Brazil: Maintaining Fiscal Discipline Amid Regional and Social Antagonisms

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In 1994, Brazil adopted a monetary stabilization plan that not only ended an era of high inflation, but also had a profound effect on federal finances. A newly stable currency brought structural imbalances to light and forced public administrators to come to terms with their accounts. In the fairly decentralized Brazilian federation, the enforcement of fiscal discipline required important institutional changes. A "fiscal discipline" law, enacted in 2000, imposed limits on personnel expenses and on the level of state and local government indebtedness. At the same time, hard budgetary constraints imposed by the macroeconomic goals of price stabilization impinged on subnational autonomy with respect to the disbursement of their budgetary resources.

Currently, vertical and horizontal inequalities in the distribution of the fiscal resources, as well as a low degree of freedom in revenue allocation at all federal levels, are major sources of inefficiency in public spending. Due to citizen reaction to further increases in the overall tax burden, the growing awareness of the need to combat inefficiency and improve quality in the use of public resources has prompted a new wave of demands to focus the fiscal debate on the expenditure side of the budget.

In the beginning of the monetary stabilization era, price stability was anchored on the overvaluation of the newly created currency, the *real*, but the successive external financial crises that hit emerging economies, such as Mexico, Southeast Asia, and Russia, in the second half of the 1990s forced the Brazilian government to abandon exchange rate controls in 1999 and let the national currency float on the market. With the devaluation of the *real*, monetary stability came to depend upon a responsible management of the fiscal accounts. A new inflation target policy was put into place and fiscal discipline took the place of the exchange rate as the anchor used to avert inflation.

The 1988 Constitution enhanced subnational tax powers and, in an effort to protect social policies, established a dual fiscal regimen. It created a social budget with a specific set of federal taxes – the so-called "social contributions" - to which subnational governments were also required to contribute. However, the ensuing economic crisis did not favour state and local government revenues, whose finances also suffered from the impact of high interest rates on their budgets. With the new fiscal discipline, the extended social rights had to rely on the federal ability to raise enough money to meet a steep rise in social spending. To that end, the new federal taxes earmarked to the social budget began to rise, initiating a process that reversed fiscal decentralization.

Besides concentrating spending power in federal hands, the recourse to the social contributions to meet increases in social spending had negative consequences for the economy and the federation. The cascading effect of such contributions generated economic inefficiencies and distorted foreign trade. For the federation, the rise of conditional grants cut deeper in subnational spending autonomy and increased vertical and, particularly, horizontal imbalances.

The reversal of fiscal decentralization affected mainly the states. Even though Brazilian states enjoy a great degree of constitutional autonomy, their decision-making power is relatively limited. The federal government defines the limits within which states and local governments can set norms for applying and collecting taxes on goods and services; establishes detailed provisions

concerning subnational budgets; and leaves almost no room in its laws for the states in areas such as public utilities, environmental protection, and the exploration of natural resources.

Even on the expenditure side, state governors' degree of freedom to allocate budgetary resources has been reduced to almost none. Entitlements and earmarked revenues plus day-to-day operational expenses leave practically no money to finance investments and, as access to loans is very limited, their ability to pursue development policies has vanished. Furthermore, the "fiscal discipline law" prohibited state and local authorities from taking actions that lead to further expenses without specifying a source of financing or an equivalent cut in other outlays. So it is not by chance that the states have resorted to the only means available to attract manufacturing plants: to engage in a fierce tax competition that has become one of the main sources of antagonism among the Brazilian states.

The situation at the local order is quite a different story; in fact, in Brazil local governments have more autonomy than the states. They are entitled to regulate the use of municipal land and the provision of urban services, impose service charges, and define their own norms for collecting property taxes. In general, they also have more autonomy over their budgets, as a significant part of their revenue comes from general purpose grants.

The revenue-sharing mechanisms enshrined in the Constitution entitle the municipalities to 22.5 percent of the federal income and manufacturing taxes and 25 percent of the states' Value Added Tax (VAT) collections. However, the criteria applied to divide the municipal share on federal taxes are biased toward smaller municipalities and penalize the core metropolitan cities, which house one-quarter of the population but get only 10 percent of this pie. These distortions in the revenue-sharing mechanisms have led to a high degree of horizontal inequality in the distribution of the public money across the federation. Sparsely populated units in the Amazon and the centre-west regions receive higher amounts of money in per capita terms than those administered by the poorer but highly populated northern states.

Due to the autonomy granted to municipalities, state governments cannot coordinate investments and the provision of urban and social services across the limits of local jurisdictions. And an increasingly direct relationship between the federal government and the municipalities, with large amounts of federal funds being channeled directly into the local purse, undermines the ability of the states to have any control over the activities that take place in their territory. Superimposition of programs and lack of integration and coordination lead to waste of resources, higher production costs, and an uneven access to public services, as poor people in less endowed municipalities may get fewer benefits than those who are more well off and living in financially rich municipalities. **As macroeconomic constraints will remain in place for some time to come, and the national reaction to further increases in the tax burden does not open much space for deeper taxation, a call for measures to reduce waste in the use of the budgetary resources echoes across the country**. Notwithstanding, the vertical and horizontal imbalances and strong antagonisms that characterize the current Brazilian federation make concrete advances in this direction very difficult without a thorough reform of Brazilian fiscal federalism.