscal federalism is an area of study in which the principles of economics are applied to the functioning of the public sector in a multi-level decision-making framework. The basic issues involved in fiscal federalism are: assignment of functions and sources of finance between different levels of government; evolving mechanism to resolve fiscal imbalances; arbitrate inter-governmental spill-overs and foster harmonious and yet competitive inter-governmental relationship.¹⁰

The current practices of fiscal federalism in different countries have raised many challenging issues. Some of these require mentioning for a balanced appreciation and understanding of the issues involved in fiscal federalism.

Challenges in Fiscal Federalism

The preceding discussion helps explain why fiscal decentralisation is so strongly recommended, especially by proponents of economic liberalisation as one of the mechanisms to raise levels of growth,

¹⁰ M. Govinda Rao and Tapas K. Sen, *Fiscal Federalism in India: Theory and Practice* (Delhi, 1996), p.13.

efficiency and equity. Misgivings, however, have also been expressed both at the theoretical level and in concrete practices. The point of discussion here is to identify situations in which fiscal decentralisation might not lead to the expected results unless important changes are made in given conditions in particular country.

Many countries have decentralised their fiscal structures. An observable phenomenon is that decentralisation has worked well in some industrial countries such as Austria, Germany, the Scandinavian countries, Switzerland and the United States and not to the same extent in developing countries. This is because for the success of fiscal decentralisation, among others, the presence of developed institutions is deemed essential at all levels of government in a country. In developed countries, trained and skilled personnel are available at the local levels of administration also. There are better developed institution at the local level. In developing countries, on the other hand, talented personnel, more generally than not, get concentrated at the central level of government for various reasons. For example, the institution of bureaucracy generally functions better at the central level of government than at the state and local levels.¹¹ It is suggested that inefficiency and wastefulness are also often more at the local than at the central level.¹²

¹¹ Tanzi, n.1, p.300.

¹² Remy Prud'homme, "The Dangers of Decentralisation", *The World Bank Research Observer*, vol. 10, no. 2, August 1995, pp.211-12.

Some of these problems create obstacles for the success of fiscal decentralisation.

In developing countries, many recent fiscal decentralisation programmes have been undertaken in response to economic and political difficulties commonly under pressure from international financial agencies. The perceived urgency results in programmes that are hastily designed and initiated without developing a minimum enabling framework. Such programmes so often tend to be superficial, focusing on text book solutions derived from the literature on fiscal federalism. The theory of fiscal federalism provides a useful entry point but its development has taken place in the context of industrialised countries particularly US. Thus, it cannot be applied to developing countries in the same way as in developed countries.¹³

Most of the developing countries have inherited relatively more centralised systems of government from their colonial past; and after independence also for a long time, there has remained often the tendency to maintain, if not, strengthen central control and centralised system of planning for the purpose of national unity. Unlike industrialised countries, public sectors in most of the developing countries did not undergo an evolutionary pattern.¹⁴

¹³ Paul Smoke, "Strategic Fiscal Decentralisation in Developing Countries: Learning from Recent Innovation" in Yusuf Shahid, W Weiping and Evene H. Simon, eds., *Local Dynamics in an Era of Globalisation* (Washington, D.C., 2000), p.10.

¹⁴ Oates, n.3, pp.1142-43.

The experiences of many countries suggest that under the circumstances often found in developing countries, sub-national governments are likely to contribute, sometime significantly, to the aggravation of macro-economic problems. In several cases, local governments have spent more than they have raised in revenue, thus increasing their debt and occasionally forcing the central government to come to their rescue. Sometimes for political reasons also, sub-national governments spend more and raise less revenue. Besides, poor expenditure management systems often make it difficult to control the spending.¹⁵

A number of countries which have implemented policies of decentralisation, such as Brazil, India and Russia have assigned major tax bases to sub-national governments for their exclusive use. In Brazil, for instance, the general value-added tax is assigned to the states. In India, the sale tax is assigned to the states. In Russia, the individual income tax and many excise taxes have been assigned to the sub-national governments. In India the central government has been left mainly with income tax, foreign trade taxes and highly distortive excise taxes. At the same time central government is responsible for servicing a progressively more burdensome public debt. As a result central government's spending has tended to grow as its share of total tax has been falling. In the same way, in Brazil, the share of total taxes received

¹⁵ Tanzi, n.1, p.305

by the central government had fallen from 69.2 per cent in 1980 to 57.5 per cent in 1990. The share of states has risen from 22.2 per cent to 27 per cent during the same period, while that of the municipalities rose from 6.6 per cent to 14.6 per cent. This eventually has led to larger fiscal deficit and macro-economic problems in Brazil during the 1990s.¹⁶

In the wake of economic liberalisation process, countries are privatising some of their public sector enterprises both at central and local levels. In many countries, public services which should have been decentralised, are being placed in the hands of private business. Thus, the more extensive is the process of privatisation, the lesser is the justification for fiscal decentralisation. What kind of activities should be privatised and what kind of them should be decentralised is an important question which has not been addressed by the proponents of fiscal federation.¹⁷

The theory of fiscal federalism provides broad guidelines for the assignment of expenditure responsibilities among the different levels of government. But it can never be precise in practice. The expenditure responsibilities of different levels of government often overlap.

Literature on fiscal federalism has focused to-date much more on policy than administrative issues. There is little doubt, however, that

¹⁶ Ibid., p.307.

¹⁷ Vito Tanzi, "On Fiscal Federalism: Issues to Worry About", www.imf.org/pubs/ft/seminar/2000/fiscal/tanzi.pdf, pp.2-3

substantial devolution of revenue raising and expenditure responsibilities poses new challenges for tax administration and for public expenditure management. A decentralised administration would entail greater responsibility and accountability of the sub-national authorities for the performance of taxes assigned to them as well as greater flexibility in adapting systems and procedure to local needs and condition. If devolution of revenue-raising responsibilities is to be accompanied by decentralisation of tax administration, substantial efforts have to be made to ensure that tax administrations at sub-national level are equipped with technology and human resources to carry out the basic functions of collection and enforcement effectively. In this effort, the central government can play an important role by providing guidance and technical support.¹⁸

Despite the challenges and obstacles, fiscal decentralisation can, arguably, live up to its promise if it is implemented carefully. Merely copying the developed countries has not proved beneficial to the developing countries. For the success of fiscal decentralisation, public expenditure management needs to be carefully developed. Local and national bureaucracies need to be of equally good quality. The key to successful fiscal decentralisation is good planning. Despite the difficulties in implementation, the arguments for decentralisation are no gainsaying,

¹⁸ Teresa Ter-Minassian, "Inter-governmental Fiscal Relations in a Macroeconomic Perspective: A Review" in Teresa Ter-minassian, ed., *Fiscal Federalism in Theory and Practice* (Washington, D.C., 1997), pp.15-16.

sound and powerful. The process can live up to its promises if properly implemented.

Fiscal federation can only help to find purely economic solution to federal problems. In shaping the actual fiscal arrangement however, historical social and political factors play a far more important role than merely the consideration of economic efficiency.¹⁹ For a better understanding of fiscal federalism in Brazil, it is imperative to examine briefly the federal experiences of Brazil. The next chapter takes an overview of federal experiences in Brazil, such an overview will help in understanding the federalism and financial arrangements, the way they have been envisaged in the 1988 Constitution.

¹⁹ Rao and Sen, n.9, p.122

CHAPTER 2

FEDERALISM IN BRAZIL

More than one hundred years of the political history of Brazil can be defined as a cyclical alternation between centralisation and decentralisation. Centralising tendencies reached their height under the authoritarian rule of Getulio Vargas (1937-45); and again, under the military governments during 1964-1985. With the onset of civilian rule in 1985, notably among others, forces favouring regionalism and local autonomy had begun dominating the political scene, and this got reflected in the political and financial decentralisation under the Constitution of 1988. As a result of such a constitutional scheme, central government have become weak; whereas sub-national governments especially states have gained considerable political and economic strength. However, the kind of fiscal problems faced by Brazil since, require a strong centre; and also new measures to restructure the economy of the country. Thus central government's role in the restructuring of Brazilian economy and the regional interests of states are creating new tension areas in the working of Brazilian federalism. To examine the above issues, the present chapter is divided in three sections. The first section examines in brief, Brazil's experience with federalism. Second section describes the political and financial aspects of decentralisation brought about by the 1988 Constitution, and the last section analyses some of the tension areas in the functioning of federalism in Brazil.

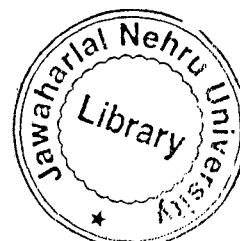
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Brazil's experience in federalism

In explaining the origins of federalism, William, H. Riker has argued that all enduring federations came into being via the same path. When a variety of political communities, each with a great deal of sovereignty believe that they could increase their sovereignty and possibly the size of their markets too, if they entered into a voluntary bargain in which they pooled as much of their sovereignty, but not more than necessary to achieve these goals, Riker called them as 'coming together' federations.¹

The path to federalism in the United States of America in 1787 approximated the so-called Rikerian path. Brazil's path to federalism is normally seen as following the US path, though there are some differences as observed by Alfred Stepan.² First, there was no 'coming together' of previously sovereign political communities. Second, there was no 'bargain' between the future members to create the federation. The military, encouraged by some political leaders mainly from Sao Paulo, had executed a coup; set up a military-led provisional government, and declared Brazil a federal republic. Unlike the US, one powerful state and its ally were thus able to gain greater control over the subsequent constitution-making and more importantly, state-building.

With its first republican constitution in 1891, Brazil became a federation. In the constituent assembly, Sao Paulo together with its ally –

¹ William H. Riker, *Federalism: Origin, Operation and Significance* (Boston, 1964)

² Alfred Stepan, "Brazil's Decentralized Federation: Bringing the Government Closer to the Citizen", *Daedalus*, vol. 129, no.2, Spring 2000, pp.154-55.

Minas Gerais - played a major role in the formulation of the constitution. Being the large, both in terms of population and wealth, it was in the interest of Sao Paulo to seek more economic and political autonomy. Therefore, it got a constitution made in which states were given a number of prerogatives including significantly the right to seek foreign loans; right to charge taxes on export merchandise; and the right to raise their own armed forces. As a result, Brazil became a federation, albeit one in which states enjoyed a high degree of economic and political autonomy. Celina Souza has called the first republican federation an 'isolated' federation because there were few constitutional and practical links between the centre and states.³ The so-called 'isolated' federation in Brazil lasted nearly four decades. The 'isolation' ceased in the 1930s, when Brazil launched its plan to transform itself into an urban industrial society under the authoritarian rule of the president Getulio Vargas. Vargas' regime marked the beginning of trend towards centralisation. Federal government had to become very powerful at the expense of state governments under the project of *estado novo*.

In 1934, a new constitution was enacted, which increased the political representation of smaller and economically weaker states in the national congress. Initially conceived to counteract the power and influence of big states over the country, this particular principle has since remained one of the

³ Celina Souza, "Political and Financial Decentralization in Democratic Brazil", *Local Government Studies*, vol. 20, no. 4, Winter 1994, pp. 590.

enduring bases of Brazilian federation until now.⁴ The most important measure adopted under the 1934 constitution was to grant the federal government jurisdiction to regulate external and inter-state exchange regulation. Thus, federalism became centralised. The linchpin of centralisation was a strong national executive dominating the entire federal system through the concentration of political and fiscal authority. This became yet another enduring feature of Brazilian political system until the framing of the 1988 Constitution. The constitution of 1934, however proved short-lived. The third constitution, promulgated in 1946, however ended up repeating most of the measures adopted in 1934, though with some changes. The constitution of 1946 made the Brazilian federation centralised in favour of federal government and at the same time, localised it too because it increased local finances by transferring several taxes to the municipalities; and also by making states share their revenues with the municipalities.⁵

In 1964, with the advent of military regime, the federation underwent profound transformation. The military government did not draw up a new constitution immediately; rather it changed several provisions of the 1946 constitution. Only in 1967, was the military constitution promulgated. The military regime concentrated and centralised both economic and political powers. But sub-national governments continued to play an important role

⁴ The Constitution of 1988, also gave small states over-representation in Congress. See, Wayne A.Selcher, "The Politics of Decentralized Federation, National Diversification and Regionalism in Brazil", *Journal of Interamerican Studies and World Affairs*, vol. 40, no. 4, Winter 1998, p. 27.

⁵ Celina Souza, "Brazil: The Prospect of a Centra-Constraining Federation in a Fragmented Polity", <http://www.bndes.gov.br/english>, p. 8.

under the centralised federation. In subsequent years, the state governments were often used by the military to legitimise the regime and to build up coalitions for the regime's survival.⁶

The military regime, lasting unto 1985, did not allow a direct election for the president. However, it allowed the congress to stay. To maintain control of the political system via. an elected congress, the military government used the means of favoritism to lure the states to ensure the support of their members in the congress. Since the developed states of the south were opposed to many of its policies, hence the military government in order to weaken the bargaining strength of the southern states, increased the representation of pro-regime states of the north-east, the north and the centre-west regions in the congress.⁷ This way, the pattern conceived of in 1934 continued under the military regime too.

Besides, the military government had created two new states out of the relatively under-populated and under-developed areas in the north and the centre-west. This further weakened the strength of anti-government lobby in the industrially developed states of the south region in the congress.⁸ The congress thus came to be dominated by the pro-government conservative

⁶ Stepen n. 2, pp. 156-57.

⁷ Ibid. , p. 156.

⁸ In 1978, the military government created the state of Mato Crosio du Sul and in 1982, another state, Rondonia. With the creation of these two states, therefore, central government got the support of six more seats in senates and 12 more deputies in the congress. This was deliberately done to counteract the strength of south region. In order to further weaken the southern region, two states in the south were fused into one state.

and land-owning interests of the north-east, north, and the centre-west regions.

When civilian government replaced the military government in 1985 and a new constitution was to be formulated, the representation in the constituent assembly (1986-1988), to a large extent, followed the military regime crafted *fait accomplis*. The states of north, north-east and centre-west, which together had 40 per cent of the population of Brazil, got 52 per cent of total seats in the constituent assembly.⁹

As a result, regional interests from the north-east, north and south-west came to dominate constituent assembly. The interests of the more developed states of south were not so strongly represented. Entitlements granted by the authoritarian regime favouring the poorer regions, such as decisions regarding the exact percentage of public money to be allocated to the states and municipalities, the very generous pension rules for senior government officials etc. were constitutionally embedded. The over-representation of smaller states was increased in the congress, whereas the big and developed states of the south were under-represented.¹⁰

⁹ *Ibid.*, p. 157.

¹⁰ Gary M. Reich "The 1988 Constitution a Decade Later: Ugly Compromise Reconsidered", *Journal of Interamerican Studies and World Affairs*, vol. 40 ,no. 4, Winter 1998, p. 13.

Federalism under the 1988 constitution

The Constitution of 1988 has decentralised the economic and the political power both horizontally and vertically. It has created three layers of governments: federal government, state governments and the governments at the municipal level. Every power – executive, legislative, and judicial – whether it belongs to the federal or to the component units, are subordinate to and controlled by the Constitution.

Powers at the federal level are constitutionally divided among executive, legislative, and judicial branches. The executive power is exercised by the president of the Republic, assisted by the members of state (Art. 76). The president is directly elected and holds office for five years. Article 84 of the Constitution gives the president administrative, legislative, and judicial powers.¹¹

The president is responsible for the appointment of ministers of the state; and he also has the authority to dismiss them. President is the head of the armed forces. He makes important appointments with the approval of the federal senate which includes the appointment of the judges of the supreme court, heads of the various departments, secretaries, ambassadors, ministers of federal administrative corporations and boards, and higher offices in the armed forces. The president is also authorised by the Constitution to negotiate treaties with foreign countries with the approval of the senate. He is

¹¹ *The Constitution of the Federative Republic of Brazil, 1988*, (Brasilia 1990), pp. 57-58.

endowed with the constitutional powers to propose legislation in various areas and he has exclusive powers to initiate legislation in some policy areas; including those that create jobs or increase salaries in different parts of the public sector. The Constitution also allows the president to adopt the provisional measures (*medidas provisórias*) that have the force of law for a thirty-day period without the approval of the congress. In short, Brazilian presidency is characterised as very powerful vis-à-vis national legislature. In practice, however, the powers of the president are circumscribed by the difficulty in marshalling the support of political parties in the congress. Brazil's party system is characterized by a great degree of party fragmentation and weak party organisation and discipline at the national level. Fragmented party system forces the president to continuously struggle to construct legislative coalitions around each new policy proposal. Senators and deputies in the congress are more loyal to the governors of their respective states and show interest only in safeguarding their vested local interests.¹²

¹² In many countries, centralised national party organisation choose both the presidential and congressional candidates. The congressional candidates, thus have a strong reason to line up behind their national leadership. In Brazil, the 26 federal states and the one federal district serve as electoral constituencies for congressional elections. By law, nomination for all offices except the president, are decided at the state level, in which national party leaders hardly have a say. During elections, candidates have strong incentives to link their campaigns to state-based political machines, and the personal, electoral popularity of their party's presidential candidates does not matter much to them. In Brazil, party organizations at the national level are weak. Candidates for governor mostly provide the organisational backing which congressional candidates seek. Thus association with gubernatorial candidates help them in winning elections. Once elected, they remain loyal to the governors as vested provincial interests.

See Barry Ames, "Electoral Strategy under Open-list Proportional Representation, *American Journal of Political Science*, Vol. 39, no. 2, May 1995, pp. 406-409.

See also, Samuels David, "Concurrent Elections, Discordant Results: Presidentialism and Governance in Brazil", *Comparative Politics* vol. 33, no. 2, January 2001, p. 43-48;

Scott V. Mainwaring, "Brazilian Party Underdevelopment in Comparative Perspective", *Political Science Quarterly*, Vol. 107, no. 1993, pp. 677-708.

The legislative power is exercised by the national congress, which is composed of the House of Deputies and the Federal Senate. The senate is composed of three representatives from each state, elected for an eight-year term. Small states are over-represented, whereas big state like Sao Paulo remain under-represented in the senate. In 1996, for instance, the voting population of Sao Paulo was 157 times more than that Roraima, but both of them have had three seats each in the senate. Alfred Stephan uses the "Gini Index" of inequality to measure the principle of representation and finds that the upper house of Brazil is among the most unequal of all the federal systems of the world.¹³

The senate is very powerful compared to the house of deputies. Senate directly appoints two-third of the judges of the supreme court that review federal expenditure. It also has right to deny or confirm the appointment of the remaining one-third of judges. The senate has exclusive competence to authorise international borrowing by the states. This means that even when the central bank is strongly opposed to a state contracting an international loan, the Senate can over-rule the central bank and authorise the states to seek external loans. The Constitution gives some special powers to the senate which it does not share with the house of deputies. By giving the powers of approving the appointment made and treaties negotiated by the president, the Constitution-framers have not only made it stronger than the

¹³ Stepen, n. 2, p. 148.

house of deputies but have also made it as one of the strongest in the world.¹⁴

The house of deputies or the lower house consists of 513 members, and representatives of the house are elected for a four year term. Election is done through a system of open-list proportional representation. A unique 'floor and ceiling' decision rule determines that no state, no matter how small in terms of population, can get not less than eight seats; and no matter how large a state, can not have more than seventy representatives in the house of deputies. In 1996, Sao Paulo had 157 times the number of registered voters than that of the Roraima but had only 8.75 times the number of seats in the lower house. This disparity was also manifest when in the mid 1990s, about 58.3 per cent of the population of Brazil's six most developed states of the south and south-east region, producing resources amounting to 79.7 per cent of the national economy, held only 48 per cent of the votes.¹⁵

The house of deputies frames laws in collaboration with the senate on subjects allocated to the congress by the Constitution. The lower house plays an important role in the amendment of the Constitution along with the senate. Constitution gives some exclusive powers to it also. It is exclusively authorised by the Constitution to initiate legal proceeding against the president, vice-president, and judge of supreme court by two-third of its

¹⁴ Ibid., pp. 148-149.

See also, for exclusive authority of the Senate, *The Constitution of the Federative Republic of Brazil*, 1988 (Brasilia, 1990), Art. 52, pp. 42-44.

¹⁵ Selcher, n. 4, p. 35.

members consenting. The house of deputies has more powers than the senate in one important aspect: bills sent to the congress by the executive, enter through the house, which has the last word in those cases in which the Senate has altered a bill and sent it back to the house.¹⁶

Governors of the states are directly elected for a four-year term. States have unicameral legislatures whose members serve for four years, with no limit on successive terms. Same pattern is repeated at the municipal levels, where mayors are elected directly and members of the municipal councils are also directly elected through the proportional representation system. Unlike other federal constitutions which typically leave the definition of the municipal government to the states, the Brazilian Constitution of 1988 gives municipalities independent and co-equal status. States have also been given powers to create new municipalities from out of the existing ones.

Governors of the states are very powerful and exercise great control over provincial congresses. This is partly because of the working of Brazil's party system. Brazil has a multi-party system. Party discipline is very weak at the national level. Many of the actions of these parties are determined more by what goes on in their own states than by what goes on in national politics.

State loyalties often force politicians to support a programme that will benefit their state, regardless of their parties. Deputies and senators are dependent on the governors for their re-election. Because of the influence of

¹⁶ Jose Serra and Jose Roberto Rodrigues Afonso, "Fiscal Federalism Brazilian Style: Some Reflection", <http://federativo.bndes.gov.br/english.htm>, pp. 6-7.

governors over deputies and senators of their states regardless of party, governors are able to thwart or facilitate presidential designs and policies. Scott Mainwaring opines that to implement his programmes, the president must construct coalitions that not only involve several parties but also satisfy regional demands. He has several means of doing so. Once elected, the president forms a *de facto* coalition government by offering jobs and resources to different parties. With comparatively weak party discipline and loyalty, these coalitions are always loose and shifting rather than hard and fast. A party's participation in the cabinet does not ensure the block support of that party's legislators.¹⁷

The Constitution of 1988 recognises three separate levels of government in the federation and delineates their responsibilities. Under Article 22, among the responsibilities assigned to the federal government are defences, foreign affairs, international trade, currency and banking, use of water resources, national highways, planning in federal and frontier areas, regulation of labour, inter-state commerce, tele-communication, inter-state transport, urban development, energy, mining, employment, insurance, immigration, citizenship, social security, national statistical system and guidelines and basis for national education. Article 24 of the Constitution also delineates concurrent responsibilities of the federal government and the states, which are: health, education, culture, protection of environment and

¹⁷ William Dillinger and Steven Webb, *Fiscal Management in Federal Democracies: Argentina and Brazil*, Policy Research Working Paper, no. 2121 (The World Bank: Washington D.C.), May 1999, pp. 11-12.

natural resources, agriculture, food distribution, housing, sanitation, social welfare, police and hydro-electricity.

Article 30 of the Constitution deals with the powers and rules of municipalities. Municipal governments have been given the legislative authority on the subjects of local interest to supplement the federal and state legislations. Furthermore, municipalities have been assigned responsibilities in areas of public transport, pre-school and elementary education, health care, and preservation of historical and cultural heritage.

Residual powers under Article 25 pertain to those subjects which have not been specified by the Constitution. They have been reserved for the state government's legislation. In terms of actual working however, all three levels of government are at substantial variance from the constitutional provisions. In the areas of education, health, urban transportation, recreation and culture, child and old-aged care, and social assistance for instance, all three levels are involved in an un-coordinated fashion leading to much confusion and chaos in the service delivery.

No system of federation can be successful unless both union and sub-national governments have at their disposal adequate financial resources to enable them to discharge their respective responsibilities under the constitution. The Constitution of 1988 is explicit in speaking about the mode of distribution of revenues. It assigns specific tax bases to each level of government and creates a system of tax sharing that substantially redistribute

revenues among the three levels. The State governments are assigned a value added tax (VAT), which is directly collected by the state government. Although the federal senate determines the rates of VAT, states have some flexibility to set the rates on intra-state sales, subject to a floor and ceiling set by the senate. The VAT is overall the highest yielding source of revenue in Brazil, and it gives the states an independent base of power of taxation. Particularly in the wealthy states of the south-east region, it is the principal source of state revenues.¹⁸

The Constitution of 1988 has decentralised political and economic power, making Brazil one of the most decentralised federation in the world. Now, state and municipalities are exercising their new powers in ways which often contradicts the federal government's neo-liberal policy. Thus a new tension areas are emerging in Brazilian federalism which will be dealt in the next section.

Tension Areas in the Functioning of Brazilian Federalism

Political and economic decentralisation under the 1988 Constitution has strengthened not only the sub-national governments both at the state and municipal levels; but federal legislature too has been vested with great powers and responsibilities. Brazilian deputies and senators are exerting new rights granted to them by the Constitution. Examples of their rights are: power to modify the budget surplus; tax proposals and government plans; approval

¹⁸ Ibid., pp. 8-9.

of budget surplus; veto power over federal executive regulation; senate approval of various presidential nominees including the central bank's directors; senate approval of all treaties and international agreements with foreign governments, private creditor banks and international financial agencies; and congressional approval of TV and radio concessions and renewals. The president has lost most of the authoritarian and exclusive powers dating to the period of military regime.¹⁹

The emergence of two new aspects viz. the strengthened sub-national governments and a strong legislative branch have changed the balance of power in the initial years of democratisation; through old political practices remain strong. The governors of the states exercise great influence over the federal deputies and the senators from their states. They compel the federal government to allocate more revenues to their states through the congress. Because of the expanded powers of the congress and the lack of any firm political support of his own, the president has to negotiate and compromise himself with the demands of sub-national governments and other local interests every time a bill is submitted to the congress.

The federal government, in order to get the support of the legislature, uses grants at its discretion. Negotiated grants are generally used to favour those states which support the government. In 1988, president Jose Sarney (1985-89) transferred some 60 per cent of total negotiated grants to the

¹⁹ Celina Souza, "Federalism and Regional Interest Intermediation in Brazilian Public Policies", *Public Administration and Development*, vol. 19, no. 3, p. 275.

south-east – the base of his government's support. In 1991, president Fernando Collor de Mello (1989-92) gave some 52 per cent of negotiated grants to the north-east region to garner their support.²⁰

To different degrees, the states have increased their bargaining powers vis-à-vis the federal government.²¹ States have also created several quasi-institutional, extra-constitutional and extra-parliamentary structures and processes in their intergovernmental relations. These structures and processes have assumed various forms. Different structures and processes are developed in some of the following ways: the most effective way has been by making the governor exert influence over the legislatures from his state in the congress.

With new powers and responsibilities, most states have increased their expenditure; at the same time, as their revenue have declined. As a result, states borrow heavily from both domestic and foreign banks. Though the Constitution of 1988 gives senate the power to control borrowing but it generously allows the states to borrow through a mutual arrangement of vested regional interests. This has led to an increase in states debt. Presidents Sarney and Collor had both failed to bring about legislation to reform the tax system and control state borrowing. Since 1995, however, President Fernando Henrique Cardoso, has to some extent succeeded in solving the major debt crisis. As a response to the debt crisis he came out

²⁰ Celina Souza, "Redemocratization and Decentralisation in Brazil: The Strength of the Member States", *Development and Change*, vol. 27, no. 3, July 1996, p. 544.

²¹ Souza, n. 20 p. 275.

with newer options thereby mustering support from the states that eventually helped him to expedite his economic restructuring measures. President Cardoso accomplished several important advances in the inter-governmental relations in his first term (1995-1998); and to a limited degree has freed the executive branch from the governors' grip. For example, his administration has successfully forced the privatisation of many banks owned by state governments, which state governors had previously used as 'bottomless barrels of politicised pork'.

New legislations such as the commonly called 'Camta Law' and 'Kandir Law', passed in 1995 and 1996 respectively, have expanded the executive's powers over sub-national government's spending. The 'Camta Law' require the states to limit their pay-roll expenditures to 60 per cent of net revenues or face losing federal transfer funds. The 'Kandir Law' has exempted exports from the tax on the circulation of goods, effectively reducing state revenues.²²

President Cardoso has employed his new sticks along with enticing carrots to induce state governments to enact economic reforms. Under the programme to support economic restructuring and fiscal adjustment at the level of the states, that are approved by the National Monetary Council (*Conselho Monetario Nacional, CMN*), the federal government in 1995 provided loans to accelerate privatisation of state firms and reductions in the size of the sub-national civil services. By rescheduling debt with favourable

²² Alfred P. Montero, "Decentralized Democracy: Spain and Brazil in Comparative Perspective", *Comparative Politics*, vol. 33, no. 2, January, 2001, pp. 162-163.

terms including low interest rates and extended repayment periods of thirty years in some cases, Cardoso could induce state governments to support structural adjustment programmes. By mid-1999, the central government had rescheduled the debt of twenty-four state governments (out of 26 state governments and one federal district). In all cases of debt rescheduling, the federal government has received stock in state governments' firms equivalent to 20 per cent of total debt, giving Brasilia a mechanism to move privatisation forward.²³

After the devaluation crisis of January 1999, a serious conflict arose between the central and state governments. In the midst of a prolonged capital flight, sparked by the Russian financial 'melt-down' of August 1998, Itamar Franco, the then governor of Minas Gerais, had declared a ninety-day moratorium on the state's debt payments to the federal government. Challenging the 'Kandir Law' and the fiscal stabilisation fund, Itamar Franco's 'fiscal revolt' triggered a financial panic that forced the federal government to float the national currency, Real. Cardoso's response was swift. He froze federal transfers to Minas Gerais and Rio Grande do Sul; another state that flirted with fiscal revolt and had convinced foreign portfolio investors to stay away from these recalcitrant states. By using Minas Gerais especially as an example for other states, Cardoso disrupted cross-state coordination by six opposing state governors.²⁴

²³ *Ibid.*, p. 163.

²⁴ *Ibid.*, p. 163.

Attempt to organise all the governors, first at Granja do Torto (Brasilia) in February 1999 and in Aracaju (Sergipe) in July 1999 highlighted the serious collective action problem faced by the states. While they all articulated common complaints about the fiscal stabilisation and the 'Kandir Law', they disagreed over how to approach Cardoso. Few were willing to follow Itamar Franco; while others continued to favour the president's fiscal reform.²⁵

Though armed with extensive legislative apparatus and divided opposition, Cardoso, still faces severe constitutional constraints in limiting sub-national spendings. The state governments retain the ability, protected by the 1988 Constitution, to defend their authority and resources with the legislation in the senate. Lasting reforms of tax and pension system and civil services need constitutional amendments that are very difficult to achieve, since they require majority votes in both the houses of the congress. In this regard, the enactment of Fiscal Responsibility Law is a new beginning. The law regulates the state's borrowing; their indebtedness; and their tax expenditure. Thus, the new law has laid the foundation for a rule-based system of decentralised federation that has left little room for discretionary policy-making at the sub-national level. Despite the political influence of state governors in congress and regional fragmentation of the Brazilian political system, reforms in the inter-governmental fiscal relation is now affecting state governments' finances adversely. The key provisions in the Fiscal

²⁵ Ibid, p. 163.

Responsibility Law and its complementary regulations preclude, at least in principle, discretion in fiscal policy making, particularly at the sub-national level.

To sum up, federalism in Brazil has undergone experiences with varying features throughout the course of the country's republican history. Brazil has come a long way starting from the so called 'isolated' federalism in early republican days to centralisation during military rules and finally to political and financial decentralisation under the Constitution of 1988. Now on the one hand, Brazil has become more federal as the states and municipalities enjoy considerable fiscal and political autonomy and on the other hand, the Brazilian experience highlights the constraints of decentralisation in countries with deep-rooted regional disparities which are undergoing economic restructuring. Furthermore, the financial weakness of federal government and increased strength of sub-national governments are creating obstacles in the functioning of federalism in Brazil. However, federal government in recent times has become successful to some extent overcoming the problems faced by it in the pursuance of market-oriented policies and controlling the regional vested interests.

CHAPTER 3

FISCAL FEDERALISM IN BRAZIL

The issues of fiscal federalism have arguably been more thoughtfully addressed in Brazil than in any other developing country undergoing both democratisation and economic liberalisation. The Constitution of 1988, in this respect is considered a benchmark in Brazilian fiscal federalism. It has hastened the process of fiscal decentralisation, begun in the late 1970s¹. Also, it has made a reasonably clear assignment of the expenditure and tax among the different levels of government which is broadly consistent with the principles of fiscal federalism.²

The first and second Chapter so far, have discussed the theoretical aspects of fiscal federalism and antecedents of federalism in Brazil respectively. Divided into three sections, the present Chapter deals with aspects of the distribution of economic power among different levels of government in Brazil. The first two sections examine separately the assignment of expenditure and tax responsibilities among different levels of government and the last section deals with inter-governmental transfers.

¹ Contrary to the common view that the fiscal decentralisation began in 1988, the process of fiscal decentralisation was already taking place since late 70s during the military regime, See Raul Velloso and Joado Carmo Oliveira, "Inter-governmental Fiscal Relations in Brazil: Trends and Issues", in S.P. Gupta, Peter Knight, Roberta Waman and Wen Yin-Kann, eds., *Inter-governmental Fiscal Relations and Macro-economic Management in Large Countries*, (New Delhi: World Bank and Indian Council of Research on International Economic Relations, 1994), pp. 123-26.

² Anwar Shah, *The New Fiscal Federalism in Brazil*, World Bank Discussion Paper, no. 124 (Washington, D.C., 1991), p. 30.

Brazil today represents a three-tiered federation of 27 states (including one federal district) and more than 5,500 municipalities³. Under the 1988 Constitution, states and municipalities enjoy considerable autonomy. Municipal governments in other federations are usually the handmaidens of the state governments, whereas the Constitution of Brazil recognises their independent and co-equal status.⁴

When fiscal decentralisation is measured in terms of the sub-national government's participation in total revenue generation and spending as well as the great autonomy with which they levy taxes and elaborate their budget, Brazil comes quite close to the more developed federations.⁵

Anwar Shah has prepared an autonomy index of sub-national governments, taking a group of ten developed and developing countries and has found that the highest autonomy index of Brazil has even surpassed that of the United States, Germany and Canada by few points.⁶

Brazil is characterised as a country of great regional economic disparities. In 1994, 56 per cent of GDP was concentrated in the south-east and 17.5 per cent in the south; whereas the north-east had 14 per cent and the north and the center-west regions had 4.8 per cent and 7.1 per cent of

³ In fact, Brazil has 26 states and one federal district. Since, federal district enjoys similar rights as the states, under constitution, many scholars include it among the states.

⁴ *Constitution of the Federative Republic of Brazil*, (Brasilia, 1990), see Art. 1, p. 3.

⁵ Sub-national governments include states and municipalities.

⁶ Anwar Shah, *The Reform of Inter-governmental Fiscal Relation in Developing and Emerging Market Economies*, World Bank Policy Research Working Paper Series 23, (Washington D.C., 1994), p. 42.

GDP respectively.⁷ To reduce the regional economic imbalances, the Constitution requires the federal government to transfer more funds to the poverty-stricken regions through the mechanism of the inter-governmental fund transfer.

A review of the assignment of tax and expenditure responsibility, and the inter-governmental transfer of funds are thus essential in order to understand the fiscal federalism in Brazil.

Assignment of the Expenditure Responsibilities

A noteworthy feature of the pre-1988 constitutional set-up was the centralisation of the spending responsibilities of purely local nature. Subjects such as urban infrastructure and elementary education were financed and carried out by the central government. The Constitution of 1988 has made clear assignment of expenditure responsibilities among the different levels of government. Following are the areas in which centre, states and municipalities can legislate and assume the expenditure responsibilities:⁸ Defence, foreign relations, currency, postal services, planning, nuclear energy, national highways, regulation of the condition of labour, foreign and inter-state commerce, finance, banking and insurance, commercial

⁷ Celina Souza, "Brazil: The Prospects of a Center-Constraining Federation in a Fragmented Policy <http://www.federativo.bndes.gov.br/> (2000), p.2.

⁸ Antulio N. Bomfim and Anwar Shah, *Macroeconomic Management and the Division of Powers in Brazil: Perspective for the Nineties*, World Bank Policy Research Working Paper Series 567 (Washington D.C., 1991), p. 5.

advertising, inter-state transport, telecommunication and data-processing, energy, mining, employment, insurance, social security, immigration and naturalisation, and native right are the exclusive domains of the federal government.

Concurrent functions such as health, education, culture, protection of environment and natural resources, food distribution, housing, sanitation, social welfare and police are joint responsibilities of the federal and state governments; with the federal government setting the standards and the state governments taking the responsibility for the delivery of these services.

Municipal governments have been given the legislative authority for expenditure on subjects of local interest to supplement the federal and state legislation. The Constitution assigns them exclusive responsibility for public transport, pre-school and primary education, health-care, land use, and historical and cultural preservation.

Any subjects not specified by the Constitution has been reserved for the legislation of the state governments.

Table 1 provides the basic details of the assignment of expenditure responsibilities as discussed above.

Table 1: Expenditure Assignment in Brazil

Responsible level of government	Expenditure category
Federal only	Defence Foreign affairs International trading, currency, banking Use of water resources National highways Planning: regional and natural Postal service Police: Federal and frontier areas Regulation of labor, interstate commerce, telecommunications, interstate transport, urban development, energy, mining, employment insurance, immigration, citizenship and native rights Social security National Statistical System Guidelines and basic for national education
Federal-state (shared)	Health Education Culture Protection of the environment and the natural resources Agriculture Food distribution Housing Sanitation Social welfare Police Hydroelectricity
States only	Residual powers, i.e. any subject not assigned to federal or municipal levels by the Constitution
Municipal only	Public transport (intracity) Preschool and elementary education Preventive health care Land use Historical and cultural preservation

Source: Anwar Shah, *New Fiscal Federalism in Brazil*, World Bank Discussion Paper, no. 124, (Washington, D.C., 1991), p. 2.

Although the Constitution is very clear in assigning the expenditure responsibilities among the different levels of government, practices in service delivery differ from the constitutional assignment. In the area of education, health, urban transportation, recreation and culture, child and old-

age care, and social assistance, all three levels (centre, states and municipalities) are involved in an un-coordinated fashion leading to much confusion and chaos in the service delivery.⁹

Contrary to the constitutional arrangement, the federal government, nevertheless continues to involve itself in the provision of education at the secondary school, college and university levels. It also involves itself in some cases in primary education.

Furthermore, the Constitution of 1988 gives the local government exclusive power for the provision of primary education but the responsibility for the delivery of the secondary education is left open.¹⁰ The provision of secondary education, which is local in nature when given to the municipalities, it was suggested, would provide incentive for allocative efficiency as well as encourage innovative learning programmes.

A similar problem exists in the delivery of the urban transportation. Urban corridors are constructed and maintained by all three levels of the government, and sometime suffer neglect because of unclear responsibilities for their maintenance and up-keep. A decentralised system of urban transport provision would be more attuned to meeting the local needs. Federal government is often involved in direct provision of urban transportation-network and service and this some times creates difficulties, particularly when

⁹ Shah, n. 2, pp. 1-3; Celina, Souza, "Political and Fiscal Decentralisation in Democratic Brazil", *Local Government Studies*, vol. 20, no. 4, Winter 1994 pp. 598-600.

¹⁰ Shah, n. 2, p. 6.

the local government takes a decision to upgrade local services or modify the existing network.¹¹

The Assignment of Tax Responsibilities

Compared to the pre-1988 constitutional set-up, the 1988 Constitution provides the states and municipalities with substantial powers of raising taxes in their jurisdictions. Before reviewing the distribution of taxes among the different levels of the government, it would be proper to know the various taxes levied in Brazil. They are as follows:

(i) Taxes on foreign trade in Brazil comprise of the import tax and the export tax (IE). Brazil has three consumption-based taxes, viz., State Value Added Tax (ICMS), Taxes on Industrial Products (IPI), which are levied by the central government, and Taxes on Services (ISS) which are levied by the municipal governments.

(ii) The taxes on financial transaction (IOF) are levied by the central government on a variety of financial transactions ranging from capital gains to banking activities and insurance.

(iii) As for the income tax, Brazil has three types of income taxes. The corporate tax (IRPJ), the personal income tax (IRPF), and the personal income tax deducted from the salary of the employees. Although income tax is under the federal jurisdiction as in other federations, almost half of its revenue is transferred to the state and municipal governments.

(iv) The property taxes have a peculiar distribution pattern. The federal government levies a tax on rural properties (ITR), while the municipalities levy a tax on urban property (IPTU).

¹¹ Provision of services (local in nature) by local government leads to efficiency. See Wallace E. Oates, *Fiscal Federalism* (New York, 1977), p. 9.

(v) The taxes on the vehicle registration (IPVA) is levied by the states which retain half of the revenues and transfer the other half to their respective municipalities where the vehicles are registered.

(vi) Then there are other taxes too. Two additional taxes which were earlier under the federal government are assigned to the states and municipalities under the Constitution of 1988. These are taxes on sales of mineral products including oil prospecting and fuels, and a hydro-electricity tax.

(vii) Finally, there are social security contributions. Brazil has a broadly defined social security system incorporating both health and social welfare provisions. It is of two types. The first comprises the contribution made by the employees, and the second is the private funds contributed by specific industrial sections which is administered by the non-governmental institutions. The employers' social security contributions are levied on a firm's gross revenue (COFINS PIS/PASEP), Pay-roll (FGTS) and net profits. The employees' contribution is levied on gross earning. Contribution levied on a firm's gross revenue and pay-roll constitutes a significant share of total contribution. Formal education is financed by a combination of tax-sharing and social security contributions including an additional contribution earmarked for education (*salario-educacao*).

Table 2 gives the distribution of fiscal responsibilities among different levels of government.

Table 2: Distribution of fiscal responsibilities among different level of government under and after the 1988 Constitution

Level of government	Proceeding Constitution	1988 Constitution
Federal	Income Tax (IR) Payroll Tax Tax on Industrial Products (IPI) Tax on Financial Operations and Insurance (IOF) Import Tax (II) Export Tax (IE) Rural Property Tax (ITR) Hydroelectricity Tax (IUEE) Mineral Products Tax (IUM) Fuel and Lubricant Tax (IULC) Tax on Communication Services Transportation Tax (IT)	Income Tax (IR) Payroll Tax Tax on Industrial Products (IPI) Tax on Financial Operations and Insurance (IOF) Import Tax (II) Export Tax (IE) Rural Property Tax (ITR) Large Fortunes (Wealth) Tax Temporary Tax on Financial Transactions (IPMF)
State	Value-added Tax (ICM) Motor Vehicles Registration Tax (IPVA) Property Transfers, Inheritance and Gift Tax (ITBI)	Value-added, Communication and Transportation Tax (ICMS) Motor Vehicles Registration Tax (IPVA) Inheritance and Gift Tax (ITCMD) Supplementary Capital Gains Tax
Municipality	Services Tax (ISS) Urban Property Tax (IPTU) Frontage Tax	Services Tax (ISS) Urban Property Tax (IPTU) Frontage Tax Property Transfers Tax on Retail Sales of Fuels Except Diesel (IVVC)

Source: Celina Souza, "Economic and Political Decentralization in Democratic Brazil", *Local Government Studies*, Vol. 20, no. 4, Winter 1994, p. 595.

The trend towards the decentralisation of tax responsibilities is best illustrated by the change that has taken place in the domain of Central Value Added Tax (ICM). Prior to 1988, constitutional provisions had empowered the federal government to levy special taxes on communications, fuels, electric power, minerals, and transports. However, all these five separate taxes were

abolished under the 1988 Constitution; and their tax bases have been shifted to the state level under State Value Added Tax (ICMS).

State Value Added Tax is administered by the Council of the States. Any change in the tax base or rate must be presented by individual states for the approval by the Council.¹² Apart from the value added tax, states have also access to taxation on inheritance and gifts, and motor vehicle registration.

Municipalities are empowered to levy taxes on services, urban properties, retail sales of fuels except diesel, property transfers (*intervivos*) and special assessments (*frontage*).

The federal government has now under its exclusive responsibility Import and Export taxes; tax on financial operation and insurance (IOF); the large fortune tax; and the temporary tax on financial transaction.

Federal government has fiscal responsibility partially overlapping within the states and municipalities. It allows states to levy supplementary rates upto 5 per cent on the federal tax bases for personal and corporate income.¹³

Thus, as a result of fiscal decentralisation, the states and municipalities have gotten many taxes at the cost of the federal government. In order to counter-balance the loss, the federal government has increased its revenue

¹² Luiz R. De Mello Jr., "Fiscal Federalism and Macro-economic Stability in Brazil: Background and Perspective", in Kiichiro Fukusaku and Luiz De Mello Jr. (eds.), *Fiscal Decentralization in Emerging Economies* (Paris, 1999), pp. 146-49

¹³ Shah, n. 2, p. 12.

levied on social security contribution. Social security contributions are revenue sources exclusively for the federal government. Unlike the major federal taxes, such as the income taxes and taxes on industrial products – which are shared with the states and the municipalities – revenue levied on social security contribution is not shared. Social security contributions are constitutionally earmarked to finance social security outlays only; it cannot be used to finance any other governmental activities.¹⁴

In the year 2000, the federal government had collected 43.8 per cent of its total revenues from social security contributions; and only 23.5 per cent from income tax, tax on industrial product (IPI), tax on financial operations (IOF), import tax (II), rural property tax (ITR) and others. The share of states in total tax of Brazil in the same year was 27 per cent; whereas municipalities were responsible for collecting 5 per cent of total tax (See table 3).

Despite the decentralisation of tax, the share of the states and municipalities in total tax of Brazil, because of their poor revenue-raising capacities, is very less. For most of the expenditure function, states and municipalities remain dependent on the transfer of funds from the federal government.

The share of states' tax in the total tax of Brazil, no doubt, have increased after 1988; and for municipalities, it has increased from 0.7 per cent of GDP in 1988 to 1.6 per cent of GDP in 2000.¹⁵

¹⁴ Ibid., p. 12.

¹⁵ Monica Mora Y Ricardo Vasano, "Fiscal Decentralization and Sub-national Fiscal Autonomy in Brazil: Some Facts of 90s" (2001), <http://www.federarativo.bndes.gov.br/english>, pp. 3-4.

Table 3: Tax Assignment and collection by different levels of government (2000)

Levels of Government/Taxes	% of GDP	% of Total
Union	22.0	67.3
Fiscal Budget	7.7	23.5
Income Tax (IR)	4.4	13.5
Tax on Industrialized Product (IPI)	1.6	4.9
Tax on Financial Operations (IOF)	0.3	0.9
Import Tax (II)	0.8	2.4
Export Tax (IE)	0.0	0.0
Rural Property Tax (ITR)	0.0	0.0
Others	0.6	1.8
Social Security Budget	14.3	43.8
Payroll Social Insurance Contribution	5.0	15.3
Payroll Contribution to the FGTS	1.7	5.2
Turnover Contributions (Pis/Pasep and Cofins)	4.4	13.5
Net Profit Contributions (CSLL)	0.8	2.4
Bank Debit Contribution (CPMF)	1.3	4.0
Others	1.1	3.4
States	9.1	27.7
ICMS	7.6	23.2
Tax on Motor Vehicles (IPVA)	0.5	1.5
Heritage and Endowment Tax (ITCMD)	0.0	0.0
Others	1.0	3.0
Municipalities	1.6	5.0
Tax on Services (ISS)	0.6	1.8
Tax on Urban Property (IPTU)	0.5	1.5
Tax on Property Transfer (ITBI)	0.1	0.3
Others	0.5	1.5
Total Tax Burden	37.2	100.0

Source: SF/BNDES; Monica Mora Y Recardo Varsano, Fiscal Decentralisation and Substantial Fiscal Autonomy in Brazil: Some Facts of the Nineties. 26 November 2001, <http://www.bndes.gov.br/english>, p. 11

Inter-governmental Transfers

The existing structure of inter-governmental fund transfer can be broadly classified into two categories: constitutional transfers; and non-constitutional transfers.

Constitutional transfers have been specified in the new Constitution. The Constitution provides strict criteria for the allocation of revenue to the different levels of government; and some guidelines on the distribution of these revenues through special institutional funding have also been provided. Significantly, specific criteria are specified by the congress. The federal government shares its revenue from income taxes and industrial product taxes with states and municipalities through participation funds established for this purpose. The federal government deposits 21.5 per cent of the above taxes in a special fund, called State Participation Fund (PPE), which is distributed by the Council of States to individual states. Out of the total PPE, 85 per cent are distributed in to the states in poor regions mainly in the north-east, north and center-west. The remaining 15 per cent is distributed to the south and south-east region. The formula for the distribution of funds takes into account the population and fiscal capacity indicators of states. Discrimination in favour of poor states was made in order to safeguard regional equity objective under the new Constitution. The Constitution also establishes deadlines for the federal government for the release of funds for distribution to states.¹⁶

A similar fund, established for the distribution of funds from central government to municipalities, is known as Municipal Participation Fund (FPM). Twelve per cent of FPMs are allocated to state capitals and

¹⁶ Jose Roberto Rodrigues, Afonoso, "Decentralization and Budget Management of Local Government in Brazil", <http://www.federativo.bndes.gov.br/english>, p. 1.

municipalities with population larger than four hundred thousand. Out of the remaining 88 per cent, 6 per cent is set aside for the Municipal Participation Reserve Fund (RFPM). The RFPMs are available only to larger municipalities other than the state capitals. The distribution of funds to all municipalities is by a formula which takes into consideration population and per capita income of each municipality. In addition to revenue sharing through the RFPM, municipalities also receive 50 per cent of revenue from the rural property tax in proportion to the value of real estate properties located in their jurisdiction; 100 per cent of payroll deductions of income taxes of municipal employees; 70 per cent of tax on gold by origin; 2.3 per cent of revenues from crude oil based on the value of production; and 50 per cent of hydro-electricity and mineral taxes by the sales value of the minerals and hydro-electricity by origin. Besides, municipalities also get 25 per cent of value added tax of states, through revenue transfer¹⁷ The Value Added Tax (ICMS) is the main source of revenue for the states.

Thus, the constitutional transfer of funds are redistributive in nature. Most of the federal taxes are generated in the economically developed states of the south and south-east; whereas less developed states of the north, north-east, and centre-west contribute very less. But the later receive much more transfer of funds from the central government. This is done to reduce the regional economic disparities among the different regions.

¹⁷ William Dillinger and Steven B. Webb, *Fiscal Management in Federal Democracies: Argentina and Brazil*, World Bank Policy Research Working Paper, Series 2121 (Washington, D.C., 1999), p. 8.

As a result of the enormous regional disparities in Brazil, tax raising capacity varies greatly both among the states and among the municipalities within each state. In fact, the tax bases in some poor states and municipalities are practically non-existent. Consequently, the poor states and municipalities are highly dependent on transfers and grants.

Besides, the constitutional transfers mentioned above, there are more than one hundred umbrella federal-state-municipal non-constitutional transfer programmes. These programmes can be broadly classified into four categories.¹⁸

The first type of transfers have been instituted to simply comply with the specific laws other than the constitutional provisions. Major transfers of this type include transfer of funds to the federal capital; transfer of funds related to the creation of new states; and financial compensation paid to states for the extraction of oil within their jurisdiction.

The second type of transfers are commonly referred to as negotiated transfers (*convenios*). These are not regulated by law, rather they are transferred on the basis of the negotiations between the federal government and other units be they states or municipalities – individually. Support for regional development, agriculture, education and housing are the priority areas for the receipt of funds through *convenios*.

¹⁸ Shah, n. 2, pp. 73-74.

The third type of transfers are special investment funds. The states and municipalities receive these funds for the projects undertaken by them on behalf of the federal government.

The fourth type of transfers are the transfers made by different agencies of federal government. Most of these transfers come from the ministries of planning, education, finance, urban development and health. The poor regions receive nearly one-third of total transfers through various governmental agencies.

Out of the four above mentioned transfers, negotiated transfers constitute a major part of the total non-constitutional transfers. It is very much true that federal government in Brazil some times, uses these funds for its own political interests.¹⁹

Thus, the negotiated transfers substantially reduce the objectives, expected through the transfer of funds. The Constitution of 1988 has sought to reduce the size of negotiated transfers of funds and increase the statutory transfers of funds. As a result, the states and municipal governments have gotten more transfers of funds as part of the fiscal decentralisation process.

Total transfer of revenue in the year 2000 was 5.8 per cent compared to 1.5 per cent of GDP in 1990s.²⁰ In the same year, the federal government transferred 1.9 per cent and 1.5 per cent of GDP to states and municipalities respectively; whereas states transferred 2.3 per cent of GDP to municipalities. Thus states transferred more revenue to the municipalities than what they got from the federal government. Table 4 details the transfer during 2000.

¹⁹ Ibid., pp. 43-55.

²⁰ Jose Roberto Rodrigues Afonso and Mello Luiz de, "Brazil: An Evolving Federation", <http://www.federativo.bndes.gov.br>, November 2000, p.6

Table 4: Brazil – Own Revenue, Constitutionally Established Tax Sharing and Disposable Revenue – 2000

Own revenue, revenue shared and disposable revenue	Amount (Rs. \$ million)	% of GDP	% of total
Own revenue	354998	32.7%	100%
Union	238769	22.0%	67%
Municipalities	17844	1.6%	5%
Total revenue shared	62522	5.8%	100%
Union to states	20813	1.9%	33%
FPE	12182	1.1%	19%
FPEX	1500	0.1%	2%
IOF OURO	0	0.0%	0%
SEGURO RECEITA ICMS ^a	2436	0.2%	4%
FUNDEF	2875	0.3%	5%
SALARIO EDUCACAO	1819	0.2%	3%
Union to municipalities	16640	1.5%	27%
FPM	12816	1.2%	20%
ITR	112	0.0%	0%
IOF.OURO	1	0.0%	0%
SEGURO RECEITA ICMS ^a	811	0.1%	1%
FUNDEF	2900	0.3%	5%
States to municipalities	25444	2.3%	41%
ICMS	17431	1.6%	28%
IPVA	2648	0.2%	4%
FPEX	375	0.0%	1%
FUNDEF	4990	0.5%	8%
Disposable revenue	354998	32.7%	100%
Union	201316	18.5%	57%
States	93755	8.6%	26%
Municipalities	59927	5.5%	17%

Source: SF/BNDES; Monica Mora Y Ricardo Varsano, "Fiscal Decentralisation and Subnational, Fiscal Autonomy in Brazil: Some Facts of the Nineties", <http://www.federativo.bndes.gov.br/english> (November 26, 2001), p. 12.

a. Non-constitutional, created by a complementary law.

One-fifth of federal government's revenue in the same year was used to finance 30 per cent and 70 per cent of the total state and municipal spendings respectively. Thus, the vertical imbalance has increased; it is lower at the state level than at the municipal level. Revenue mobilisation indicators vary significantly among the states. Total revenue collection excluding revenue-sharing transfer amounted to approximately 36 per cent of state GDP in the developed states of south and south-east, as against 27 per cent of the state GDP in the less prosperous states of north, north-east and center-west in 1999. Limited ability of states to collect taxes is associated with high dependency ratio, defined as the share of inter-governmental grants. Dependency ratio varies between approximately 38 per cent in the case of rich states to nearly 64 per cent in the case of the poor states as has been detailed in Table 5.

In short, after the constitution of 1988, Brazil has become one of the most fiscally decentralised federation of the world. The constitution has not only clearly assigned the expenditure and revenue responsibilities, among the different levels of government but also provided for inter-governmental transfers. Though fiscal federalism in Brazil is to a large extent consistent with the theoretical consideration of fiscal federalism, it is facing a number of constraints. However some positive developments have also been witnessed. The next Chapter will examine both positive and negative developments in Brazil's fiscal federalism.

Table 5: Social and Fiscal Indicators by Region and State, 1999

	Development indicators			Tax Revenue 5/		Dependen cy ratio 7/
	Population 2/	Human developme nt index 3/	GDP per capita 4/	Total	Subnation al 6/	
Brazil	100.0	0.72	100	34.0	15.0	
More developed regions	57.3	0.77	131	36.4	13.3	37.9
Southeast	42.4	0.77	138	38.8	13.3	34.9
Minas Gerais	10.6	0.73	92	24.5	14.7	49.9
Espirito Santo	1.8	0.74	83	40.6	20.7	45.8
Rio de Janeiro	8.3	0.79	133	40.1	12.4	34.4
Sao Paulo	21.8	0.81	167	42.2	12.8	29.7
South	14.8	0.78	110	27.6	13.4	48.4
Parana	5.7	0.75	102	28.8	13.9	50.2
Santa Catarina	3.1	0.80	106	27.1	14.1	47.9
Rio Grande do Sul	6.0	0.80	120	26.9	12.8	47.0
Less developed regions	42.7	0.64	58	26.7	20.0	64.1
North	7.5	0.62	64	18.5	20.8	71.4
Aere	0.3	0.58	64	14.2	38.1	82.5
Amazonas	1.6	0.63	82		17.5	50.9
				31.2		
Para	3.6	0.61	59	12.8	15.9	74.0
Rondonia	0.8	0.66	84	12.3	15.5	69.0
Roraima	0.2	0.67	77	17.3	42.9	85.4
Amapa	0.3	0.67	62	15.8	40.3	86.6
Tocantins	0.7	0.56	22	29.2	78.5	82.0
Northeast	28.4	0.57	46	22.4	2.9	68.7
Maranhao	3.3	0.50	29	15.1	29.9	84.5
Piaui	1.7	0.55	27	21.0	36.8	80.7
Ceara	4.4	0.56	41	27.0	25.9	67.0
Rio Grande do Norte	1.6	0.61	54	19.5	24.3	71.3
Paraba	2.1	0.57	33	25.2	32.9	74.4
Pernambuco	4.7	0.62	50	27.6	21.8	60.7
Alagoas	1.7	0.54	50	14.4	20.8	75.9
Sergipe	1.0	0.61	53	22.4	26.8	71.8
Bahia	7.8	0.59	57	21.2	17.4	61.8
Center-West	6.8	0.74	105	39.9	14.3	43.8
Distrito Federal	1.2	0.82	217	72.8	8.6	14.9
Goias	2.9	0.72	69	25.7	19.1	50.4
Mato Grosso	1.5	0.69	76	23.0	21.0	53.7
Mato Grosso do Sul	1.2	0.72	118	14.1	12.4	52.0

Sources: IPEA, IBGE, FGV, STN (Balanco Geral da Unitaio, Financas do Brasil), SFR, Ministry of Social Assistance, CEF, CONFAZ and ABRASF; Roberto Afonso, r. Jose and Luiz de Mello, "Brazil: An Evolving Federation, [http://www.federativo.bndes.gov.br/english\(2000\)](http://www.federativo.bndes.gov.br/english(2000)), p.22

1/ in percent of total population of 165.4 million

2/ refers to the 1998 UNDP Human Development Index (HDI)

3/ In percent of the national average

5/ in percent of state GDP

6/ Excludes constitutional revenue-sharing transfers

7/ Ratio of intergovernmental transfers in total net revenues

CHAPTER 4

THE WORKING OF FISCAL FEDERALISM IN BRAZIL

The preceding three Chapters have so far discussed a number of related issues. The first Chapter has dealt with the trends towards fiscal decentralisation; the theoretical aspects of fiscal federalism; and some of the challenges it is posing in different countries, more specifically the developing ones. The second Chapter has examined specifically, how the federalism in Brazil has changed after the promulgation of the 1988 Constitution. With the political and economic decentralisation, states and municipalities have become fiscally and politically powerful at the cost of federal government. As a result, federal government is compelled to negotiate with sub-national governments in order to find solutions for the national issues, thereby creating many tension areas in the working of Brazilian federation. Third Chapter has focused on issues of the assignment of economic functions and mechanisms of inter-governmental transfers. The assignment of tax and expenditure responsibilities is to a large extent consistent with the theoretical consideration of fiscal federalism. However, fiscal federalism has limitations in a country like Brazil which is characterised by deep regional economic disparities, and where regional interests of different political actors dominate the national scene and thereby the national interests too. Building the argument further, the present Chapter examines the various factors which are responsible for some innovative reforms as well as for creating obstacles in the functioning of fiscal federalism in Brazil. Chapter is divided into two sections; while the first section focuses on the negative developments in fiscal federalism in Brazil, the second section highlights some innovative measures and positive gains.

Negative Developments

The decision of the constituent assembly to decentralise the political and economic powers was an act of constitutional and political engineering. The key questions that had emerged was how to divide the resources in a regionally uneven country? Conflicts concerning the division of financial resources were in fact less politicised and more regionalised. Secondly, there was a broad consensus on rejecting whatever had been done by the military government in terms of centralisation of resources; thus the move was also confronting the federal executive, where most powers were concentrated during the military rule. Paradoxically, the federal government did not react at the moment against its financial losses; it was too worried about short-term issues related to the then president Jose Sarney's own political survival. Furthermore, the credibility of the federal bureaucracy was also in question; and it was also busy lobbying for its own demands. Thirdly, the regional cleavages especially between weak and powerful economic states coupled with weak party discipline meant that each parliamentarian was an individual player and a solitary negotiator promoting and protecting the regional and vested interests that had facilitated his entry into the constituent assembly. Fourthly, economic issues such as public deficit and inflation control were not on the agenda of the constitution-makers. All this helped to create a federation in which power has been decentralised, and where several unequal but competing centers have the strength to play a part in the

decision-making process. Nevertheless, as argued by Celina Souza, decentralisation was not followed by a consensus on what was to be achieved by it.¹

However, when the constitution was promulgated in 1988, the country's economic predicament ran deeper than it had at the beginning of the decade. The failure of several stabilisation plans had been followed by the reduction in public resources, recession, and by uncontrollable inflation, constraining fiscal policy and deficit control measures.

After the promulgation of the Constitution, the federal government started to react against its financial losses; and has continued to do so to this day. However, the federal government's reaction has always been somewhat ambiguous. Different civilian presidents have tried to put the blame on sub-national levels for public sector problems. Yet, because of the increase in the powers of legislation granted by the Constitution, and also that of the state governors and mayors of large cities, the civilian presidents continuously need their support to obtain congressional approval for their policies. This is because every president, since the 1988 Constitution, has had difficulties guaranteeing a stable parliamentary base of support for himself. In a milieu of fragmentation and fragility of most political parties and of an electoral system based on open list proportional representation system, the governors

¹ Celina Souza, "Brazil: The Prospect of a Center Constraining Federation in a Fragmented Polity", <http://federativo.bndes.gov.br>, 2000, p. 12.

have become one of the main players in endowing and assuring the federal government its capacity to govern. As a result, the federal government alone is not in a position to overcome the constraints of Brazil's public finance².

As a result of fiscal decentralisation, Brazil's regional economic disparities have increased further. Decentralisation has been done without a thorough understanding of the various issues such as administrative capacity of individual municipalities, which varies greatly. In some states and municipalities, policies have thus deteriorated instead of improving as a result of decentralisation.

Empirical studies show that there are no guarantees that the virtuous cycle of decentralised policies will be distributed equitably. Bremaekar had found that in the year 1994, for instance, over 2000 municipalities in the north-east had no chance of expanding their tax bases; nor pay for anything other than salaries to their civil servants- most of whom were earning below the minimum wage. Samuels' study shows that in the year 2000, almost 75 per cent of Brazil's municipalities with 10000 or fewer inhabitants depended on transfers for 90 per cent or more of their revenues. As for the states, seven of them collect less than 0.5 per cent of the total ICMS levied in the country.³ Therefore, Brazil's regional inequality acts against the ultimate goal of fiscal federalism because fiscal decentralisation itself limit the opportunities for the federal government to transfer resources from better-off regions to worse-off

² Ibid, pp.12-13

³ Ibid., p. 19.

ones. Even with schemes aimed at fiscal horizontal balance, these schemes are of little effect in redressing the imbalance. This shows the limit of fiscal decentralisation in countries characterised by extreme regional inequalities.

Under the Constitution of 1988, creation of new municipalities is a prerogative of the states. Anticipating the greater flow of resources mandated to the municipalities, many states went on creating new ones by sub-dividing others, just to receive more federal transfers. The total number of municipalities jumped 31.4 per cent in ten years, from 4189 in 1988 to 5507 in early 1998.⁴ Creation of municipalities only increases sub-national outlays on personnel and administration, in addition to transfer for their legislative spendings at the expense of more productive spendings on, for instance, social programmes and urban infrastructure.

It is argued that municipal government have weak incentives to fully exploit their tax bases, particularly after the promulgation of the 1988 Constitution, given the increased reliance on mandated transfers from the federal and state governments. The absence of any tax effort parameter in the revenue sharing formula has not encouraged local revenue mobilisation in Brazil. Also generous revenue-sharing provisions have been cited as an important factor leading to a rapid increase in the number of municipalities.⁵

⁴ Wayne A. Selcher, "The Politics of Decentralised Federation, National Diversification and Regionalism in Brazil", *Journal of Interamerican Studies and World Affairs*, vol. 40, no. 4, winter 1998, p. 41.

⁵ Jose Rodrigues Roberto Afonos and Luiz de Mello, "Brazil: An Evolving Federation", <http://federativo.bndes.gov.br>, November 2000, p. 9.

The practice of reducing value added taxes to attract new investments has been unlawful since 1975, except in cases in which the intended reduction is unanimously approved by the 26 states and the federal district. Yet, the law has been disregarded, and tax competition among Brazilian states intensified particularly in the nineties. Fore-most among the cases is the dispute and competition for the wave of new automobile industrial plants that have looked for a location in the country since 1995. The competition to lure investors by waiving the value added tax (ICMS) has been termed as 'fiscal war'. One of the features of 'fiscal war' is that it tends to engulf all the states.⁶

The Constitution of 1988 assigns same expenditure responsibilities to all municipalities nation-wide despite their varying capacities to meet their expenditure needs. Rural municipalities in three poorer regions of north,

⁶ From the standpoint of any particular states, granting fiscal incentives to attract investment seems worthwhile. The amount of tax revenue forgone would not exist any where, unless the beneficiary would choose to locate his business in the state even in absence of the incentive. Plus, aside from their direct impact on production and employment, newly attracted firms induce additional economic activity, creating still more jobs and income, and of course, some tax revenue. If this were the whole story, state tax incentive would be a valuable development tool. But when other states replicates the successful experience of one of them a destructive tax competition – the so called fiscal war – starts. One of features of fiscal war is that it tends to engulf all the states. Firms benefiting from fiscal incentive are conferred an advantage in relation to competitors located in other states. These competitors may threaten to move into state granting the incentive, unless a similar benefit is offered in the sate when they are acted. Soon, to avoid the risk, all states engage in tax competition. As saturation of new investors grows more difficult, state incentive policies become more aggressive. This includes sending government officials to other states in order to entice firm into relocation. As the practice of granting incentives spread out, the efficacy fades: revenue goes down in all states; and since taxes have been equally reduced every where, the fiscal benefit ultimately loses its power to induce relocation of production. When the process reaches this stage, firms choose their location considering only market and production condition. See Monica, Mora Y. Ricardo Vasano, "Fiscal Decentralisation and Sub-national Fiscal Autonomy in Brazil: Some Facts of the Nineties", <http://federativo.bndes.gov.br.>, November 2001, pp. 10-13.

north-east and center-west are falling badly in quality of services. Most of them cannot raise revenue and therefore, depend heavily on transfer of funds from the federal government and their respective state governments. The federal *Fundo de Participacao dos Municipios* (Municipal Participation Fund) is an indispensable source of income for most of the municipalities. Even those that have tax base do not bother to utilize it fully, preferring to depend on federal and state transfers.

Since 1988, two major changes in the division of powers between federal and sub-national governments have enhanced the role of monetary policy as a tool for macro-economic management in Brazil. First with the elimination of monetary budget, a very important channel for extra-budgetary transfers to sub-national government has disappeared. Secondly, the diminished role of National Monetary Council, which was perceived as being more easily influenced by regional interests, has contributed to strengthening the central bank's control over the money supply. A third monetary policy issue remains firmly in the hand of the federal government concerns the implementation of income policies. Income policies are defined as a means aimed at direct control of nominal variables – such as prices, wages and nominally denominated assets – as part of an effort to lower the inflation rate and restore macro-economic equilibrium. The federal government is empowered with the exclusive authority to improve and enforce price and wage control throughout the nation, with no formal consultation being required with sub-national governments. Such authority is frequently used,

since there has been decentralisation of more traditional levers of macro-economic management such as taxes and public spending⁷. Despite the exclusive federal jurisdiction over the implementation of income policies and the existence of better federal control of monetary aggregate, the quasi-fiscal nature of the central bank has not been completely eliminated. An important remaining issue concerns the inter-governmental relations that take place in the banking system. The conspicuous nature of the central bank's transfer review by state banks is not desirable from a fiscal federalism perspective.⁸ Moreover, increase in the monetary base caused by the central bank's 'bail outs' of failing state banks represents an important source of monetary instability and a significant obstacle to macro-economic management. The chronically weak situation of many state banks in Brazil is attributed to their special relationship with their respective governments. State governments exercise substantial influence in the portfolio allocation of their banks. This is evidenced by the fact that these banks make a majority of loans to their own governments often without due regard to profitability of the loans.

As has been discussed in third Chapter , the Constitution of 1988 has assigned expenditure and tax responsibilities among different levels of government; it has also increased the inter-governmental transfer to sub-national governments. However, federal government continued spending responsibilities at the states and municipal levels. The large increase in tax

⁷ Anwar Shah, *Fiscal Federalism and Macroeconomic Governance: For Better or Worse?* World Bank Policy Research Working Paper Series 2005 (Washington, D.C., November, 1998), p. 6.

⁸ *Ibid.*, p. 7.

sharing mandated by the Constitution prompted some observers to fear for Brazil's macro-economic stability. There were concerns that increase in tax sharing would provoke federal deficit, unless the federal government cut expenditure at the sub-national level. Besides, the federal government switched from developmentalist strategies in the 1980s to neo-liberalism in 1990s. The new strategies also required the federal government to cut expenditure at sub-national level and reduce inter-governmental transfers. Federal government started devolving expenditure responsibilities to the state and municipalities. As a result, expenditure responsibilities of sub-national government increased. Between 1986 and 1995, expenditure at state level increased 33 per cent in real terms, while the GDP grew only 14 per cent.⁹ Because of public pressure to spend more and tax less, sub-national governments could not raise their revenues to meet their expenditure needs. Besides, fourth constitutional amendment authorised the federal government to reduce by 20 per cent the portion of taxes on income and industrial products subject to sharing with sub-national governments.

To meet their expenditure needs, to begin with, states borrowed heavily from different sources. They issued bonds on the domestic market and borrowed from domestic private federal banks and abroad. The federal senate has powers to control borrowing but because of the influence of governors on senators, it did not do so and often generously allowed the

⁹ William Dillinger and Steven B. Webb, *Fiscal Management in Federal Democracies: Argentina and Brazil*, World Bank Policy Research Working Paper, Series 2121 (Washington D.C., May 1999), p. 22.

states to borrow. The generous availability of loans and federal 'bail out' in cases of trouble, encouraged states to borrow even when they were facing debt crisis. Federal government's advice to reduce expenditure was, in general, undermined by states.

The result was, after the promulgation of new constitution, states' first debt crisis had begun in the late 1980s itself. This was resolved in 1993 by rescheduling roughly \$28 billion such debt, and transferring them to the federal treasury. But the federal government had written an escape clause into the agreement. If the ratio of state debt service to revenue rose above a threshold fixed by the federal senate, the excess could be deferred. Deferred debt service would be capitalised into the stock of debt, to be repaid when debt service fell below the threshold amount or in the 10 years after the original 20 year repayment period had expired. With principal rescheduled, debt servicing was considerably reduced. With debt service subject to a ceiling, however, excess debt service was capitalised into the stock of debt, expanding it at a rate that would accelerate whenever real interest rates increased.¹⁰

The agreement established three precedents that influenced debt agreements. First, the agreement reinforced the perception that the federal government was prepared to provide debt relief to any state requiring it. Second, a precedent was set for providing such relief in the form of

¹⁰ *Ibid.*, p. 22

rescheduling, rather than forgiveness. Through the combination of grace periods, rescheduling and debt service caps, the agreements reduced the debt service of sitting administrations, leaving the fiscal consequences to their successors. Third, for heavily indebted states, the limit on debt service largely eliminated the expected future cost of current borrowing and interest capitalisation. The major state debt crisis was precipitated by the success of the federal government's stabilisation plan. The *Plano Real*, introduced in mid-1994, consisted of an initial fiscal and wage adjustment, an exchange rate anchor and a tight monetary policy. The plan had remarkable success. Annual inflation fell from 929 per cent in 1994 to 22 per cent in 1995 and to 9 per cent in 1996. The plan, however, removed a past mechanism of state internal financial control, the ability to reduce real salaries and pension via inflation. As a result, state governments found themselves with payrolls equal to 80 or 90 per cent of their total revenues.¹¹

¹¹ The Brazil' experience also demonstrate critical role of consistency in federal government policies affecting sub-national finances. In Brazil, federal government's policies concerning states debt conflicted with personnel policies embedded in the constitution. While the federal government was urging states to resume servicing their debt, the constitution prevented the states from taking steps needed to do so. The 1988 Constitution has extended central control in areas such as personnel. The constitution defines the rights of public sector employees at all three levels of government. under the constitution, state cannot dismiss redundant employee nor reduce salaries in nominal term. Public employees have right to retire after only 35 years of employment, with a pension equal to their exit salary plus any subsequent increases granted to their previous position. These constitutional guarantees severely restrict the states' ability to adjust. However, constitution provides that in case of high inflation, states can reduce salaries of public employees. In 1994 *plano real* reduced the inflation to a great extent and states were no longer in a position to reduce the costs on personnel. As a result, throughout the debt crisis states' revenues were largely consumed by expenditure on personnel.
see, *ibid.*, p. 23.

The impact of *Plano Real* on interest rates also adversely affected state finances. Because the state debt was indexed, it was still large in real terms when triple-digit inflation ended. Moreover, much of the existing debt was vulnerable to fluctuation in short-term interest rate. 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 debt rate on federal bonds. Domestic real interest rates had been high for several years preceding the *Plano Real*, due to risks associated with inflation. While reducing those risks, the plan's tight monetary policy perpetuated high interest rates. Faced with inflexible personnel costs and persistently high interest costs, the state chose to default. Three main categories of obligations that went into default were: medium-term state bonds, short-term advances and arrears, and losses of state banks.¹²

The largest single objects of default were state bonds. Although 15 states and two municipalities had issued bonds, bonds financing was dominated by four states – Sao Paulo, Rio de Janeiro, Minas Gerais and Rio Grande do Sul. Unable to liquidate the bond debt, the state sought relief from the federal government. Under the so called *troca* (exchange) arrangement,

¹² William Dillinger, Brazil's state Debt Crisis: Lessons Learned, Economic Notes, Country Department 1, Latin American Caribbean Region, The World Bank, <http://www.worldbank.org>, p. 4.

the federal government authorised states to exchange their bonds for more readily marketable federal or central bank bonds.¹³

During the high-inflation years, states regularly used revenue anticipation loans (AROs) and arrears to personnel and suppliers as tactics to cut the real value of outlays, but once inflation declined (after the Real Plan) and real interest rose, states were unable to pay them short-term obligations. As the state AROs debt and arrears to personnel and suppliers mounted, pressure for federal relief increased. In 1995, federal government responded. The third component of state debt originated from the collapse of state banks which had made bad loans to their respective state governments.¹⁴

Negotiations to resolve the debt situations began in mid-1995 with three parties: the federal congress, the president and his economic team and the states. But not until 1998, all states agreed to sign a binding agreement with federal government. Debt was rescheduled rather than written off and a debt service ceiling was imposed above which costs could be capitalised into the stock of debt. The main innovation of the new debt agreements is a large interest rate subsidising rather than requiring sub-national governments to pay the existing interest rate on federal bond, the federal government agreed to impose a fixed real interest rate of 6 per cent.

¹³ *ibid.*, p. 4-5.

¹⁴ Dillinger and Webb, p. 25.

With debt worked out, the federal government has tried to tighten the regulation on state borrowing and persuaded states to privatise their banks. The federal government has been trying to establish a comprehensive framework of discipline and transparency in fiscal affairs and public finance that aims at sustained, long term financial stability and fiscal sustainability at all levels of government. Essential components of these new framework, which will be discussed in the next section are: (i) Fiscal Responsibility Law (ii) tax reform, (iii) administrative reform, and (iv) reform in the social security system.

Innovative Measures and Positive Gains

The fiscal and financial restructuring programme mark a change in the nature of inter-governmental fiscal relations. The simple limitation imposed on sub-national borrowing was replaced by a comprehensive monitoring of their fiscal and financial account, which intend to prevent excessive borrowing and, thus, financial crisis. This new approach was strengthened by the enactment of the Fiscal Responsibility Law (FRL). This is a very complex law, which encompasses many public finance aspects. The key provision of the law are (i) expenditure on personnel shall not exceed 50 per cent for the federal government, 60 per cent for the states, and 60 percent for municipal government of net current revenues; (ii) ceiling for public sector debt, quarterly verifiable, for the state and municipal governments and for the

federal government; and (iii) regulation of the “golden rule”, which establishes that the volume of credit operations cannot exceed capital expenditure.¹⁵

With the purpose of modernising the tax system, a number of proposals of constitutional amendment are being discussed. The main objectives of tax reform are to reduce tax evasion and to strengthen local revenue mobilisation, particularly at the municipal level, within the broad parameters of the current tax legislation. The emphasis on local revenue mobilisation reflects the efforts to reduce dependency of lower levels of government on grants and transfers from higher levels of government, and foster transparency and accountability of public finance, with greater social control and civil society participation in service delivery.

Some of the important measures already taken by the government on the administrative reforms are : (i) constitutional amendment to the Federal Constitution on 14 June 1998 , which increased accession to job tenure to three years of active services from the former two years; established the rule of performance evaluation for the civil servants, with the possibility of terminating the job because of poor performance, and established proportional remuneration for laid-off or part-time civil servants; and (ii) complementary and ordinary laws as well as administrative measures, including the reduction in 20 per cent of the expenditure with commissioned functions, the institution of rules for the dismissal of non-tenured personnel,

¹⁵ The text of Fiscal Responsibility Law, <http://www.federativo.bndes.gov.br>.

the institution of compensation for the job termination for the tenured civil servant, the prohibition of reopening extinct positions, and provision of suspension of financial transfers to the states and municipalities that do not adjust their account to legal expenditure limit with personnel.¹⁶

These initiatives have set the foundations for the construction of a new management system for the public sector, aiming at enabling greater flexibility to changes in society and in public demands. In the present scenario, in order to assure the compliance with targets for the primary surplus for the next three years, the federal government has reduced its capacity of hiring new civil servants through the abolition of over one hundred thousand positions. In addition, the government has adopted a new remuneration policy guidelines for personnel, with the prohibition of new salary increases, new benefits or gratification that have the effect of increasing total payroll of each public entity. Similar measures are being adopted by the states and municipalities.

Local governments, in recent years, rather than the states have become important element in Brazilian federation.¹⁷ The role of municipal governments is changing significantly, not only due to their increased revenue

¹⁶ The Brazilian Embassy, *Brizil Now: Nation of Wonders* (Delhi, December 2000), p. 27.

¹⁷ According to an Ibope public opinion poll of March 1988, 55 percent of a nationwide sample of voters considered the municipalities to be the most important level of government for dealing with daily issues, while only 17 percent cited the states and 16 per cent the federal government. Fifty-one per cent felt that the local governments should have most financial resources of the three governments; only 20 per cent favoured the states and 14 per cent the federal government. Popular support for decentralisation was evidence when 40 per cent said that the municipalities should provide most public services, while 25 per cent favoured the federal government and 21 per cent the state government. see Selcher, n. 4, p. 39.

mobilisations capacity as discussed in the third Chapter but also in terms of their more active role in service delivery, particularly in the social area. It has been argued that the fiscal decentralisations under the 1988 Constitution was essentially a process of municipalisation of revenue mobilisation and service delivery.

It is often being argued that the revenue mobilisation at the municipal level can be improved, particularly through better local tax administration. More recently, the federal government has provided financial, and technical assistance to state and municipal government to improve their tax administration capabilities. Other programmes are now available reflecting the wider diversity of the local demand and capacity building needs. One such major programme providing assistance is called CIATA.¹⁸

¹⁸ CIATA (Convenio de Incentivos ao Aperfeicoamento Tecnico – Administrativo das Pequenas Municipalidades) was one of the first technical assistance programs implemented by the federal government in the area of tax administration. Small municipalities were targeted. The program was implemented in the period 1973-81 and benefited 769 municipalities (one-fifth of the Brazilian municipalities at the time). In the case of local property taxation, for instance, over 3,5 million properties were cadastred with an unprecedented impact on local revenue collection. More recently, attention has been focused at the Ministry of Finance on capacity building at the state, rather than municipal level. A core programme – PNAFE (Programa nacional de Apoio a Administracao Fiscal para os Estados brasileiros), implemented in December 1996, was motivated by the need to improve local revenue mobilization in the context of the state debt renegotiation process. Given the success of PNAFE, a program (PNAFEM, Programa de Modernizacao das Administracoes Tributarias Municipais) will be launched in 2001 to foster capacity building at the municipal level).

Past experience suggests that the most important obstacles to improving revenue mobilization at the municipal level are (1) the maintenance and upgrading of the cadastre of properties for the collection of local property taxes and the selection of appropriate property evaluation mechanisms, and (2) weak municipal tax administration capacity, particularly in auditing. Inadequate municipal tax codes have also been singled out as an important institutional weakness impeding improvements in local revenue mobilization.

Some municipal governments are now using participatory budget formulation process to encourage accountability in expenditure management. For instance, in the municipality of Porto Alegre, consultations with residents are a common place in the formulation of public investment budget. To strengthen accountability and to improve public government, the federal government has launched a programme (*Brasil Transparents*) aimed at encouraging civil society control over budget formulation and expenditure management.

In line with the programs implemented by the Finance ministry, the National Development Bank (BNDES) launched in 1996 a program to strengthen tax administration at the municipal level – PMAT (Programa de Modernizacao das Administracoes Tributarias Locais e de seus Setores Sociais Basicos). Financial support is provided through PMAT for upgrading information technology equipment software and infrastructure; human capital development and training; and contracting-out of technical assistance, among others. Initially, the programs focused on tax administration activities (institutional capacity building, systems and legislation; filing, payment, audit and enforcement; and tax payers services). At the request of municipal governments, the services were extended to encompass expenditure management and control (budget formulation, accounting, and auditing) as well as public administration in the areas of education, health care, social assistance, among others. Currently, PMAT's portfolio in the neighbourhood of US\$200 million, benefiting 92 municipalities, home to 24 per cent of the country's population and 55 per cent of total municipal tax revenues. The program is under way in 26 municipalities with a loan portfolio of US\$ 785 million. In small municipalities not eligible for assistance under these programs, capacity building has been pursued through the distribution of manuals (FGV/EAESP, 2000) with basic legislation and provisions for a local tax code. The increase in collection in the period covered by the program is on average 60 per cent. The program is also cost effective in that the increase in revenues during the program exceeds the total cost of the program in most beneficiary municipalities. Efforts have also been made by BNDES to disseminate successful experiences and best practices, especially through the internet. Technical Assistance Programme: A Brief Survey, <http://www.federativo.bndes.gov.br>.

Rather than aiming at a rapid increase in municipal revenues in short term, improvements in tax administration should focus on longer term, permanent, self-sustained increases in revenue mobilisation capacity, particularly in those municipalities that are more dependent on revenue sharing to finance their local spending. The experience of the municipality of Rio de Janeiro is noteworthy in this areas. A Case in point in the strengthening tax administration is Rio de Janerio.¹⁹

It is interesting to note that the more prosperous sub-national governments are not necessarily the ones that use the best system and have the highest standard in tax administration, and expenditure management and control. Some poor sub-national governments also use state-of-the-art

¹⁹ With a population of 5,6 million, the municipality of Rio de Janeiro has the eight largest subnational budget in Brazil. Among the large state capitals, Rio de Janeiro has the highest share of own revenues in total municipal spending or approximately 60 per cent. This is due, at least in part, to efforts to strengthen tax administration, to improve the cadastre or properties, and the upgrading of integrated tax administration systems and interfaces with tax payers. However, further improvements in municipal tax administration are needed because of the increased demand for public services and the need for fiscal adjustment needed ins support of the consolidation of macroeconomic stabilization.

At end-1998, a three-year programme (PRTOMAT) was implemented to strengthen municipal tax administration. The programme underscores the view that improvements in tax administration should be permanent and self-sustained; and strengthens synergies between tax administration and other institutions such as urban planning, audit and collection enforcement authorities, budget formulation and information technology. The focus is on institutional capacity building in organisation and administration, including reform of functional structures and systems, as well as labor training and re-training, particularly in the provision of services to taxpayers; and on improvement in the cadastre of properties, development of monitoring and control systems for collection, including the recovery of arrears, standardisation of systems and procedures, and the creation of new services to taxpayers. The latter have involved, for example, setting up centres in shopping areas and extension of services to weekends. Preliminary results have shown show speedier resolution of disputes regarding the payment of local property tax (IPTU), the updating of cadastres for 166000 properties and the collection of arrears relative to the municipal VAT (ISS), Strengthening of Tax Administration, The Case Study of Rio De Janerio, <http://www.federativo.bndes.gov.br>.

the highest standard in tax administration, and expenditure management and control. Some poor sub-national governments also use state-of-the-art system and equipment. A variety of e-government system have also been implemented not only for the dissemination of information and public relation initiative, but also for service delivery and quality control. Tax administration has also been benefited from the dissemination of modern IT system to municipal government. For instance, Brazil has been acknowledged for having one of the most advanced systems of electronic filing of income tax returns in the world. Various states are also processing their value added tax (ICMS) return through the internet, including the on-line provision of services to large tax payers. More recently, the federal government and the state of Sao Paulo have not only started to regulate supplier electronically, but also implemented procurement system through the internet via electronic auction.²⁰

The 14th amendment of the Constitution in 1996 provides that for a period of ten years, state and municipalities must spend at least 60 per cent of the resources earmarked for education at the local level of primary education. Federal government must spent no less than 30 per cent of its

²⁰ Afonso and Mello, n.5, p. 11.

earmarked resources in the eradication of illiteracy and development of primary education.

The constitutional amendment has also created the funds for Maintenance and Development of Primary Education and Valorisations of Professorship (FUNDEF). The equalisation of expenditure capacity across and within the states has been an additional objective of the FUNDEF.²¹ The reform in education system has yielded encouraging results. Since 1998, the coverage of the municipal primary education system has increased significantly, pay differential have been reduced across and within the states, and the municipalities have become the main providers of primary education, even in the states where the coverage of the municipal the municipal primary education system was limited. Table 1 shows that compared to the year 1996, in 1999 the enrolment in primary education and pre-school education has increased significantly.

²¹ Ibid., pp. 12-13.

Table 1: Brazil: School enrolment indicators by Government level, 1996-899

	1999					1996				
	Public schools			Private schools	Total	Public schools			Private schools	Total
	Federal	State	Municipal	Federal		State	Municipal			
Total enrolment (in thousands)	122	23111	19245	5557	48034	149	23365	13722	5904	43141
Pre-schools	0	380	2799	1055	4234	2	759	2489	1019	4270
Primary education	0	16589	16164	3277	36031	34	18469	10921	3708	33131
Secondary education	122	6142	281	1224	7769	113	4137	312	1177	5739
(in percent of total enrolment)										
Total enrolment (in thousands)	0.3	48.1	40.1	11.6	100.0	0.3	54.2	31.8	13.7	100.0
Pre-schools	0.0	9.0	66.1	24.9	100.0	0.1	17.8	58.3	23.9	100.0
Primary education	0.0	46.0	44.9	9.1	100.0	0.1	55.7	33.0	11.2	100.0
Secondary education	1.6	79.1	3.6	15.8	100.0	2.0	72.1	5.4	20.5	100.0

Source: IBGE (*base de informacoes Municipais*); Jose Roberto Rodrigues Afonso and Luiz de Mello, "Brazil" An Evolving Federation", November 2000, <http://www.federativo.bndes.gov.br>.

Sub-national governments particularly the municipalities are enjoying greater autonomy in programme design and implementation. This is unprecedented in Brazil, given that policy making had been concentrated at the federal level, often with little concern over differences in regional preferences and needs. In education, concomitantly with that expansion of the municipal primary system more policy making autonomy has been exercised at the local level with increased use of demand-driven, result-oriented, participatory administration in public schools.

In health-care, transfers from the federal government to the states and municipalities are based on the costs of the services provided at the municipal level, rather than needs, and past trends in state budget allocation. As a result, the health care system does not ensure equalisation of spending across municipal jurisdiction. More prosperous municipalities where a wider range of more sophisticated, costly health care services are provided, receive more transfers on a per capita basis than poor municipalities. Recent initiatives have addressed some of the limitation of decentralised provision of health care. Budget allocation for the poor states and municipalities have increased in recent times. Funding for basic and preventive health care programmes has also increased; thereby benefiting poor municipalities. Municipal government are often too small to reap the benefits of economies of scale in health care provision and cannot finance more specialised curative care services. To overcome these difficulties, inter-municipal administrative

ventures have been created within the national health care system. These ventures also perform functions such as personnel management, hiring new staff, licensing private health care providers and procurement.²² In addition to dealing with economies of scale in service delivery, inter-municipal revenues are also important, given the regional externalities associated with the provision of health care.

In short, fiscal decentralisation in Brazil has led to a number of problems. It has only helped rich states and municipalities to increase revenues while poor states and municipalities are incapable of raising revenues. The decentralisation of tax and expenditure have increased the regional economic disparities. Fiscal decentralisation combined with political decentralisation under the 1988 Constitution have weakened the federal government which is responsible for macro-economic stability of the economy. Political decentralisation increased the strength of governors and mayors. Regional interests of governors and mayors and their influence over senators and deputies often oppose the policies pursued by the federal government. Moreover, fiscal decentralisation has led to increase in state debt; inter-state, so called, tax wars to attract investment; and macro-economic instability. However, federal government in recent times has to some extent succeeded in bringing about some reforms such as through Fiscal Responsibility Law, tax reforms administrative reforms and reforms in

²² Ibid., p. 15.

social security. These reforms deal with some of above mentioned problems. Besides some states and municipalities are doing a good job in service delivery in social areas such as health and education. Some states and municipalities have also improved their tax administration; and some have provided for the participation of civil society in budget formulation.

CHAPTER 5

SUMMARY AND CONCLUSIONS

There has been a resurgence of interest in fiscal federalism in virtually every part of the world in recent years. The renewal of interest is observed in countries with federal as well as unitary types of government, spanning across both developed and developing world. Literature on fiscal federalism emphasises upon the gains from fiscal decentralisation. Fiscal federalism, like the political concept of democracy, is considered to be an optimal institutional arrangement for the provision of public services. It combines the advantage of decentralisation with economies of scale. In addition, inter-jurisdictional competition, it is suggested, provides incentives for innovation and increase in productivity in the provision of public services. Fiscal federalism ensures that public services are provided corresponding to the diversified demand conditions in a federal or a non-federal polity. The matching of preference with the supply of public services is enabled by the existence of a large number of jurisdictions with different mixes of public services and tax rates. The larger the number of jurisdictions, the wider is the consumer choice. Also, the more diverse the demand for public services in different jurisdictions, the greater are the welfare gains from fiscal decentralisation. The assignment of expenditure and tax responsibilities are most fundamental issue in any federation. Literature on fiscal federalism provides significant guidance in the

assignment of expenditure and tax responsibilities to different levels of government. It also explains how the inter-governmental transfers should be made to correct imbalances between expenditure needs and revenue means of different jurisdictions in a federation. Thus theoretically, the case for fiscal decentralisation is strong. However, theoretical consideration can guide the assignment of tax and expenditure responsibilities and arrangement of inter-governmental transfers only up to a point; in shaping inter-governmental relationship in actual practice, often historical, social, economic and political factors play an important role.

Therefore, in recent times, fiscal federal arrangements in several countries more specifically developing ones are facing a number of problems. Thus, it is necessary to be cautious about qualified application of economic solution to the problems of different federations without considering the political, social and historical constraints.

Fiscal federalism in Brazil is facing a number of constraints. Federalism in Brazil has not only assumed different federal arrangements throughout its republican history but also did survive the authoritarian military regime between 1964-1985. The Constitution of 1988 marks a landmark which has led to the political and fiscal reconstruction of federalism in Brazil. When the constitution was being formulated, regional interests dominated the constituent assembly. The major concern of the constitution-makers was, how to decentralise economic and political

power. The result is that Brazil has become one of the most decentralised federations in the world. Political and financial decentralisation has strengthened sub-national entities, be they states or municipalities as well as the local political elites. Now, governors and mayors have become important political actors with whom federal policies have to be negotiated. Although constitutional powers of the president are numerous, he nevertheless faces problems in marshalling the support of political parties as party discipline at the national level is weak. Besides, governors act as the leaders of their respective state representatives in the federal congress. For national deputies and senators, loyalty to their respective state governors are more important than to their parties. A new balance of power thus has been established in which diffused power and a fragmented polity have become main elements of the Brazil's political system, with a direct effect on federation. The balance of power between federal and sub-national government has become more delicate than ever. The expanded powers of congress in which governors and mayors have strong influence and the lack of any sustained support for the president means that the president has to negotiate with sub-national governments, each time a bill is to be passed in the congress.

Coming back to fiscal federalism in Brazil, the issues of fiscal federalism have arguably been more thoughtfully addressed in Brazil than in any other developing country. The Constitution of 1988 has made clear assignment of expenditure and tax responsibilities which is broadly

consistent with the theoretical considerations of fiscal federalism. Now states and municipalities are responsible for service delivery in a number of areas which were earlier the responsibilities of the federal government. The decentralisation of tax responsibilities is best illustrated by the change that has taken place in the domain of central value-added tax.

Before the Constitution of 1988, federal government was empowered to levy taxes on communication, fuels, electric power, minerals and transports. However, all these five separate taxes were abolished under the new Constitution, and their tax bases were shifted to the state level. Municipalities are also empowered to levy taxes on services, urban properties, retail sales of fuels except diesel, property transfers and special assessments (*frontage*).

Inter-governmental transfers from federal government to states and municipalities have also increased. The federal government shares its revenue from income taxes and industrial product taxes with states and municipalities through various participation funds established for this purpose. Inter-governmental transfers are redistributive in nature. Most of federal taxes are generated in rich regions; whereas less developed regions contribute less. But the later receive more transfers of fund.

Though fiscal federalism in Brazil is consistent with the theoretical consideration to a large extent, at the same time, it shows the limitations of fiscal federalism in a country characterised by deep- rooted regional

economic disparities and multiple power centers to influence national policy. The decentralisation of tax has only benefitted the rich states and municipalities of south-east, while most of states and municipalities of the less developed regions of north, north-east and center-west are not capable of raising revenues. Thus, fiscal decentralisation has led to increase in regional economic disparities. It has also led to inter-state tax war to attract the private investments by reducing the high-yielding state VAT (value added tax). After the promulgation of 1988 Constitution, the devolution of tax responsibilities was made, while the transfer of expenditure responsibilities was delayed because of political reasons. As a result, sub-national governments enjoyed the revenue responsibilities without corresponding expenditure responsibilities.

However, as the federal government switched from the developmentalist strategies in the 1980s to neo-liberalism in the 1990s, efforts were made to cut expenditure at the sub-national level, and also to reduce inter-governmental transfers. Now, sub-national governments because of their increased expenditure responsibilities, began borrowing heavily from domestic as well as foreign banks. The federal senate has powers to control borrowings; but because of the influence of governors on senators, senate generously continued to allow the states to borrow. Federal government's advice to restrict borrowing and debt was ignored, and this led to increase in states' debt crisis. Taken as a whole, decentralised political federalism in Brazil led states to un-cooperative

fiscal federalism. Political federalism lodges power in state governors and organises interest in regionally state-based political parties. Political stability has come in Brazil at the cost of fiscal uncertainty as the decentralised political system leads state to pursue fiscal strategies that answer local demands, at times leading them to diverge from the federal government's macro-economic strategies.

Federal government, however in recent years, to some extent, has become successful in putting restrictions on states borrowing and in solving debt crisis. President Fernando Henrique Cardoso has taken policy measures to establish a comprehensive framework of discipline and transparency in fiscal affairs that aims at sustained, long-term financial stability and fiscal sustainability at all three levels of government. Fiscal Responsibility Law, tax reforms, administrative reforms, and reforms in social security are emblematic of these developments. Local governments, in recent times, have become important elements in Brazilian federation. Municipalities have progressively taken up expenditure responsibilities assigned to them by the Constitution, particularly in social areas such as health and education. Some municipalities have also improved upon revenue mobilisation. Progress has been remarkable, for instance, in the implementation of information technology system at the local level for the purpose of tax administration and expenditure management and control. Brazil, now has been acknowledged for having one of the most advanced system of electronic filing of income tax returns in the world. Some

municipal governments are also involving civil society in budget formulation. For instance, municipal model of participatory budgeting, developed in Proto Alegre has invited international acclaim.

The theory of fiscal federalism though provides a general normative framework for the assignment of expenditure and revenue responsibilities, and for arrangement of inter-governmental transfers, it does not intend to specify the optimum degree of decentralisation that should exist in a particular country. Each system needs to look for its own solutions. Notwithstanding, a country's experiences -positive or negative - may be helpful for the improvement of federal system. The success and failure of fiscal federalism thus for Brazil must be viewed in a long term perspective. Policy-making in a democracy, especially a new one, is a continuous process. In addition to changes of rules and players, the reputation of institution as well as individuals are also being established. Those with mainly regional interests are learning to get more out of federal, changing and pushing the rule in their favour. While those with nation-wide interests are learning to defend them. The case of Brazil illustrates the problems in fiscal federalism and also some solutions in establishing fiscal restraints in a federal system.

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