VENEZUELA
GUYANA
FRENCH GUIANA (Fr.)
SURINAME
COLOMBIA
ECUADOR
PERU
BOLIVIA
PARAGUAY
CHILE
ARGENTINA
URUGUAY

Atlantic Ocean

Pacific Ocean

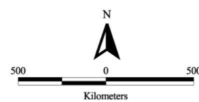
Roraima
Amapa
Amazonas
Pará
Maranhao
Ceará
Rio Grande do Norte
Paraíba
Piauí
Pernambuco
Alagoas
Sergipe
Acre
Rondônia
Mato Grosso
Tocantins
Bahia
Goiás
Distrito Federal Brasilia
Minas Gerais
Espírito Santo
Mato Grosso do Sul
Sao Paulo
Rio de Janeiro
Paraná
Santa Catarina
Rio Grande do Sul

Brazil

Capital: Brasilia
Population: 178 Million
(2004 est.)

Brasilia, the Capital, is situated within the Distrito Federal.

Boundaries and place names are representative only and do not imply official endorsement.



Sources: ESRI Ltd.; CIA World Factbook; Times Atlas of the World

Federal Republic of Brazil

FERNANDO REZENDE

The Federal Republic of Brazil covers 8.5 million square kilometres – about half the total area of South America. Its 184 million inhabitants are unequally dispersed among twenty-six states and the federal district, or 5,558 municipalities (see Table 1 for basic data). Most of the population is located in the six southern states, where the demographic density reaches sixty inhabitants per square kilometre. Although the centre-west and the Amazon regions represent more than 60 percent of the territory, they account for only 15 percent of the population. Population density is also high in the nine poor northeast states on the coast, where nearly 18 percent of the population resides within a perimeter of 1.5 million square kilometres

Africans brought in during the slavery era and a large inflow of migrants from every corner of the world, especially in the late nineteenth and early twentieth centuries, contributed to the multiple faces that characterize Brazil's population nowadays. Despite this, intermarriage and cultural assimilation has produced a quite homogeneous society. Everyone speaks Portuguese, the official language, and cultural values do not differ to a significant extent.

The demographic concentration mirrors the concentration of economic activity. The six southern states account jointly for three-fourths of the gross domestic product (GDP), which reached about US$800 billion in 2005 (1,580 billion in purchasing power parity dollars), placing Brazil among the leading countries in the world in terms of economic size. The country's modern agribusiness and growing modern service economy contribute to a better balanced composition of domestic output. Recent data (2004) point to an economic structure akin to those of modern industrial countries, with the dominance of services (about half of GDP) and a sizable manufacturing sector (about one-fourth of GDP). A still

Table 1
Basic information

Official name: Federative Republic of Brazil
Population: 184 million inhabitants
Area (square kilometres): 8.5 million square kilometres
GDP per capita in US: $ 4,323 (2005)
Constitution: 1988, Republican
Orders of government: Three
Constitutional status of local government: independent units of the federation
Official language: Portuguese
Number and types of constituent units: 26 states, the Federal District, and 5,558 municipalities
Population, area, and per capita GDP in US$ of the largest constituent unit: São Paulo – 38.7 million inhabitants; 248,200 square kilometres; GDP pc = US$4,163
Population, area, and per capita GDP in US$ of the smallest constituent unit: Roraima – 357,300 inhabitants; 224,300 square kilometres; GDP pc = US$1,529

important agriculture sector (10 percent of GDP) reflects the recent expansion of highly productive farms that emerged from the incorporation of modern technologies into rural areas.

From a regional standpoint, due to a bias in regional representation in the National Parliament in favour of the less developed north, northeast, and centre-west regions, economic size does not translate directly into political influence on national policies. These regions have sparsely populated states, which are entitled to a minimum of eight representatives in the Lower House, while the highly populated states in the south have a maximum of seventy representatives. Thus, the less populous states exert a strong influence on decision making pertaining to issues related to fiscal and intergovernmental relations.[1] The political imbalance in the representation of the states in the Lower House is reinforced by the equal representation in the Federal Senate (three per state). Although this is a common federal feature, the extended role of the Senate in the Brazilian Federation – all legislation, not only that directly related to federal issues, has to pass through both legislative houses before being sanctioned by the president – creates additional difficulties.[2]

Imbalances in political representation result from the dominance of the regional issue in the formation and consolidation of the Brazilian Federation. The federal regime put into place by the first republican Constitution in 1891 empowered the states with a substantial degree of autonomy and sowed the seeds for the autonomy of local government. Since then, subnational autonomy and regional balance have become intertwined issues, and a proper balance between them has been seen as essential in maintaining internal cohesion in an economically and socially unequal society.[3]

Inequality is, therefore, one of the main features of the country. Parts of the south and the southeast – particularly the state of São Paulo – present indicators of economic development akin to those of modern industrial countries: a high level of per capita income, a high degree of urbanization, diversification in industrial production, and satisfactory social conditions. At the same time, large portions of the country – especially in the north and northeast – still show the classic signs of underdevelopment: low per capita income, poor sanitary conditions, and widespread poverty. It is worth noting, however, that the incidence of poverty is not associated with regional imbalances in economic development. This is because the developed regions have attracted and retained a large number of people below the poverty line.

With the exception of intermittent periods of authoritarian rule, democracy evolved over time and achieved high standards after the mid-1980s. A multi-party system allows for a fairly diversified composition with respect to the distribution of political power in the federation. Despite this, governability is achieved by means of coalitions that, in national politics, contribute to increasing the weight of small political parties beyond what is indicated by their actual size. The practice of forming coalitions has contributed to the stability of the Brazilian democracy, which recently passed two important tests: (1) the impeachment of the president who was elected in 1989 and (2) the 2003 hand-over of the federal government to the first leftist president to be elected in the entire republican period.

A stable democratic regime and sound institutional arrangements have contributed to helping the Brazilian economy muddle through the turbulence generated by the sequence of external financial crises that have hit emerging economies worldwide since the mid-1990s. Yet the macroeconomic policies the country adopted to attenuate the impact of this turbulence severely hampered economic growth, which showed a meager 2.4 percent annual average rate of increase between 1995 and 2004. These policies also impinged upon the subnational autonomy envisaged by the 1988 Constitution.

Being a creature of the transition from authoritarianism to democracy, the 1988 Constitution reacted to two strong forces: (1) the demand for greater autonomy for subnational governments and (2) calls from organized pressure groups for more and better access to state-sponsored social protection. In so doing, it installed a dual fiscal regime. On one hand, the states and municipalities acquired greater power to tax and a greater share of traditional federal revenues; on the other hand, a distinct set of compulsory levies – the so-called social contributions – was assigned to the federal government to finance pensions and free access to health care and social services for every Brazilian citizen regardless of previous contribution to

the social security system. Because the extended social rights depended on the federal government's ability to raise enough money to meet a steep rise in social spending, in addition to large surpluses in the public accounts to keep inflation at bay, recourse to social contributions fed a process that reversed the fiscal decentralization intended by the 1988 Constitution.

Over time, equality, autonomy, efficiency, and growth objectives collided. Increasing reliance on federally collected social contributions eroded subnational autonomy. It also worked against promoting efficiency and accountability in public policies through decentralization as earmarked grants from the federal government, supported by revenues from such contributions, became necessary to finance the provision of social services by state and local governments. At the same time, vertical and horizontal imbalances increased in so far as the basis of equalization funds lost importance over time. In addition, inefficient social contributions created further obstacles to economic growth. Therefore, an overhaul of the Brazilian fiscal federalism system is desperately needed.

STRUCTURE OF GOVERNMENT AND DIVISION OF FISCAL POWERS

Brazil is a three-tier federation. According to the 1988 Constitution, states and municipalities are independent units of the Brazilian Federation. Both have independent taxing powers and share with the federal government responsibilities for public services and development policies. A growing direct relationship between the federal and local governments is a source of intergovernmental conflicts and increasing complexity in fiscal relations.

The formal assignment of expenditure responsibilities follows the subsidiary principle. Thus, the Constitution assigns the provision of basic urban and social services (urban roads, water supply and sewerage, public transportation, streetlights, primary education, and basic health and social assistance services) primarily to local governments. These local governments count on technical and financial assistance from the federal and state governments to carry out these responsibilities (see Table 2). Following the usual pattern, the federal government is solely responsible for the armed forces, foreign relations, international trade, and monetary control.[4]

In practice, however, due to high economic and social inequalities, most of the responsibilities are shared in the federation. Responsibility for law and order is mainly in the states' hands, but organized crime, drug trafficking, weapons smuggling, money laundering, and other illegal activities are in the federal jurisdiction. In the social area, with the exception of social protection for private-sector workers (pensions and related benefits),

Table 2
Legislative responsibility and actual provision of services by different orders of government

Legislative responsibility (de jure)	*Public service*	*Actual allocation of function (de facto)*
Federal	Defence	Federal
Federal/state	Law & order	Federal/state
Federal/state	Basic Education	State/local
Federal/state	Higher education	Federal/state
Federal	Health	State/local
Federal	Social assistance	Local
Local	Water and sewerage	State/local
State	Police	State
Federal	Environmental protection	Federal/state
Local	Street cleaning and lighting	Local
Local	Public transportation	Local
Local	Urban infrastructure	Local
Local	Waste collection	Local
State	Fire Protection	State

which is the sole responsibility of the federal government, provision of basic education, health care, and other social services is split among states and local governments on a more or less equal basis (see Table 3). The federal government intervenes directly in higher education and in more sophisticated health services.

The absence of a clear definition of the functions to be performed by each order of government is a major source of continuing conflicts. On the tax side, conflicts come up whenever measures adopted by the federal government reduce revenues from the income and manufacturing taxes that form the basis of the present revenue-sharing system. Conflicts also arise when federally sponsored legislation interferes with subnational tax autonomy, for example by granting exemptions from the state value-added tax (VAT) for exports. In such cases, demand for financial compensation becomes a permanent focus of conflict because the compensation has to be negotiated annually during the regular budgetary process. On the expenditure side, changes in rules governing federal financial aid to social programs carried out by the subnational governments are also a source of intermittent conflict.

Table 3
Direct expenditures by function and level of government (percent)

Function	*Federal (%)*	*State (%)*	*Municipal (%)*	*Total (%)*	*% of GDP*
Defence	99.8	–	0.2	100.0	0.9
Debt servicing	85.4	12.0	2.6	100.0	10.4
General administration	46.1	28.9	25.0	100.0	5.3
Law and order	26.2	71.5	2.4	100.0	3.2
Economic services[1]	53.7	33.9	12.4	100.0	3.3
Social services	51.9	25.3	22.8	100.0	23.6
Health	26.5	33.6	39.8	100.0	3.8
Education	15.6	49.8	34.6	100.0	5.3
Old age	85.5	11.3	3.3	100.0	10.7
Other social services	32.6	22.6	44.8	100.0	3.7
Subsidies[2]	...	...	...	...	...
Total	58.0	26.1	15.9	100.0	46.7
Local Public Services	13.6	43.3	43.0	100.0	10.1
Primary and secondary education[3]	1.7	43.5	54.9	100.0	3.2
Health	26.5	33.6	39.8	100.0	3.8
Housing and community amenities[4]	3.9	14.3	81.9	100.0	1.2
Environmental protection[5]	14.6	42.8	42.5	100.0	0.3
Police services	10.1	87.1	2.8	100.0	1.6

Notes
The functional classification of expense basically follows the IMF/GFS 2001 methodology.
1. Includes general economic and commercial affairs, agriculture, forestry, fishing and hunting, fuel and energy, transport, communications, R&D, and economic affairs.
2. Amounts related to subsidies are not broken down.
3. Amounts were estimated to exclude outlays other than for primary and preschool and secondary education.
4. Includes housing development, expenditures related to urbanism – street paving and lighting, waste collection, traffic and other urban services.
5. Includes waste water management, water supply, and sewerage.

Conflicts among the states and their municipalities are also noteworthy. The 1988 Constitution granted state legislators the authority to set the criteria for dividing one-fourth of the proceedings of the state VAT that belongs to the municipalities. Quite often, such changes prove contentious because they may be seen to favour political allies or to create losses for some municipalities.

A council of the states' finance ministers was created in the 1970s and was the sole attempt to provide an institution that would be in charge of mediating conflicts. The federal finance minister presided over the council, which worked properly during the authoritarian regimes for obvious reasons. After redemocratization, the federal government could no longer impose rules that had to be obeyed by all, and the council, albeit still formally in existence, was deprived of any power to harmonize states' tax policies. The council lost credibility and became unable to enforce legislation prohibiting special tax concessions by any state without the unanimous approval of all twenty-six states and the federal district.

A long tradition of applying symmetric arrangements to asymmetric situations makes it difficult to avoid conflicts or to find proper solutions. In the fairly heterogeneous Brazilian Federation, symmetric arrangements cannot lead to a proper equilibrium among subnational government units. Symmetry is reflected in equal powers being granted by the Constitution to every state or municipality whatever its size, region, and economic and social characteristics. Well-developed industrialized states and frontier states have to abide by the same rules with regard to administrative organization, tax powers, and expenditure responsibilities. The same goes for large metropolitan cities and small rural municipalities, where differences are even greater. Both have similar organizational structures, a directly elected legislative body, and direct access to federal funds.

Although subnational governments enjoy a great degree of constitutional autonomy, the amplitude of the legislative power of the federal government, in fiscal and regulatory matters, has curtailed the decision-making power of the former. By means of complementary laws to the Constitution, the federal government defines the framework within which states and local governments can set norms for imposing and collecting their own taxes. Federal legislation also establishes detailed provisions concerning the elaboration and execution of subnational budgets. With regard to regulation, the detailed rules of the federal laws leave almost no room for the states in areas such as public utilities, environmental protection, and the exploration and exploitation of natural resources.

In fact, local governments have more autonomy than do the states in so far as the former are entitled to regulate the use of municipal land and the provision of urban services, impose user charges, and define norms for collecting property taxes. In general, local governments also have a

reasonable degree of autonomy over their budget because, on average, about 40 percent of their revenues come from general-purpose grants.

Through earmarked grants and control of the subnational debt, the federal government has increased its influence on subnational policies. Coupled with hard budgetary constraints that were put in place to sustain macroeconomic stability, the degree of freedom of state governors to allocate budgetary resources has been curtailed significantly. The situation is somewhat better at the local level, the large metropolitan cities aside, because the criteria applied to divide the municipal share of federal taxes is biased towards smaller municipalities and penalizes the states' capital cities. The state capitals generate one-third of GDP and house one-fourth of the population but get only 10 percent of this pie.

Conversely, subnational governments can interfere in national policies only by means of their representatives' actions in the national Congress. That happens when proposals for federal regulation on the use of natural resources, the provision of public services, or the exercise of tax powers by state and local governments affect state and local government interests. However, due to the fragmentation of political parties and the nature of the electoral process, representatives from the states in the Lower House and the Senate do not always act in accordance with the wishes of state governors, weakening subnational influence on national politics.

FISCAL FEDERALISM AND MACROECONOMIC MANAGEMENT

The success of a monetary stabilization plan adopted in 1994 to close an era of high inflation had important consequences for federal finance. For decades, inflation made it easy to curb budgetary deficits as tax revenues were fully indexed and most expenditure items were not. Thus, through postponing payments and adjusting nominal salaries and pensions only once a year, fiscal disequilibria were easily corrected.

A stable currency brought structural imbalances to light. Expenditure on personnel and social security benefits showed the real effect of a paternalistic approach to past policies concerning employment and pensions across the federation. At the same time, a tight monetary policy to protect the Brazilian economy from external shocks raised the amount of money required to service the public debt.

In the beginning of this new era, price stability was anchored to the overvaluation of the new currency – the real. But the successive external financial crises that hit emerging economies in the second half of the 1990s – Mexico (1995), Southeast Asia (1997), and Russia (1998) – forced the Brazilian government to abandon its policy to control the exchange rate in 1999 and, instead, to let the national currency float. Thus, monetary

stability came to depend on responsible management of the fiscal accounts, and fiscal discipline took the place of the exchange rate as the anchor for averting inflation.

The new inflation targeting regime, adopted in 2000, relies on properly functioning monetary and fiscal policies. The National Monetary Council formed by the finance and planning ministers and the president of the Central Bank not only set targets for the inflation rate for two years in a row but also set the interval within which the actual result could differ from the desired outcome. The Central Bank is in charge of bringing inflation as close to the mark as possible, making use of the interest rate to adjust expectations and force convergence towards the target. To that end, the Central Bank has enjoyed a fairly large degree of autonomy, although it does not have formal independence from the national government.

In the fairly decentralized Brazilian Federation, the enforcement of fiscal discipline required important institutional changes. The Fiscal Responsibility Law (FRL), inspired by the highly praised New Zealand experience, was enacted in 2000. This law enforces fiscal discipline at the federal, state, and local government levels through the imposition of objective and clear rules for administering revenue and expenditure policies, the public debt, and government assets. It emphasizes transparency in the public administrator's use of the resources extracted from taxation. Among the norms set by the FRL, the following are worth noting:

1 Limits on spending for personnel. Remuneration of public employees shall not exceed 50 percent of net current revenues at the federal level and 60 percent at the subnational level.
2 Indebtedness limits. Outstanding debts cannot exceed two times current revenues for the states and 1.2 times for local governments. With regard to debt service, annual payments cannot surpass 11.5 percent of current revenues in both cases. In addition, resources from new loans cannot exceed 16 percent of current revenues in any fiscal year.
3 Provision for recurrent expenditures. Public authorities cannot take actions that create future expenses lasting more than two years without identifying a source of financing or a compensating cut in other expenses.
4 Special provision for electoral years. The law prohibits outgoing governors and mayors (in their last year in office) from using tax revenues to provide short-term loans, increase wages, or contract new public servants.

Failure to fulfill obligations imposed by the FRL leads to several administrative penalties, to which personal incriminations included in an additional law may be added. More serious misbehaviours may be punished with the loss of the mandate, ineligibility for employment in the public

service, fines, and imprisonment. It is worth emphasizing that all levels of government, federal included, have to abide by the conditions established in the FRL.

To make it possible for states and large municipalities to adhere to the new rules concerning the public debt, previous debts with the federal government were refinanced on favourable terms for a period of thirty-five years. However, unlike previous bailouts, the beneficiaries of such renegotiations were prohibited from issuing new bonds and were required to transfer between 11 percent and 13 percent of their current revenues to the federal treasury on a monthly basis for the duration of these contracts. Together with limits set by the Central Bank on the exposure of public and private banks to public clients, control over subnational government indebtedness was duly enforced. To ensure enforcement, debt-refinancing contracts entitled the federal government to sequester state and local government revenues from federal transfers in the case of failure to comply with the agreed-upon rules.

The hard budgetary constraints put into place by the Fiscal Responsibility Law brought control to public finance. Since its inception, the public sector as a whole has saved a sizable amount of money and reversed the ascending trajectory of the total public-sector debt-to-GDP ratio. The primary surplus – that is, the balance between total revenues and non-financial expenditures – rose steadily between 1999 and 2005, with states and local governments contributing approximately one-tenth of the overall result. Thus, after having reached 7.5 percent of GDP in 1998, the public-sector debt ratio dropped to 2.7 percent in 2004 despite a tight monetary policy that sustained high interest rates.

Conditions built into subnational government debt contracts became a good substitute for macroeconomic fiscal coordination. The revenue sequestration mechanisms adopted, as well as the forced privatization of state-owned banks, worked as a tool to force fiscal discipline at the subnational level. Together with the limits set in the FRL for personnel spending and debt financing, previous windows for irresponsible management of subnational government accounts were duly closed.

As time goes by, incumbent and opposition leaders alike perceive that the culture of fiscal discipline is an important political asset. Yet, present concerns point to the consequences of a lengthy period of public spending restraints on economic growth and income inequality. As public investment plunged, notably at the federal level, road construction and maintenance suffered a severe setback, creating an important handicap for growth in exports of goods. In the social area, difficulties in improving the quality of education and health services will increase the problems faced by low-income people in gaining access to better-paid jobs and escaping the poverty trap.

ISSUES IN REVENUE-RAISING RESPONSIBILITIES

The 1988 Constitution is the basis of the current assignment of taxing powers in the Brazilian Federation (see Table 4). The federal government is solely responsible for imposing taxes on income (corporate and personal), foreign trade, and rural property as well as on payroll. The federal government can also make use of contributions intended to intervene in the economic domain and of any other potential tax source not explicitly attributed to the state or local governments by the Constitution (residual powers).

Federal and state governments have overlapping powers for taxing goods and services. The former is entitled to taxes on manufacturing goods and the social contributions earmarked to finance pensions, health, and social assistance. The states are empowered to levy a VAT type of tax on goods, which is also applied to transportation and telecommunications services. In addition to taxing general services, local governments are entitled to tax ownership and sales of urban property and to apply user charges. An inheritance property tax and a motor vehicle tax are also under the states' jurisdiction.

Despite the constitutional separation of tax powers, subnational governments do not have total autonomy to apply their most important taxes. As mentioned before, complementary laws to the Constitution set the basic rules to be followed by states and municipalities with regard to the state value-added tax (the ICMS) and the municipal services tax (the ISS). These laws narrow the scope of state and local government legislators with regard to the definition of the tax basis but do not interfere with rates. Rates of the states' VAT are only constrained by a constitutional provision that prohibits internal transactions from being taxed at a rate lower than the smallest rate applied to interstate sales.

Restrictions imposed on the subnational governments' ability to implement their most important taxes do not mean that the tax system is harmonized. The residual legislative powers of state governments allow for great differences with regard to the rates applied to each category of goods, ways to reduce the effective tax burden (reduction in the tax base, for instance), special regimes for small businesses, criteria adopted for the utilization of tax credits paid on inputs used to produce exempted export goods, and preferred tax rates for food and other essential consumption items.

Another source of differences in the tax burden imposed on the same goods across the federation arose out of demands from less developed states to apply a reduced rate on goods shipped from the more industrialized south and southeast states to the north, northeast, and centre-west regions to allow consumer states to reap part of the revenues from interstate sales. As a result, a 7 percent rate applies to shipments from the south/

Table 4
Tax assignment for various orders of government
F = Federal; S = State; L = Local; R = Regional

	Determination of			*Shares in revenue (%)*				
	Base	*Rate*	*Tax collection and administration*	*F*	*S*	*L*	*R*[1]	*All orders*
Federal								
TAXES								
Import tax – II	F	F	F	100.0				100.0
Export tax – IE	F	F	F	100.0				100.0
Rural territorial tax – ITR	F	F	F	50.0		50.0		100.0
Income tax – IR	F	F	F	53.0	21.5	22.5	3.0	100.0
Tax on manufactured goods – IPI	F	F	F	43.0	29.0	25.0	3.0	100.0
Tax on financial operations – IOF				100.0				100.0
Financial operations dealing with gold – IOF-Ouro	F	F	F		30.0	70.0		100.0
Other taxes and fees	F	F	F	100.0				100.0
CONTRIBUTIONS								
Social contributions								
On sales of goods and services	F	F	F	100.0				100.0
On financial transactions – CPMF	F	F	F	100.0				100.0
On net profit – CSLL	F	F	F	100.0				100.0
On payroll – employee/employer	F	F	F	100.0				100.0
On payroll earmarked to primary education	F	F	F	Shared under special legislation[2]				
Other contributions	F	F	F	100.0				100.0
Royalties – oil and hydroelectric dams	F	F	F	Shared under special legislation[3]				
Contribution on production and imports of oil – CIDE	F	F	F	71.0	21.8	7.2		100.0

Table 4
Tax assignment for various orders of government
F = Federal; S = State; L = Local; R = Regional (*Continued*)

	Determination of			*Shares in revenue (%)*				
	Base	*Rate*	*Tax collection and administration*	*F*	*S*	*L*	*R*[1]	*All orders*
State or provincial								
TAXES								
IRRF withheld on state civil servants' wages[4]	F	F	S		100.0			100.0
Motor vehicle property tax – IPVA	S	S	S		50.0	50.0		100.0
Tax on inheritance and gifts – ITCD	S	S	S		100.0			100.0
Tax on circulation of goods and services – ICMS	F, S	F, S	S		75.0	25.0		100.0
CONTRIBUTIONS								
On employees' wages earmarked to pensions	S	S	S		100.0			100.0
Local								
TAXES								
IRRF withheld on municipalities' civil servants' wages[4]	F	F	L			100.0		100.0
Urban land and territorial tax – IPTU	L	L	L			100.0		100.0
Tax on real estate ownership transfer – ITBI	L	L	L			100.0		100.0
Tax on services – ISS	F	F, L	L			100.0		100.0
Betterment taxes	L	L	L			100.0		100.0
CONTRIBUTIONS	L	L	L			100.0		100.0
On employees' wages earmarked to pensions	L	L	L			100.0		100.0

Primary sources: Federal Constitution and Federal Revenue Service.
1. Amount channelled into a regional development fund.
2. Two-thirds goes to the states on a derivation basis. States and municipalities can have access to the other one-third on a project basis.
3. Royalties: states and municipalities receive compensation for the exploration of petroleum, gas, hydroelectricity, and other mineral resources inside their territory or in the adjacent maritime platform.
4. Income tax withheld on the earnings of state and local government public servants.

southeast to the north/northeast/centre-west regions, whereas a 12 percent rate applies to interstate sales flowing in the opposite direction. The same 12 percent rate applies to interregional transactions. This mixed origin-destination principle caused distortions in resource allocation and provided a strong incentive for tax evasion. It also led to the main weapon used in the so-called fiscal war in which Brazilian states have been engaged in order to attract investments and new industries to their jurisdictions.[5]

With respect to the municipal tax on services, a recent constitutional amendment exempted exports from this tax and allowed for the imposition of a ceiling and a floor on rates by way of a complementary law whose purpose was to avoid great variation and to curb harmful competition in metropolitan areas.[6] However, other less visible means for providing fiscal benefits, such as reducing the tax base and providing better terms for payment, may compensate for that.

Fiscal competition among the states in Brazil gained new impetus in the mid-1990s in a bid to attract a new wave of foreign direct investment in the Brazilian automotive sector away from the São Paulo metropolitan region. Due to the mixed origin-destination principle applied to the state VAT, neighbouring states could shift the burden of the fiscal incentives offered to foreign investors to the state of São Paulo, which houses the most important consumer market. In what came to be known as a fiscal war, southern states (mainly Parana, Rio de Janeiro, and Rio Grande do Sul) succeeded in luring investors to locate new plants in their territories. They did this by providing additional benefits, such as infrastructure and training programs for the labour force, to the more usual tax concessions. In one case only, the federal government intervened to move the location of an automotive plant to the northern state of Bahia. Several studies pointed to the irrationality of a fiscal war for attracting investment. However, politicians and public administrators thought it was a good response to the absence of a federal policy to discourage even greater concentration in the already highly concentrated manufacturing activities in a few locations in the country.[7]

Of course conflicts arose out of the fiscal war, making it very difficult to implement any proposal for harmonizing the tax system and propelling tax administrators to cooperate. Cooperation is also hampered by conflicts related to the taxation of natural resources – oil in particular. For oil, as well as for electricity generation, the 1988 Constitution adopted a destination principle for the states' VAT so that producer states would not reap all the revenues from these important tax bases. However, as revenues from oil and electricity came to represent a sizable portion of the taxes collected by the state treasuries, producer states claimed that this exception to the general rule did a lot of harm to their finances. In recent years, states have recognized the cost of this fiscal war and are currently engaged in serious negotiations in an attempt to bring an end to wasteful tax competition.

FISCAL EQUITY AND EFFICIENCY CONCERNS AND INTERGOVERNMENTAL FISCAL TRANSFERS

Despite the tax powers assigned to states and local governments by the Constitution, data on tax collections by each order of the federation show a remarkable degree of vertical imbalance. The federal government obtains a little less than 70 percent of all the money extracted from businesses and households through various taxes. The states collect about 25 percent of total tax revenues, and local governments account for the rest.

Three distinct regimes attempt to address the vertical disequilibria: (1) a conventional revenue sharing system, (2) separate rules concerning the share of state and local governments in revenues from specific taxes, and (3) conditional transfers.

The pillar of the revenue-sharing system is the participation of states and local governments in sharing the proceeds of federal income and manufacturing taxes. According to the 1988 Constitution, 21.5 percent of federal revenues from these taxes goes to the states and 22.5 percent to the municipalities. At the same time as the Constitution more than doubled the share of federal taxes going to states and municipalities, it asked for a revision of the apportionment formula. But implementing this provision became impossible due to conflicts that arose over attempts to carry out the revision. Consequently, quotas for each state and municipality were frozen on the basis of the coefficients prevailing at the time the Constitution was promulgated, and the previous practice of making adjustments in light of updated income and population estimates was abandoned.[8]

Another important component of the revenue-sharing system is the 25 percent share of local governments in their states' VAT collections. Three-fourths of the municipal share is distributed according to the value added in each local jurisdiction; the rest follows rules set by the respective state legislators. Municipalities with a strong economic base benefit from the first criteria, whereas the formulas adopted by the states tend to favour political allies and are subject to frequent changes. Local governments also get 50 percent of revenues from the rural property tax collected by the federal government and from the motor vehicle tax applied by the states.

States and local governments are entitled to keep revenues from the income taxes withheld from their own employees, to receive 100 percent of the proceeds from the federal tax on financial operations in gold (30 percent for the states and 70 percent for the municipalities), to participate in a compulsory levy on the wage bill (earmarked for basic education), to share in federal revenues from a compulsory levy on oil imports, and to receive compensation for exempting exports from the states' VAT. These other sources of subnational revenues are not important in global terms.[9]

Table 5
Vertical fiscal gaps, 2003[1]

Percentage of GDP

Level	*Total revenue collected*[2]	*Total revenue available, including net transfers for that level of government*	*Expenditures*[3]
National	28.8	23.3	31.7
Subnational	13.3	18.7	21.1
State/provincial	10.6	11.3	13.5
Local	2.7	7.4	7.6
All orders	42.1	42.1	52.8

Percentage of total

Level	*Total revenue collected*[2]	*Total revenue available, including net transfers for that level of government*	*Expenditures*[3]
National	68.4	55.4	60.1
Subnational	31.6	44.6	39.9
State/provincial	25.3	26.9	25.6
Local	6.4	17.7	14.4
All orders	100.0	100.0	100.0

US$ millions

Level	*Total revenue collected*[2]	*Total revenue available, including net transfers for that level of government*	*Expenditures*[3]
National	145,777.8	118,239.0	160,667.9
Subnational	67,462.1	95,000.9	106,823.7
State/provincial	53,878.2	57,312.3	68,376.9
Local	13,583.9	37,688.5	38,446.8
All orders	213,239.8	213,239.8	267,491.6

Primary source: National Treasury Secretariat, Federal Finance Minister.

1. 2003 average exchange rate: US$ 1 = R$ 3.07.
2. Current and capital revenues. Does not include loans.
3. Current and capital expenses. Capital expenses exclude debt refinancing.

Royalties from the exploration of natural resources should also be mentioned. Federal legislation establishes the rules for compensating states and municipalities for the extraction of oil, mining, and loss of land due to inundation provoked by hydroelectric dams. Municipal governments are the main beneficiaries of these royalties. The most important distortions in the distribution of royalties are found in the extraction of oil in the maritime plateau in the northern coast of the state of Rio de Janeiro.

With the exception of a constitutional mandate to earmark 25 percent for basic education, resources channelled to state and local government coffers under the revenue-sharing system do not carry any provisions concerning their use. The same applies to the shares of the specific taxes listed above, with the sole exception of the one earmarked for basic education.

Among the conditional transfers, the most important is the health transfer system. A recent constitutional amendment established that the money allocated in the federal budget to finance health spending should increase in line with GDP growth on the basis of the amount spent in the previous year.[10] There is no fixed amount to be transferred to subnational governments. One portion is allocated to state and local governments on a per capita basis to cover basic health care services. Another is distributed on a service provision basis and so follows the spatial distribution of the health service network. Financial cooperation in health care is assured by earmarking 12 percent of state revenues and 15 percent of municipality revenues for health care spending. On the whole, the federal government covers about 60 percent of the health care bill. States and municipalities split the rest on a more or less equal basis. Given the concentration of sophisticated health care facilities, in larger municipalities resources from the health transfer system are more important than is the share of federal government revenues.

The abandonment of the original formula conceived for the revenue-sharing system and the proliferation of other transfers led to the absence of any criteria guiding the intergovernmental flow of resources in the federation. The outcome of such a situation is a hazardous process of redistributing the fiscal pie. On the vertical perspective, the big winners are the municipalities, who have seen their share of the fiscal pie more than treble in relation to own revenues (after taking into account all kinds of intergovernmental money transfers), while the increase for the states has been only 40 percent. As a result, total disposable revenues are roughly split in the following manner: 50 percent to the federal government, 30 percent to the states, and 20 percent to the municipalities. Besides passing on about 30 percent of what it collects to subnational governments, the federal government has lost discretion over more than half its available revenues as it increasingly depends on taxes earmarked for social spending.[11]

Worse still is the outcome regarding the horizontal distribution of fiscal resources. Of the total amount collected by the states, nearly three-fourths belongs to the seven states that comprise the south and southeast region. Among the municipalities, the twenty-six more important metropolitan cities raise more than 60 percent of total local government own-source revenues. Moreover, as each specific transfer follows its own logic to distribute money across the twenty-six states, the federal district, and nearly 5,558 municipalities, an enormous horizontal disparity arises in the distribution of fiscal resources across the federation.[12]

Data on the per capita revenues of the states and municipalities illustrate the size of these imbalances. Current budgetary per capita revenues can be as much as twenty to thirty times greater in small municipalities located in thinly populated regions than they are in the more populous municipalities. Among states, disparities are less severe but still significant. In this case, the low population density of the newly created states in the Amazon and centre-west regions means that the per capita revenues of these states are more than three times higher than the national average. More densely populated states in the northeast, with the single exception of Sergipe, are among those with the lowest per capita revenues.

Inequalities are particularly severe in metropolitan areas, where the outcome is determined by the manner in which economic activity and population are distributed geographically. In general, due to their share in state tax collections, municipalities with an important manufacturing sector and a small population have per capita budgets several times higher than the regional average. At the other extreme, municipalities with a very large population and a fragile economy, usually functioning as a dormitory city, are severely underfinanced, having per capita budgets well below the regional average.

One undesirable consequence of expanding transfers to municipalities without a concomitant revision of the distribution formula was the proliferation of new units. More than one thousand municipalities were created after 1988 because the distribution formula rewarded districts that decided to "emancipate" themselves. They were rewarded either because they housed major industries, in which case they would receive a high quota of the state ICMS, or because they had few people, in which case they would benefit from the apportionment under the Municipal Participation Fund. The combination of these two factors provided an ideal opportunity for demanding autonomy because, in the case of secession, the rules at the time did not require the approval of residents in other parts of the municipality.

Lack of a well-designed institutional arrangement to provide a rationale for the system and to mediate conflicts of interest is a large handicap for better functioning intergovernmental fiscal relations. Brazil does not have a formal fiscal equalization transfer program but, rather, a constitutionally

mandated revenue-sharing mechanism that automatically delivers a fixed proportion of income and federal manufacturing tax revenues, plus other minor taxes, to states and local governments on the basis of predetermined fixed rates.[13] Coupled with specific purpose grants, the absence of an equalization thrust in the general-purpose transfers is responsible for a fairly high degree of horizontal disequilibria in the distribution of fiscal resources in the Brazilian Federation, and this adds to the difficulties faced in achieving cooperation in public policies.

FINANCING CAPITAL INVESTMENT

A very low degree of budgetary flexibility – due to excesses in earmarking revenues and a large interest and pension bill – led to insignificant levels of public savings throughout the federation. Data for the public sector as a whole point to a current account surplus of a meager 2.06 percent of GDP, with the federal government showing zero savings and the states as a whole only 0.9 percent of GDP. Conversely, the municipalities show healthier figures. About two-thirds of local governments' investments are financed by savings. Municipalities, on average, show a savings ratio of 1.12 percent of GDP.

Coupled with high indebtedness ratios, the fall in public savings brought public investment along with it. The average rate of public investment was around 3 percent of GDP in the early 2000s, down from the already low 4.2 percent registered in the second half of the 1990s, and shows no sign that it will improve to a significant degree in the short run. Contrasting with the situation that prevailed in the 1970s, when the public sector accounted for a sizable part of total gross capital formation in the Brazilian economy, the state now accounts for less than 20 percent of the annual rate of capital accumulation in the country.

In theory, lack of savings could be compensated by an increase in borrowing. The Brazilian Constitution grants autonomy to federal, state, and local governments with respect to access to the financial market. The only restriction is the requirement of Senate approval for state and local government access to money from external sources.

In practice, however, the situation is much different. As mentioned earlier, the Fiscal Responsibility Law put into place tough limits for the outstanding debt of states and local governments as well as for the amount of their current revenues that can be used yearly for debt servicing. Moreover, Central Bank regulations impose a severe limit on the exposure of public and private financial institutions to public entities, with the result that even financially sound subnational public entities cannot get extra money for financing capital investments. As for the federal government, although limits demanded by the FRL have not yet been put in place, the already high debt-to-GDP ratio imposes a natural barrier to borrowing.

Restrictions on capital financing could be relaxed by reducing the earmarking of government revenues at all levels and going forward with institutional reforms to alleviate the pressures that pension systems put on public budgets. This would allow for the restoration of public savings. Proposals to deal with this situation have been put forward recently, but politicians do not look favourably on the very sensitive issue of cutting pensions or erasing the guarantees to their financing. The proposals also face strong resistance from labour unions and better organized lobbies.

The low level of public investment generates problems for economic growth and inequalities in income distribution, and this has led to a search for alternative means of investment financing. A new federal law, along with similar laws adopted in some states, has been enacted to open room for the formation of partnerships between public and private organizations aimed mainly at gathering resources to finance infrastructure projects. These new institutional arrangements have not had enough time to show how much can be expected from them. The still low degree of confidence in the capabilities of the regulatory agencies and the public bureaucracy's lack of familiarity with such arrangements mean that this alternative may take some time to show its full potential.

Whatever the possibility of exploring alternatives, the need to restore public investment is compelling. In less developed regions, privatization or partnerships will not meet the needs of infrastructure modernization. In metropolitan areas, the absence of public investment means that many low-income families do not have access to good basic urban services, and many newcomers have no access at all. At the same time, health and education infrastructure deserves more attention, especially from state governments.

FISCAL FEDERALISM DIMENSIONS OF THE PUBLIC MANAGEMENT FRAMEWORK

Subnational governments exercise almost complete discretion with respect to the management of their internal affairs. State and local governments alike are free to set rules governing the careers of public servants, hire personnel, set wages and salaries, and establish employee pension systems. In matters related to their own workforce, they are only constrained by the constitutional provisions that require candidates to pass exams in order to obtain permanent positions in the public sector, the federal government included, and that prohibit public administrators from firing public servants without justifiable cause. To circumvent the rigours of the rules concerning public-sector employment, menial jobs – such as security, cleaning, transportation, and low-level administrative tasks – are contracted out to private firms selected by special auction procedures. This introduces some flexibility into areas where it is most needed. The FRL has

established limits on personnel costs, which have also induced the substitution of private services for direct public employment.

Health care provides the main example of private agents being actively engaged in service provision under special agreements. The national health system joins the financial, managerial, and human resources of the federal, state, and local governments to give free access to every Brazilian citizen to basic health care as well as to more complex procedures carried out at public and private hospitals. The health care model has been extended to social assistance, and proposals have been floated for adopting a similar approach in the case of public safety. The health system is the most important attempt to improve efficiency and efficacy in public management by means of coordinating policies throughout the federation.

Coordination of public investment and services provision by local governments is impaired by the inability of state governments to organize production of urban and social services across the limits of local jurisdictions. This is particularly important in metropolitan regions and other urban agglomerations. In so far as the states cannot interfere in municipal autonomy, they lack the legislative power and administrative capability to enforce metropolitan policies. In addition, the increasingly direct relationship between the federal government and the municipalities, with high amounts of federal funds being channelled directly into the local purse, undermines the ability of the states to control activities that take place in their territory. Superimposition of programs and lack of integration and coordination lead to waste of resources, higher costs, and uneven access to public services – that is, poor people in less endowed municipalities may receive fewer benefits than the less poor in financially rich municipalities. Attempts to achieve coordination by means of a consortium of municipalities to deal with issues of common interest have proved to be unsatisfactory because the volatile political alignment of mayors contributes to the instability of such arrangements.[14]

Excessive dependence on transfers can be blamed for the non-materialization of the expected benefits from fiscal decentralization. As transfers become the major source of revenues for half the states and the majority of municipalities, efficiency in the use of resources at the subnational level is impaired and accountability cannot be properly exercised. Less reliance on own taxes makes individuals less conscious of the consequences of the expenditure decisions of governors and mayors. And lack of accountability adds to inefficiency and facilitates misconduct in dealing with the public money.

THE WAY FORWARD

Most of the flaws in Brazil's fiscal federalism observed in recent years are the direct result of the dual fiscal regime that was adopted in the 1988 Constitution and of the lack of will to pursue thorough reform thereafter.

Coupled with the dominance of macroeconomic issues in the fiscal policies designed in past decades, this duality led to a reversal of the fiscal decentralization envisaged at that time. There has been backward movement in the quality of the tax system, and increasing constraints on the actual exercise of the fiscal autonomy formally granted to states and local governments, with deleterious impacts on the efficiency and efficacy of public policies.

Nonetheless, politicians and policy makers alike do not see reform as a high priority. Conflicts of interest among developed and less developed states as well as among large and small municipalities may be one of the reasons for that. Another is the fear expressed by federal authorities that any reform proposal could reduce federal revenues and so jeopardize the sustainability of macroeconomic fiscal targets. In addition to more objective reasons for immobilization, it seems that politicians as a whole, mainly those from less developed regions, might be stuck in the view that the present system works to benefit their constituencies. In fact, everyone fears that any movement could lead to unexpected results and so could undermine their particular interests.

An opportunity to reform the entire system was lost in 1993, when the federal Constitution opened a window for a complete reform to be carried out under favourable terms.[15] After that, federal authorities opted for a narrow focus, directed only at minor issues related to taxation, reasoning that any attempt to pursue a broader reform, including changes in the revenue-sharing system, could endanger macroeconomic stability. Meanwhile, successive ad hoc measures have helped to exacerbate distortions and to increase conflicts in the federation.

A consensus among pundits about the need to go for a thorough reform of the Brazilian fiscal federalism model is being formed, but public authorities and politicians are still far from endorsing this view. In the midst of strong antagonisms, every federal entity fears that a structural reform could run against its particular interests. To make matters worse, private business is now very active in the fiscal policy arena and lobbies against any change that might be prejudicial to its interests. On the positive side, society at large has a general aversion to further increases in taxation; this may help to convince political leaders that a complete reform is long overdue.

These are positive signs, but large challenges must be faced in order to achieve a broad understanding of proposals for a new fiscal federalism. A new model will have to be able to reconcile tax harmonization, macroeconomic fiscal discipline, subnational autonomy, and governments that are efficient in the use of fiscal resources and accountable to their citizens. Moreover, the likelihood of an increase in regional disparities in the wake of higher rates of economic growth is not conducive to a reduction in antagonisms that block the search for structural changes.

Nevertheless, the main impediment to reform is the still uncertain situation concerning the vulnerability of the Brazilian economy to external shocks. In the event of an international crisis, macroeconomic pressures may be conducive to renewed resistance on the part of the federal government to changing the present system, thus postponing the reconciliation of Brazil's fiscal federalism with the challenges of economic globalization and monetary stability.[16]

In the meantime, efforts should be made to expose in a clear and understandable way the present system's lack of economic and political rationale. Empirical evidence contained in recent studies has to be translated into terms that can be easily perceived by regional and local leaders throughout the federation so that the need for a thorough reform can be clearly stated and understood.

A forum to discuss the present system and to appraise alternatives to improve federal cohesion and efficiency in public services provision would be of much help. To that end, thirteen states have taken an important first step by creating the Fiscal Forum of the Brazilian States, which has just begun to explore the main issues involved as a prelude to the preparation of a package of reform proposals. Such a process could create a window of opportunity for fundamental reform of the fiscal system in Brazil.

NOTES

1 On imbalances in political representation, see José Serra and José Roberto Afonso, "Federalismo Fiscal à Brasileira: Algumas Reflexões," *Revista do BNDES* (Rio de Janeiro) 6, 12 (1999): 3–30.

2 This particular aspect led Alfred Stepan to consider Brazil an extreme case of a democratically constrained federation. See Alfred Stepan, "Toward a New Comparative Analysis of Democracy and Federalism: Demos Constraining and Demos Enabling Federations," mimeo, Coréia do Sul, 1997.

3 On the importance of the regional issue, see Celina Souza, "Constitutional Aspects of Federalism in Brazil," in *A Global Dialogue on Federalism,* vol 1: *Constitutional Origins, Structure and Change in Federal Democracies,* ed. John Kincaid and G. Alan Tarr, 77–102 (Montreal and Kingston: McGill-Queen's University Press for the Forum of Federations, 2005).

4 For a detailed account of the division of responsibilities in the Brazilian Federation, see Marcelo Piancastelli, "The Federal Republic of Brazil," in *A Global Dialogue on Federalism,* vol 2: *Distribution of Powers and Responsibility in Federal Countries,* ed. Akhtar Majeed, Ronald L. Watts, and Douglas M. Brown, 67–90 (Montreal and Kingston: McGill-Queen's University Press for the Forum of Federations, 2006).

5 See Ricardo Varsano, "Subnational Taxation and Treatment of Interstate Trade in Brazil: Problems and a Proposed Solution," ABCD-LAC Conference, Valdivia, Chile, 1999.

6 Constitutional Amendment 37/2002. A top rate of 5 percent was imposed afterwards.

7 For details on fiscal competition in Brazil, see Ricardo Varsano, "A Guerra Fiscal do ICMS: Quem Ganha e quem perde," IPEA Discussion Paper, Brasília, 1997.

8 The shares of each state were established by CONFAZ. A percentage was set for all municipalities within each state in order to prevent the creation of new municipalities from having outside effects.

9 For the municipalities as a whole, these other revenue sources represent about 6 percent of total revenues.

10 Constitutional amendment 29/2000.

11 By means of transitory amendments to the Constitution, the federal government regained discretionary spending power over 20 percent of revenues from contributions earmarked for social spending.

12 The extent of the fiscal gaps can be seen in Sergio Prado, Waldemar Quadros, and Carlos Cavalcanti, "Partilha de Recursos na Federação Brasileira," FUNDAP, São Paulo, 2003.

13 The 1967 original formula established that the state quotas would be directly related to population and inversely related to per capita income, whereas the municipal quotas would grow with population size but at a decreasing rate.

14 See Fernando Rezende and Sol Garson, "Financing Metropolitan Areas in Brazil: Political, Institutional, Legal Obstacles and Emergence of New Proposals for Improving Coordination," *Revista de Economia Contemporânea* (Rio de Janeiro) 10, 1 (2006): 5–34.

15 The 1988 Constitution called for an entire revision to be carried out five years after its promulgation under special procedures that included approval by single majority in a joint parliamentary session.

16 These challenges are the subject of Fernando Rezende and Jose Roberto Afonso, "The Brazilian Federation, Facts, Challenges and Perspectives," in *Federalism and Economic Reform: International Perspectives,* ed. Jessica Wallack and T.N. Srinivasan, 143–88 (New York, NY: Cambridge University Press, 2006).