Brazil's parties switch sides on fiscal federalism

How President Lula da Silva's party changed from advocate to opponent of fiscal decentralization

BY *MATIAS VERNENGO*

In Brazil, President Lula da Sliva's party has always defended fiscal federalism — the decentralization of responsibilities and revenues — until now. The Workers' Party — *Partido dos Trabalhadores* or PT — was until recently on the side of decentralization while the conservatives in Brazil opposed it. In fact, not only did the PT fight for the federal government to share the burdens of administration with the states and municipalities, but internally the party always rejected the "democratic centralism" common to orthodox leftist parties. For the PT, democracy and decentralization of power went hand in hand.

The PT party platform during Lula's successful bid for the presidency last year promised that "together with a tax reform, our administration will recommend to states and municipalities a redefinition of the federal pact, with the intent of promoting decentralization of social policies and supporting local action." Therefore, it would only be logical to expect, as the tax reform starts to be discussed in congress, to see the administration firmly behind fiscal federalist principles. Alas, that is not the case.

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Long shadow of the IMF

The reasons for this sudden and perplexing about-face on fiscal federalism are far from simple and are to a great extent related to the legacies of the previous administration. More importantly, perhaps, the administration is trying to stay within the fiscal parameters set by the stand-by agreement with the International Monetary Fund (IMF). It is important in understanding the reasons behind Lula's change of heart to analyze both the fiscal situation at the end of Fernando Henrique Cardoso's administration and the logic of the agreement with the IMF.

For more than a decade Brazil has been pushing for a serious adjustment of its fiscal accounts. From 1991 to 2002 the Federal government maintained on average a primary surplus of 2.3 per cent of GDP excluding interest payments on the accumulated debt. The primary surplus in 2002 was 3.9 per cent of GDP. In roughly the same period, transfers to states and local governments fell from around 25 per cent of total federal government outlays to slightly more than 15 per cent. Also, spending on public sector salaries was cut from 32 per cent to 22 per cent of government expenses as part of a difficult reform of the public sector administration. In addition, one should note that during the previous administration the federal government refinanced the debts of states and local governments. These efforts were crowned with a new fiscal responsibility law that imposed limits on expenses related to workers' salaries and a limit to indebtedness.

Lula(l.) speaks to the governor of Minas Gerais.

Taxes higher than OECD countries

Revenues to federal, state and municipal governments increased all through the 1990s, reaching around 36 per cent of GDP in 2002, a level more in accordance with standards of the OECD countries where public services are broader and the quality is better. For taxes however, countries with OECD-level standards of living usually have a much lower tax burden, around 20 per cent of GDP. Part of the increase in federal government revenues was at the expense of state and local governments. Municipalities, in particular, increasingly depend on transfers from the federal government. In 1995 less than 30 per cent of local government revenues were transfers, whereas by 2001 the level had risen to more than 40 per cent of all its resources.

However, despite all the efforts in fiscal adjustment, the public debt for the federal, state, and municipal governments soared

Matias Vernengo, *Assistant Professor of Economics, University of Utah, Salt Lake City (Vernengo@economics.utah.edu).*

from less than 30 per cent of GDP to almost 60 per cent last year. The explanation lies in the heavy burden of debt servicing caused by incredibly high rates of interest. Nominal deficits (including the interest payments on outstanding debt) are on the order of 5 per cent of GDP. In other words, the reason why the public debt soared is related to debt servicing, which is high as a result of the high interest rates maintained to avoid the flight of capital.

Revenues and regressive taxes

Arguably, this mounting public debt is the reason why the IMF and the newly-elected PT government agreed to hike the primary surplus target from 3.75 per cent to 4.25 per cent of GDP at the beginning of the year. Hence, the combination of a long decade of fiscal adjustment — which greatly reduced the ability of states and local authorities to spend — and the IMF agreement meant that there was not much hope for increasing transfers to states and municipalities.

The problems of the Brazilian tax structure are not limited to disputes between the local and federal administrations. The Brazilian tax system is neither efficient nor just in terms of distribution. Hence, there is a lot of room for improvement. For example, indirect taxes are well known to be regressive. In the Brazilian case indirect taxes are particularly troublesome, since the poorest 10 per cent spend 25 per cent of their income on indirect taxes, while for the richest 10 per cent the equivalent share is only 12.5 per cent. Further, a problem emphasized by exporters and by all producers is that several social contributions are cumulative and overtax both exports and production for domestic consumption, making local goods less competitive than imports. Therefore, the government needs to make the tax system more just and efficient, without reducing tax revenues, and without sharing resources with the lower levels of administration.

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Municipalities cut spending

On the local level, in the last few years of the previous administration the states and cities were forced to make severe cuts on their expenses during a period in which inner city problems were increasing as a result of higher unemployment. Some relief was expected from the new administration. As the year progressed and the actual primary surplus was kept above the level agreed with the IMF, at around 6 per cent of GDP; municipalities in Bahia, Minas Gerais, Paraná, Piauí, Rio Grande do Sul, São Paulo and other states announced a two day work stoppage to protest the reduction in the Municipalities Participation Fund *(Fundo de Participação dos Municípios* or FPM).

It became clear that the current crisis of municipal administration could only be resolved by increasing the transfers from the federal government. However, the IMF agreement and the ballooning debt meant that the only possible way to raise transfers would be in turn to increase taxes. Increasing taxes in the midst of a recession would spell disaster for a government that promised to fight unemployment and hunger.

Negotiations on the tax reform in congress got tangled up with the discussion of the federal pact. The PT wants to maintain current levels of revenues, in order to be able to comply with the IMF. For that reason they wanted to transform the temporary tax on financial transactions into a permanent feature of the tax code. The conservative Party of the Liberal Front (*Partido da Frente Liberal* or PFL) insisted that this could only happen if the administration decided to share these revenues with the lower levels of administration. As a result the government decided to extend the temporary tax until 2007 and to share part of the revenues with the states.

A tax break on food and medicine

The tax reform proposal sent to congress also sets a four per cent limit on the sales tax that can be charged on food and medicine. Other goods can be taxed at a higher rate. The tax in this case is Brazil's version of a Value Added Tax — the *Imposto sobre Circulação de Mercadorias e Serviços* or ICMS. There are now more than 40 different rates charged for this tax in different parts of the country. According to the text of the reform only five rates will survive, and the 27 different pieces of state legislation that regulate the ICMS will be unified. This should lead to greater fairness, since the poor spend proportionally more of their income on food and medicine. It will also increase efficiency by reducing bureaucracy. However, there is no guarantee that the maximum ICMS rate of 25 per cent that can be charged on goods other than food and medicine will not lead to an increase in the tax burden.

Given these small concessions, the administration was able to approve the first round of votes on reform in the lower chamber. Another vote in the lower chamber is due before the end of the year and it must also be approved in the Senate. However, the deal with states and municipalities does not necessarily imply sharing resources. The most likely result is that the deal with the lower levels of administration will lead to an increase of taxes. Not only could the ICMS revenues increase, but also new municipal taxes on garbage collection and public lighting have been introduced in the text of the reform. The National Confederation of Industry has already complained that the current reform will not solve the problems of overtaxation and inefficiency. Dissidents within the PT have complained that the reforms are not enough to redress the problems of inequality.

The administration has signaled that given the current situation this is the only possible reform. The solution for the federal pact crisis is to increase the burden of taxation while maintaining the greater degree of fiscal centralism that was implemented by the previous administration. The tables have been turned and the PFL, a party that was behind the fiscal centralization of the 1990s, is now for federalism, while the PT will have to fight for maintaining the present level of centralization, and in the process perhaps lose its identity. It's time for a rewrite of the old dictum of 19th century Brazilian politics: "Nothing resembles a conservative more than a liberal in power." As it is, nothing resembles a fiscal centralist more than a fiscal federalist in power.