

**IMPACTS OF GLOBALIZATION ON STRATEGIES FOR
COMPETITION IN SUBNATIONAL GOVERNMENTS—
THE CASE OF BRAZIL**

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1) GLOBALIZATION, FEDERALISM AND COMPETITION

International relations began the 1990s amidst a scenario conventionally known as the post-Cold War, and there was ample space for new political, economic, and environmental debate, in addition to issues such as the democratization of States and the universal spread of human rights². The phenomenon of globalization became recognized

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² Gilberto M. A. Rodrigues. *O que são relações internacionais (What are international relations)*. 2nd ed., São Paulo: Brasiliense, 1999.

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as the sign of a new age – of values, norms and processes that would be adopted and applied across the planet³.

Among the diverse, complex consequences of globalization, two simultaneous but opposing trends were at work: integration and fragmentation. The setting-up of economic blocs in Europe (*EU*) and in the Americas (*NAFTA*, *Mercosur*), led to new political and economic scenarios with competition no longer between individual States, but between groups of States. These blocs have been developing, now in harmony, now in discord, and always with a tenuous regard for the global international norms regulated since 1995 by the World Trade Organization (*WTO*).

At the same time, national States disintegrated: peacefully, as with Czechoslovakia (Slovakia and the Czech Republic) and the USSR (Russia and other Republics), or violently, as with Yugoslavia (Slovenia, Croatia, Bosnia-Herzegovina, Serbia and Montenegro), throwing into stark relief the problem of ethnic, racial and linguistic conflicts involving vulnerable minorities faced with state structures that historically tried to impose homogeneity, and were often artificial.

The phenomenon of globalization, which gained so much strength and intensity in the 1990s, created what Professor John Kincaid⁴ aptly dubbed *federalist ferment*. The strong tendency toward decentralization, which was the hoped-for and demanded consequence of the redemocratization or the strengthening of democratic regimes, put the idea and practice of federalism on the international agenda. This *federalist ferment* has helped create new “cakes” and make existing ones more sophisticated, giving them new shape.

In the case of Latin America, the three largest States in the region (coincidentally all are federal states) – Argentina, Brazil and Mexico – embarked upon processes of profound macroeconomic reform *pari passu* with political decentralization, which has demanded redefinition within their respective federative pacts.

³ Gilberto M. A. Rodrigues and Clóvis Brigagao. *Globalização a olho nu (Globalization visible to the naked eye)*. São Paulo: Moderna, 1998.

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In Kincaid's view, a democratic federation is "a republic of republics, which emphasizes partnership and cooperation for the common good, while also allowing diversity and competition to foster liberty and efficiency"⁵ (my emphasis).

In States that have a federative or quasi-federative form, the issue of competition is no longer merely a preoccupation of central governments. With the opening-up of trade frontiers, subnational governments have been exposed to new capital and investment flows and have begun to dispute these resources directly, where this was formerly the monopoly of federal government. One of the consequences of globalization has been the deterritorialization of production, the possibility of manufacturing virtually anywhere, leading transnational corporations to turn to the so-called emerging markets, which began to be part of global webs⁶, prompting fierce competition within and between subnational governments.

The emergence of subnational governments as international players is meaningfully illustrated by the ranking of the world's most competitive economies drawn up by the International Management Development Institute (*IMD*), headquartered in Switzerland. The 2003 ranking put the State of São Paulo, a component part of Brazil, in thirteenth place, the best placing of a subnational government on the list, ahead of countries like Korea (15th), Italy (17th), India (20th) and Brazil itself (21st)⁷.

If subnational governments have the autonomy to compete for resources, which is a consequence of the strengthening of democratic federations, it must be recognized that this competition brings with it the risk of being harmful to the well being of citizens and threatens the sustainability of the national State, possibly weakening its sovereign integration into the international scenario.

⁴ John Kincaid. Introduction. In: Handbook of Federal Countries, 2002. Forum of Federations (2002), p. 6.

⁵ Op. cit., p. 7.

⁶ Robert Reich. A Teia Global (*The Global Web*). In: O Trabalho das Nações (*The Work of Nations*) (1994), p. 102-109.

⁷ São Paulo é uma das 15 economias mais competitivas do mundo (*SP is one of the 15 most competitive economies in the world*). Valor Econômico, 14/5/2003, p. A4.

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Brazil faces what Rubens Ricupero has called the ‘dilemma of globalization’⁸. Solution of this dilemma, from the standpoint of the Brazilian federation, demands a thorough analysis of the impact of globalization on the new strategies of subnational governments, particularly of the distortions created by international trade and fiscal competition among the constituent units.

To better understand this challenge in the case of Brazil, it is necessary to understand the structure of Brazil’s federalism. What, then, are its peculiarities?

2) BRAZILIAN FEDERALISM

One can identify a pre-federative scenario even in the colonial period (1500-1822), among the 14 hereditary captaincies (*capitanias hereditárias*), which were territorial units created by the Portuguese Empire in order to make possible the defense, upkeep and administration of its vast territory in South America at minimum cost⁹.

After independence was proclaimed on 7 September 1822, Brazil became a parliamentary monarchy, in the form of a unitary State, possessing merely administrative provinces (*províncias*). Throughout the Monarchy (1822-1889) there were permanent tensions between the central government and revolutionary movements that often led to bloody local uprisings. In the parliament there were those who championed centralization and decentralization: the former bolstered by political realism and fed by the Portuguese inheritance; the latter encouraged by regional interests and the growing influence of North American federalism¹⁰.

Only with the end of the monarchy and the institution of the Republic through the military coup of 15 November 1889 did political decentralization become a reality both within the legal constitutional framework, by the transformation of provinces into states

⁸ Rubens Ricupero. *O Brasil e o dilema da globalização (Brazil and the dilemma of globalization)*. São Paulo: Senac, 2001.

⁹ Valeriano Mendes Ferreira Costa. Brazil. In: *Handbook of Federal Countries*, 2002, p. 91-104.

¹⁰ Gabriela Nunes Ferreira. *Centralização e descentralização no Império (Centralization and Decentralization in the Imperial Period)*. São Paulo: Editora 34, 1999.

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(*estados*), and in the strongly regional relations that sprang up in the period from 1889 to 1930—known as the “politics of the governors” (*política dos governadores*)¹¹. Within the Legislative Branch the states gained their own representation, by means of the Federal Senate.

In the following period (1930-1945), under the dictatorial regime of Getúlio Vargas, the states lost their autonomy. They were to win it back from 1946 to the military coup of 1964, which installed an authoritarian military government, when the Brazilian Federation was once again centralized, under the domination of the Union. The redemocratization process of the 1980s, which culminated in the constituent process of the 1988 Constitution led again to the autonomy of subnational governments and ushered in the contemporary federative phase.

The 1988 Constitution of the Federative Republic of Brazil sets forth in its very first article the federative principle among other fundamental principles, thus characterizing the form of the Brazilian State:

*Article 1 – The Federative Republic of Brazil, formed by the indissoluble union of the states and municipalities and of the Federal District, is a legal democratic state (...)*¹².

This legal device, an immutable clause (*cláusula pétrea*) of the Constitution – in that it may not be amended¹³ - shows that the Brazilian federation has three federative tiers: the Union, the states and the municipalities. The Federal District, although it stands out, is similar to the other states.

The subnational governments thus make up 26 states plus the Federal District, and some 5,561 municipalities¹⁴. From a legal-formal standpoint the states have identical powers and duties among themselves, granted by the Constitution, in the same way as the

¹¹ Fernando Henrique Cardoso. *Dos governos militares a Prudente-Campos Sales (From the military governments to Prudente-Campos Sales)*. In: FAUSTO, Boris (dir.). *O Brasil . Estrutura de Poder e Economia (1889-1930) (Brazil: The Structure of Power and Economy)*. São Paulo: Bertrand Brasil, 1989, p. 15-50.

¹² Constitution of the Federative Republic of Brazil, 1988. Senado Federal (1997), p. 3.

¹³ According to Article 60, paragraph 4 – No proposal of amendment shall be considered which is aimed at abolishing: I – The federative form of State. *Op.cit.*, p.49.

¹⁴ <http://www.ibge.gov.br> (July, 2003).

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municipalities have, among themselves. There are therefore no historical-constitutional rights to differentiate subnational governments within the same tier of government.

Each state, regardless of its characteristics, is represented equally in the Federal Senate (*Senado Federal*), through three senators, elected by universal suffrage, with eight-year mandates and the right to unrestricted re-election. Article 46 sets forth that:

Article 46. The Federal Senate is composed by representatives of the states and of the Federal District, elected by a majority vote.

Paragraph 1 –Each state and the Federal District shall elect three senators for a term of office of eight years¹⁵.

The inequality among states is acknowledged in their representation in the Chamber of Deputies (*Câmara dos Deputados*), in which each one may elect a minimum and a maximum number of members of parliament by a populational criterion. In this way, as an example, the State of São Paulo (22% of Brazil's total population) has 70 Deputies, while the State of Amapá (0.03%) has eight¹⁶.

Some criticize this ratio as distorted and unjust toward the more highly-populated states which are under-represented *vis-à-vis* their populations; others accept and defend it as necessary for federative balance. At the core of this debate lies the problem of regional economic inequalities, the struggle between the North and North-East (less developed and less populated) on one side, and the South and South-East (more developed and more populated), on the other.

The Federal Supreme Court (*Supremo Tribunal Federal*) is the highest instance of the Brazilian Judicial Branch and has the power to settle vertical or horizontal (inter-tier or within-tier) disputes between federated entities by direct or indirect control of constitutionality.

All states elect governors (*governadores*) and all municipalities elect mayors (*prefeitos*) by direct secret ballot, with four-year mandates and the right to re-election.

¹⁵ Op. cit., p. 39.

¹⁶ Valeriano Mendes F. Costa, Handbook of Federal Countries, 2002 (2002), p. 100.

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Exclusive taxation powers of subnational governments

The taxation powers of Brazil's federative entities are fixed by the Federal Constitution. Article 155 sets forth for states, that:

Article 155. The states and the Federal District shall have the competence to institute taxes on:

I – transfer by death and donation of any property rights;

II- transactions relating to the circulation of goods and the rendering of interstate and intermunicipal transportation services and services of communication, even when such transactions and renderings begin abroad;

III –ownership of automotive vehicles;¹⁷

Among state taxes, the Value-Added Tax on Merchandise and Services—*Imposto sobre Circulação de Mercadorias e Servicos (ICMS)*, provided for in item II, of article 155, is the most important¹⁸.

The municipalities became autonomous federal entities in Brazil under the 1988 Constitution, thus setting up a third formal tier of government within the structure of the State. Only Brazil and Mexico possess this system in Latin America. Constitutional tax autonomy of the municipalities is established in article 156:

Article 156. The municipalities shall have the competence to institute taxes on:

I - urban buildings and urban land property;

II – inter vivos transfer, on any account, by onerous acts, of real property by nature or physical accession, and of real rights to property, except for real security, as well as the assignment of rights to the purchase thereof;

III – services of any nature not included in article 155, II, as defined in a supplementary law;¹⁹

This legal power to levy taxes of the states and municipalities is supplemented by a complex resource-sharing system in the Brazilian federation, including a States' Participation Fund and a Municipalities' Participation Fund²⁰.

¹⁷ Op. cit., p. 93-94.

¹⁸ Valeriano Mendes F. Costa. Handbook on Federal Countries, 2002 (2002), p. 97.

Intergovernmental relations

Valeriano Mendes Costa writes that “the non-existence of administrative institutions and structures intended to manage the coordination of public policies, and the incipient culture of horizontal or vertical cooperation among units of the federation has given way to very heterogeneous and fragmentary patterns of intergovernmental relations”²¹.

The National Internal Revenue Policy Council—*Conselho Nacional de Política Fazendária* (CONFAZ), the major mechanism for inter-state cooperation, has proved incapable and unrepresentative by virtue of its inappropriate structure and the unilateral practices of its members. Among municipalities there can be seen to be a growing movement towards aggregations at a national level, well represented by the National Confederation of Municipalities—*Confederação Nacional de Municípios* (CNM) and the National Mayors’ Front—*Frente Nacional de Prefeitos* (FNP).

It must be recognized that the Brazilian federative structure, made up of the old framework and the emerging models, is being fuelled by the *federalist ferment*. So how is globalization impacting Brazil’s “cake”?

3) THE IMPACT OF GLOBALIZATION ON THE BRAZILIAN FEDERATION

Rui de Britto Álvares Affonso, analyzing decentralization and local development in Brazil from the federative standpoint, states that both have been marked by two trends. “On one hand by the globalization of the international economy and Brazil’s adhesion through moderate increased external openness, and on the other hand by the

¹⁹ Op. cit, p. 96.

²⁰ Sergio Prado et alli. *Partilha de Recursos na Federação Brasileira (Resource-sharing in the Brazilian Federation)*. São Paulo: Fundap, Brasília: IPEA, 2003.

²¹ Valeriano Mendes F. Costa. Las relaciones intergubernamentales em Brasil: acontecimientos recientes y perspectivas. In: *Las relaciones intergubernamentales em los países federales*. Forum of Federations, 2002, p.65.

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introduction of liberalizing reforms that led to the destructuring of the State apparatus inherited from the national-developmental period”²².

These trends stem from the Washington Consensus, a set of World Bank and IMF guidelines of the early 1990s, proposing fiscal adjustments, economic openness and the shrinking of the role of the State, which directly hit the formulation and management of economic policy in Latin America²³.

The 1990s saw reform of the State and the crisis within the federation. With the Real Plan for economic stability launched in 1994 by the then Minister of Finance, Fernando Henrique Cardoso, Brazil entered upon a phase of gradual fiscal adjustments and the dismantling of the State that would reduce the *de facto* autonomy of states and municipalities.

During the two mandates of President Fernando Henrique Cardoso (1995-1998, 1999-2002), the federal government’s priority was to guarantee continued stability of the currency, absolute control over inflation and the modernization of the Brazilian State.

Renegotiation of states’ and municipalities’ debts was linked to privatization programs for their public corporations and state banks, which had played a traditional role as the means of financing and carrying out the development of the states of Brazil, but which were in equal measure long-standing political and electoral bargaining instruments and the source of mismanagement of Brazil’s public goods.

The renegotiation of the debt of the State of São Paulo, which accounts for 37% of Brazil’s GDP²⁴, was key for the federal government to consolidate its own strategy with regard to the remaining states. The deal was only possible because the state governor,

²² Rui de Britto Alvares Affonso. *Descentralização, Desenvolvimento Local e Crise da Federação no Brasil. (Decentralization, Local Development and Crisis in the Federation in Brazil)* Santiago (Chile): CEPAL, 2000, p. 3.

²³ Aldo Ferrer. *De Cristóbal Colón a Internet: América Latina y la Globalización*. Buenos Aires: Fondo de Cultura Económica, 1999, p. 75.

²⁴ Data for 1998. <http://www.seade.gov.br>

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former senator Mario Covas, the founder and major political leader of the PSDB²⁵, was a staunch defender of the adjustment of the state's public accounts²⁶.

The need to manage and maintain primary surpluses in the trade balance, in order to make possible the payment of international commitments and enhance Brazil's credibility, so as to attract direct investors, drove the federal government on several fronts, one of which was approval of Complementary Law No. 87 (*The Kandir Law*), enacted in 1996, which exempted agricultural produce and semi-manufactured products intended for export from VAT (*ICMS*), the major state-level tax.

By exempting exports from VAT, the *Kandir Law* provoked a significant loss for the more developed states such as São Paulo and Minas Gerais, and the compensation mechanisms put in place were insufficient to appease the dissatisfaction of those states' governments, which became a permanent item on the governors' agendas of tax and fiscal reform²⁷.

Fiscal accountability is another issue that is directly linked to globalization, and more specifically to the capital crisis that hit Brazil in January 1999 and led the country to further negotiations with the FMI. From then on the federal government committed itself to deepening the fiscal adjustment, which became feasible with the enactment of Complementary Law No. 101, of 2000, known as the Fiscal Accountability Law (*Lei de Responsabilidade Fiscal*), and which laid down strict limits to public spending for all subnational governments.

Undergoing a profound financial crisis that was the most visible and worrying impact of globalization on the intra-federative scenario, several states indulged in a so-called fiscal war among each other (*guerra fiscal*). The unbridled and "staticidal" dispute for

²⁵ Partido da Social Democracia Brasileira (*Brazilian Social Democratic Party*), of which former President Fernando Henrique Cardoso is a founding member.

²⁶ *Ministry of Finance* (Ministério da Fazenda). Ajuste fiscal de São Paulo. Protocolo de Acordo entre o Governo Federal e o Governo do Estado de São Paulo (*Fiscal adjustment in São Paulo: Protocol of Agreement between the Federal Government and the State Government of São Paulo*). <http://www.fazenda.gov.br> (July, 2003).

²⁷ Fernando Resende. *Compensações Financeiras e Desequilíbrios Fiscais na Federação Brasileira*. (*Financial Compensation and Fiscal Imbalances in the Brazilian Federation*) In: W. Hofmeister &

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foreign investments disfigured fiscal competition in Brazil and is presently one of the major challenges to be faced, as will be seen below.

Factors enabling the practice of cooperative federalism

When one analyzes Brazil's international relations, what strikes one first of all is the absence of territorial or boundary conflicts with its ten neighbors in South America. Mercosur (1991) enhanced the density and quality of relations among member-States and their constituent units, above all those located along the frontier zones. Celso Lafer sees these elements as defining Brazil's international identity²⁸.

Within the domestic context, there are likewise no observable conflicts between states, since the territories of the constituent entities have been long consolidated. Inter-municipal boundary disputes, if and when they occur, may be considered irrelevant.

Culturally speaking, Brazil enjoys regional diversity including regional ways of speaking, but it is a country where only one language, Portuguese, is spoken by the overwhelming majority of its population. This is an advantage that is hardly acknowledged by the various tiers of government or by the population itself. These are important factors in the *globalization-federalism-competition* equation, compared with the complex situations of other federations such as South Africa, India, Nigeria and Russia.

Brazil's challenges are other. As Rui Affonso points out, "the problem of federalism in Brazil has to do with the issue of development. We therefore have to bear in mind that one of the constituent factors of the federal organization of our State is also a threat to its existence²⁹.

J.M.Brasiliense Carneiro (org.). *Federalismo na Alemanha e no Brasil (Federalism in Germany and Brazil)*. São Paulo: Fundação Konrad Adenauer, 2001, p.190 (Série Debates, n° 22, Vol.I).

²⁸ Celso Lafer. *A Identidade Internacional do Brasil e a Política Externa Brasileira (Brazil's International Identity and Foreign Policy)* São Paulo: Perspectiva, 2001.

²⁹ Op. cit, p.12.

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How are subnational governments facing this challenge of development in an environment of intra and extra-federative competition?

4) NEW COMPETITION STRATEGIES AMONG SUBNATIONAL GOVERNMENTS

There are three important moves taken by subnational governments that together help understand the current problem of intra-federative competition influenced by globalization: international loans, the process of integration and international trade, and fiscal competition.

Disputing international loans

One significant phenomenon relating to the international integration of Brazilian subnational governments in the 1990s may be clearly seen in the dispute for international loans, particularly from the World Bank and the Inter-American Development Bank.

This dispute has been incorporated as a subnational strategy by several state governors and by the mayors of some state capitals and other major cities, who have begun negotiating loans directly with the various private and public-sector international organizations.

Legally speaking, within Brazil it is the responsibility of the Federal Senate to control any and all foreign financial operations relating to any federative entity. Article 52, V, of the Constitution establishes that:

Article 52. It is exclusively the competence of the Federal Senate:

*V – to authorize foreign transactions of a financial nature, of the interest of the Union, the states, the Federal District, the territories and the municipalities;*³⁰

³⁰ Op. cit., p. 42-43.

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It is therefore enlightening to verify the foreign financial operations of federate states that were approved by the Senate during the two mandates of President Fernando Henrique Cardoso (1995-1998, 1999-2002)³¹.

During the first mandate of President Fernando Henrique Cardoso (1995-1998), the Senate issued a total of 121³² resolutions on foreign operations, 42 (35%) of which relate to the authorization of loans to 18 different federated states, from the following lenders: 20 from the IBRD (World Bank), 7 IDB and 21 from other public and private institutions³³.

In President Cardoso's second mandate (1999-2002), the Senate issued 145³⁴ resolutions of the same nature, 31 (21%) of which relate to loan authorizations to 17 distinct federated states, from the following lenders: IBRD 13, IDB 12, and six from other institutions³⁵.

What can be inferred from these merely quantitative figures? Subnational governments have been seeking to finance their local development through a new strategy for obtaining international loans directly from the international community. To this end they have rapidly and progressively adapted to the demands and conditions of international organizations, which involve a range of aspects from accountability to the preservation of the environment.

The Brazilian states began this international practice of negotiating and obtaining loans directly from IBRD³⁶. The Union comes into the deal as a guarantor/underwriter, but the drafting and negotiation of the project have been carried out by subnational governments guided by their own interests³⁷.

³¹ Loans authorized for municipalities have not been included.

³² Of which: 19 in 1995; 24 in 1996; 43 in 1997; and 35 in 1998.

³³ Federal Senate. Economic Affairs Commission. <http://www.senado.com.br> (July 2003).

³⁴ Of which: 32 in 1999; 49 in 2000; 22 in 2001; and 42 in 2002.

³⁵ Op. Cit.

³⁶ Bird financía quatro estados (*IBRD finances four states*). *Gazeta Mercantil*, São Paulo, 7/3/97.

³⁷ Gilberto Marcos Antonio Rodrigues, *Globalización y gobiernos subnacionales in Brasil*. Vetas, San Luis Potosí, México, mayo-agosto, 2002, p.

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There can be no doubt that the issue deserves to be studied more deeply in terms of its qualitative aspects, which may shed light on important elements of the competitiveness profile of current subnational governments.

Economic integration and the regional / subnational trade profile

The setting-up of the Common Market of the South (*Mercosur*) between Argentina, Brazil, Paraguay and Uruguay, through the Treaty of Asuncion of 26 March 1991³⁸, was a turning-point in economic and particularly in commercial relations, for Brazil and its subnational governments.

With the Ouro Preto Protocol of 17 December 1994³⁹, the process of integration took great strides forwards, changing from being a free trade zone to becoming a customs union after 1 January 1995, with the creation of a common external tariff (*Tarifa Externa Comum-TEC*). However, the TEC was put in place with a huge list of exceptions for products from all four members, and allowing Paraguay and Uruguay longer adaptation periods.

In this process of integration, which is cooperative in scope while mandatory after national ratification of accords has occurred, the subnational governments must adapt and submit to the approved guidelines, and may not discriminate against products either by means of tariff or non-tariff barriers. The only exceptions are the Free Trade Zone of Manaus (Brazil) and the Special Customs Area of Tierra del Fuego (Argentina), where special low-tariff import regimens exist, but whose products can only be commercialized within each country.

As the crisis in Argentina deepened in 2001, the Common External Tariff was hard hit by violations practiced systematically by Buenos Aires, with the aim of protecting Argentinean farmers and buying equipment cheaply to re-equip and modernize its industry. This was one reason underlying the Mercosur crisis, but Presidents Lula and

³⁸ Brazilian ratification in 30/10/1991; Enforcement on 29/11/1991.

³⁹ Brazilian ratification and enforcement on 16/11/1996.

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Kirchner reaffirmed their commitment to the project in 2003, as a *sine qua non* for integrating both countries from the bloc in the global economy.

To this end the feasibility and efficacy of Mercosur in its customs union phase depend largely on the real harmonization process among member-states. Lack of coordination in this area and the fiscal war among Brazilian subnational governments lead to undesirable flaws in the process and the resulting unfair competition among subnational governments within the bloc.

Mercosur has played an important role in integrating Brazil's subnational governments internationally. Brazilian federated states have begun to inter-relate with Argentinean provinces, in some cases systematically. State consultancy agencies or secretariats for international affairs and integration have been set up, and the same goes for some municipalities. In the latter case, the major novelty was the appearance of the Merco-Cities Network (*Rede Mercocidades*), which brings together almost one hundred municipalities from the four countries that make up the bloc, including Chile and Bolivia, with the aim of integrating at a local level. These are spontaneous movements that have enriched or often exceeded aspects of the process of integration among national governments.

If relations among subnational governments after the Southern Cone integration have been progressing through cooperative actions, identification of the commercial profile of the regions and of the respective Brazilian subnational governments *vis-à-vis* the economic blocs and regions of the world is one of the most important pathways to diagnosing the problems of intra-federative competition. Eduardo Haddad and Fernando Perobelli, in a ground-breaking essay on the theme⁴⁰, studied the patterns of trade between Brazilian states from 1997 to 1999 and carried out an interesting analysis based on the theory of comparative advantage. Their study shows that the profile of the Brazilian trade balance is not reproduced in Brazilian regions and states, thus demonstrating that the deepening of current international inter-bloc agreements, or the setting up of new agreements, may sharply alter Brazil's regional development.

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From 1997 to 1999, Brazil's major trading partners were scattered evenly around the globe. The make-up of Brazil's exports was: 17% to Mercosur, 22% to NAFTA, 8% to the remaining FTAA (ALCA) countries, 28% to the European Union and the remaining 25% to other regions of the globe⁴¹. The origin of its imports also showed balance: 15% from Mercosur, 27% from NAFTA, 4% from the rest of FTAA, 29% from the European Union and 24% from the remaining regions⁴².

Looking at the pattern of exports and imports by region within Brazil, the picture is highly uneven. The North⁴³ sends 72% of its exports to the European Union and other regions⁴⁴, and receives 54% of its imports from the other regions. Some 58% of the exports from the North-East⁴⁵ go to NAFTA and other regions, but there is balance among the regions from which it imports.

In the South-East⁴⁶, which concentrates the most industrialized states, exports are focused toward the European Union (25%) and NAFTA (24%), and imports are balanced between the various blocs. The South⁴⁷, the nearest to the other Mercosur countries, curiously enough sends only 15% of its exports to this bloc, while the European Union (31%) is its major destination; imports come mainly from Mercosur (33%) and the European Union (28%).

The Mid-West⁴⁸, the only region entirely made up of landlocked States, directs 85% of its exports to the European Union and remaining countries, while its imports come from NAFTA (34%) and the European Union (24%).

⁴⁰ Eduardo Haddad and Fernando Perobelli. *Integracao regional e padrao de comércio dos estados brasileiros. (Regional integration and patterns of trade of Brazilian States)* In: Anita Kon (Org.) *Unidade e Fragmentacao (Unity and Fragmentation)*. São Paulo: Perspectiva, 2002, p. 221-246.

⁴¹ Op. cit., p. 222.

⁴² Op. cit., p. 222.

⁴³ Made up of the States of Acre, Amapá, Amazonas, Pará, Rondônia, Roraima and Tocantins.

⁴⁴ In this study, "remaining regions" encompass all countries outside the European Union, NAFTA, Latin America and the Caribbean and the Mercosur.

⁴⁵ Made up of: Alagoas, Bahia, Ceará, Maranhão, Paraíba, Pernambuco, Piauí, Rio Grande do Norte and Sergipe.

⁴⁶ Made up of: Espírito Santo, Minas Gerais, Rio de Janeiro and São Paulo.

⁴⁷ Made up of: Paraná, Santa Catarina and Rio Grande do Sul.

⁴⁸ Made up of: Distrito Federal, Goiás, Mato Grosso and Mato Grosso do Sul.

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Given the mismatches between destinations and origins of products by Region of Brazil, it can be seen that possible decisions taken by the Federal Government to prioritize trading links with other blocs (Brazil faces the dilemma FTAA versus European Union) will directly affect subnational flows, likely prompting distortions –by skewing intra-federative trade patterns.

Another factor to be taken into account in this analysis resides in the great degree of specialization within the more outlying regions (North, North-East and Mid-West), compared with the diversified list of commerce in the Center-South of Brazil. The challenge lies in enhancing the capacity of the peripheral states to add value to their exports, which are generally primary products. In some cases this has been done through successful direct international partnerships, incorporating foreign know-how, as is the case in the partnership between the State of Amapá⁴⁹ and French entities to develop products derived from the Brazil-nut (*Castanha do Brasil*).

Fiscal competition versus fiscal war

Fiscal competition⁵⁰ is one of the most complex issues within fiscal federalism and the existing literature does not yet offer convincing answers to many of its most crucial questions.

In the case of Brazil, competition to attract foreign direct investment to spur economic growth and create employment has caused fierce intra-federative disputes among states.

José Roberto Affonso and others explain that, “Instead of lowering taxes in attempt to attract business, decentralized governments may resort to the concession of tax incentives, subsidies, and provision of public inputs to specific firms. These are typical regional development policy instruments. When used for decentralized industrial

⁴⁹ During the mandate of Governor João Alberto Capiberibe (1995-1998, 1999-2002). Located in the North of Brazil, Amapá borders on French Guyana (a French Département de l’Outremer).

⁵⁰ Jose Roberto Affonso et al. Fiscal Competition. In BLINDENBACHER and KOLLER (ed.). Federalism in a Changing World – Learning from Each Other. Scientific Background, Proceedings and Plenary Speeches of the International Conference on Federalism, 2002. Montreal & Kingston: McGill-Queen’s University Press, 2003, p. 412-431.

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policies, they may bring about destructive competition. The so-called fiscal war among Brazilian states illustrates this point”⁵¹.

The fiscal war (*guerra fiscal*) has been one of the few federative issues to gain widespread exposure in the media, owing to the confrontations and public stand-offs between state governors. Although the topic is highly relevant for subnational governments, few institutions have devoted themselves to studying the issue, but among those that have, the Getúlio Vargas Foundation (FGV), the Foundation for Administrative Development—*Fundação do Desenvolvimento Administrativo* (FUNDAP), and the Applied Economic Research Institute—*Instituto de Pesquisa Econômica Aplicada* (IPEA), stand out.

Rui de Britto Álvares Affonso points out the factors underpinning the fiscal war in Brazil during the 1990s: “The increased diversity of the Brazilian economy, with the decline of some sectors and the expansion of others; the reduction in direct spending by the Union in the more backward regions and the reduction in non-constitutional transfers of funds to various states; and, by no means the least important factor, the absence of a regional development policy”⁵².

In Brazil, VAT is levied by the principle of the origin, in other words, it is the state in which the good was produced that has the power to levy the tax. This confers great powers of negotiation upon many states, since they have full powers to grant tax breaks and incentives. This does not mean that there are no limits: the National Internal Revenue Policy Council (CONFAZ) has been the intergovernmental forum for the authorization of all benefits since 1975. But CONFAZ lost its ability to fully operate owing to the rule that approval must be unanimous, which renders unfeasible the exercise of its legitimacy and it cannot therefore prevent unilateral actions by member-states.

⁵¹ Op. cit., p. 419.

⁵² Op. cit, p.31.

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Sergio Prado and Carlos Cavalcanti consider the federal government's inability to order and regulate competitive practices among states to be the main cause of the fiscal war⁵³.

What might have been a healthy policy of intra-federative fiscal competition has become a predatory exercise in public revenues. Owing to Brazil's economic and political stability, particularly after the Real Plan and under President Fernando Henrique Cardoso, Brazil has become one of the major emerging markets and the preferred recipient of investment by transnational corporations, a situation reinforced by the setting-up of Mercosur.

Their argument, then, is that the fiscal war fails to acknowledge this "natural" propensity on the part of foreign investors to turn toward Brazil, and by acting haphazardly as a substitute for industrial de-concentration, as José Roberto Affonso and others have said⁵⁴, the gains for the state that "wins" the war are trifling in comparison with what Brazil as a whole may lose.

An emblematic case generated by an exacerbated fiscal competition policy occurred in the state of Rio Grande do Sul, involving the automotive sector, which is one of Brazil's major industries. After receiving a far-reaching package of tax incentives from one state administration, Ford do Brasil found itself in the position of having to re-negotiate the deal with the following government, which deemed the agreement to be unconstitutional and harmful to the public good.

A major legal battle ensued. The then governor, Olívio Dutra, in a letter sent to Ford Motor Company's world CEO, asks him to understand the position of the new government. The letter illustrates well the problems underlying the fiscal war: "*By seeking to renegotiate the deal that was signed before, we are not in breach of contract, but rather putting forward a proposal within the limits of what is possible, given our financial situation. At no time did Ford do Brasil agree to discuss our proposal, and*

⁵³ Sergio Prado and Carlos Eduardo Cavalcanti. *Guerra fiscal no Brasil: três estudos de caso. (Fiscal war in Brazil: three case studies)* São Paulo: FUNDAP, 1999, p. 7-8.

⁵⁴ Op. cit.

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*chose instead to announce that it was pulling back from setting up a plant in our State*⁵⁵”.

Faced with this situation, the Brazilian management of Ford decided to close its plant in Rio Grande do Sul and reinvest in another state where it could obtain equal or greater advantages. In actual fact it obtained a generous package of incentives from the state government of Bahia and reinstalled its plant in the latter state.

Rubens Ricupero argues that building a consensus within the federation to eliminate fiscal war is one part of the reforms and measures that depend solely on Brazilians themselves, and which are a condition for the country to achieve competitiveness in global markets⁵⁶.

5) FEDERATIVE FOREIGN POLICY?

As has been seen, the impact of globalization has led Brazil's subnational governments to interact directly with the foreign environment and modify the terms of intra-federative competition on the basis of this interaction. To shed some final light on the issues raised in this essay, we may ask: 1) How did Brazil's federal government react to these new subnational international relations? 2) Might one acknowledge that subnational governments are developing a new kind of federative foreign policy?

In 1997, during President Fernando Henrique Cardoso's first mandate, the Federative Relations Bureau (*ARF*)⁵⁷, was set up, linked directly to the office of the Minister for Foreign Affairs, to render assistance to states and municipalities in their international relations.

⁵⁵ Correspondence from the State Governor to the World CEO of Ford Motor Company, on 14/5/1999. In: Caso Ford: em defesa do interesse público. (*The Ford Case: in defense of the public interest*) Revista da PGE, Porto Alegre, March, 2002, p. 255-257 (Special Edition).

⁵⁶ Rubens Ricupero. O Brasil e o dilema da globalização. (*Brazil and the dilemma of globalization*) São Paulo: Senac, 2001, p. 123.

⁵⁷ Transformed into the Federative and Parliamentary Relations Bureau in 2003.

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The Foreign Ministry additionally opened offices in several states. The then head of ARF, the diplomat Cesario Melantonio Neto, in an interview given to *Federations*, declared that this would be one way of involving the states in Brazil's foreign policy⁵⁸.

The federal government admitted that the phenomenon of subnational international relations was irreversible and decided to accompany it, with the apparent desire of monitoring it, in order to guarantee the constitutional monopoly of the Union in exercising foreign policy. ARF has since then been involved in several subnational international activities, and the cooperative nature of at least some of its actions cannot be denied⁵⁹.

The new subnational competition strategies, leveraged by globalization, in themselves involve changes in the subnational governments' policies regarding domestic and foreign integration.

The strategic management of subnational governments has begun to incorporate the international element, greatly extending their scope of activity. In the State of São Paulo, for example, a research study was conducted dealing with subnational strategy within the Latin American sphere⁶⁰. The competition strategies of subnational governments require prospecting for markets, sending trade missions overseas, welcoming business and government delegations, and a wide range of arrangements and actions that require trained managers and personnel who are up to the challenge of the new tasks.

In reality, there is a new field of subnational activities waiting to be developed. The emergence of a federative foreign policy, within the perspective of subnational

⁵⁸ C. Melantonio Neto. How to involve the states in foreign policy. *Federations*, Vol.1, n°5, Summer 2001.

⁵⁹ The issue is gradually attracting the interest of the Ministry of Foreign Affairs, and has already produced two theses in the Advanced Studies Course of the *Instituto Rio Branco*, Brazil's diplomatic training school: by the diplomats Antenor Boga, *Diplomacia Federativa* [Federative Diplomacy] (2001); and José Vicente da Silva Lessa, *A Paradiplomacia e os Aspectos Legais dos Compromissos Internacionais* [Paradiplomacy and Legal Aspects of International Commitments] (2003). Neither study has been published.

⁶⁰ Gestão Pública Estratégica de Governos Subnacionais Frente aos Processos de Inserção Internacional e Integração Latino-Americana. (*Strategic Public Management of Subnational Governments in the face of International Positioning and Latin American Integration*) FUNDAP/CEDEC/PUC-SP, 2000-2002.

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governments, is visibly a reality⁶¹. Its importance in improving the competitiveness of subnational governments is obvious from what has been set forth in the present essay. For this reason intergovernmental relations urgently need strengthening in Brazil, to avoid more conflict arising in the not-too-distant future⁶².

6) TRENDS IN THE ADMINISTRATION OF PRESIDENT LUIS INÁCIO “LULA” DA SILVA (2003-)

Six months into its mandate, the administration of President Lula shows a strong tendency to place renewed value on the federative pact and intergovernmental relations, both with states and with municipalities. The federal government’s strategy can be detected behind certain isolated political facts.

In its relations with the states, the Lula administration hopes to gain the support of the governors for its constitutional reforms (in particular the welfare and tax reforms) and for the exercise of governability in Congress, since the Workers Party of President Lula (*Partido dos Trabalhadores—PT*), and allied parties from which it draws its support, cannot achieve a majority for qualified votes. To achieve this support, President Lula held a meeting with all the 27 Federal District and state governors in Brasilia in April 2003, a meeting without precedent in the history of the Republic, in order to begin an informal political cooperation, fraught with commitment and meaning⁶³.

This alliance may be the embryo of new intergovernmental relations between Union and states, opening up the possibility of federative cooperation capable of solving the problems of co-existence, competition between the states, and the fiscal war.

The Union also moved innovatively with regard to the municipalities, although in constitutional fashion, by setting up a Federative Alliance Committee—*Comitê de*

⁶¹ Gilberto M. A. Rodrigues, *Globalización y Gobiernos Subnacionales en Brasil*. Vetas, San Luis Potosí (México), n° 11, Mayo-agosto, 2002.

⁶² Gilberto M.A. Rodrigues. *International Relations of Subnational Governments: a New Source of Conflict In Brazil?* 43rd Annual Convention, (ISA), New Orleans, March, 2002, 15 p.

⁶³ Os Estados unidos do Brasil. (*The United Staes of Brazil*) Valor Econômico, 9-11/5/2003, p.10-15 (Weekend supplement).

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Articulação Federativa to bring together representative entities for the municipalities, such as the National Confederation of Municipalities (CNM) and the National Front of Mayors (FNP). In this case the agenda is more far-reaching, involving not only the question of the reforms but also several other issues from the urban agenda, which finds in the newly-created Ministry of Cities its great new champion.

There is a Ministry of National Integration whose major role is to reformulate and propose a new regional development model. A Council for Economic and Social Development has also been set up, made up of representatives of the government and of civil society, and whose objective is to foster discussion of reforms and propose economic policy strategies to boost an upturn in national development.

The first steps have been taken toward facilitating a more fluid intergovernmental dialog. The federalist ferment seems now to be shaping the “cake”. Baking it will take a long time and will depend not only on political will but also on good pastry chefs to assure adequate cooking, which is why a *federative culture* needs to emerge in Brazil⁶⁴. Improvement in cooperation in intergovernmental relations will undoubtedly contribute toward more just and balanced subnational competition among the constituent units.

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⁶⁴ Gilberto M.A.Rodrigues. Brazil votes: change crucial to its cities and states, *Federations*, November, 2002, p. 4.

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