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**NEW ECONOMIC AND FISCAL FEDERALISM:
THE BRAZILIAN CASE**

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1. As the 20th century draws to a close, Brazil ranks as the tenth largest GDP in the world economy, with the fifth largest territory and population on the planet. The Brazilian economy faced a long period of stagnation in the 19th century, but exploded into an accelerated growth process, unparalleled in almost any other nation of the world, from the 1870s to the 1970s. However, in the last twenty years, the vibrant growth trajectory that culminated in the period after World War II, has turned clearly downward. Today, per capita income ranks in forty-fifth position, while income distribution is still one of the most unequal in the world.

Brazil has become somewhat impatient in these final years of the century in its efforts to regain a dynamic growth trajectory without, however, compromising the price stability so arduously won over the past five years. It is anxious to regain growth in order to generate significant improvement in the living conditions of the poorer segments of the population through more employment and adequate social policies.

One cannot ignore the fact that, in three quarters of the long period of semi-stagnation, the country suffered through an acute process of rampant inflation that was only arrested in the 1990s, following about ten very painful previous failures. Since that time, the federal administration of President Fernando Henrique Cardoso (beginning in 1995) has sought to redefine the role of the State in the economic life of the nation, the degree of commercial and financial liberalization in the economy and the trajectory of industrial and social policies, while introducing measures designed to streamline the fiscal and federative systems. And it is precisely the latter item that is of interest to us here today.

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This papers reflects the personal positions of its authors. For more precise information on the Brazilian experience as well as access to the statistical and reference sources used in the elaboration of this paper, contact The Federal Fiscal Databank on the internet, a highly specialized data bank on federalism and public finance in Brazil: <http://federativo.bndes.gov.br> .

Actually, improvements in fiscal federalism in Brazil are matters of importance both to economic stability, through a better control of the deficit and overall public debt, and to regaining the dynamics of sustained development through better public resources allocation and more appropriate economic policies which depend on internal and external tax harmonization.

2. Background : Brazil is a country with no significant cultural frictions generated by differences of language, religion or even race. Following proclamation of the Republic, the Brazilian federation was founded in 1891 in response to regional dissimilarities and administrative demands rooted in the continental dimensions of the nation's territory. The federation was not born out of conviction "from below", shared by and pushed from the diverse segments of society, but rather on the basis of a decision taken at the highest levels of authority to divide the then unitary State. From the point of view of the tax system, the concept of federation was solidly supported by the more developed provinces of the central-south region, particularly São Paulo, the then throbbing center of an expanding sector of agricultural exports. The rationale underlying this support was simple: such a system would give that region the freedom it desired to levy local taxes on foreign sale operations. In exchange, more than proportionate representation in the legislative branch was granted to the less developed regions of the country.

Since its founding, the Brazilian federative system has gone through clearly defined cycles of shrinkage and expansion in relation to the central power.²

Due attention should be given to an important aspect of the Brazilian tax system that contrasts with the American experience – as often cited by Prof. Alcides Jorge Costa. Intermediate government levels have long sought and preserved their right to levy taxation on exports, including industrialized products (reflecting a situation that, in fact, dates to the colonial period). In comparison to the voluminous revenues generated by the export tax, rural property taxes, which today account for an almost negligible fraction of revenues, were delegated to the central government.

²See, among others, GOLDSMITH (1986) and MAHAR (1976).

Thus, in the period known as the Old Republic, between 1891 and 1930,

corresponding to the apex of the export-oriented coffee economy, the central authority was relatively weak. Along this period, federal government participation in national public spending declined from a level of three-quarters to approximately half. At the same time, the share of overall state government revenues concentrated in the hands of the Province of São Paulo increased from just over 10% to almost 40%.

The following period extended from 1930 to 1946 and was marked by a process of centralization of authority that began with the Revolution of 1930. This cycle accompanied the world depression and culminated in the Getúlio Vargas dictatorship (Estado Novo). The intense centralization of authority in the hands of the federal government made it possible to conclude the process of internal market unification, while strengthening the foundations of industrialization (federal government spending moved from 50% to 55% of the overall total for all government levels in the period).

The end of World War II, restoration of a democratic political system and the new 1946 Constitution initiated a period of intense decentralization (the share of central government spending slid back down to half in terms of the overall public sector total).

The advent of the military regime in 1964 marked the start of two decades of centralization. It was a period characterized by fiscal reform in the first half -- revenue and spending controls concentrated within the federal sphere of government -- and the political and social controls demanded by the authoritarian political regime in the latter half. Financial centralization was so high that in 1980, the central government held sway over approximately two-thirds of disposable tax revenues (after constitutional transfers) and national public spending.

In the first half of the 1980s, the weakening of the military regime coupled with growing political freedoms undermined the central authority and led to restoration of the democratic system and a new Constitution (1988). During the Constituent Assembly, the frailty of the tax system became evident as the participation of national taxes in GDP declined from 25% in the early 1970s to just 20%, while the federal share of national tax revenues slipped to just over 60%, thanks to some redistribution promoted by Congress during the agonizing period of the military regime in the first half of the 80s as well as by the civil Federal Government in 1985-87.

3. Actually, since the early 1980s, fiscal decentralization and the weakening of central authority were directly linked to the idea of redemocratization. The 80's was a period marked by an enormous shift of federal tax revenues to subnational governments. The percentage of the two major federal taxes transferred into State and Municipal revenue sharing funds (FPE and FPM, respectively) – income tax and industrial products tax, a valued added tax on industrial production --

climbed from 18% to 44% from 1980 to 1990. If one were to include all constitutional transfers³, the volume would climb to 47% of the income tax and 57% of the tax on industrialized products (in 1980, transfers accounted for just 20%).

³Three percent is channeled to the regional banks of the northern region (BASA), northeast (BNB) and central-west (since there was no regional bank in the latter region, the task was transferred to Banco do Brasil). The funding is provided on a no-return basis for use in regional financing. Ten percent of the IPI is channeled into a fund to "compensate" states for the loss of ICMS revenues on exports of manufactured goods.

Moreover, the new Constitution consolidated and strengthened the taxation authority of the states and local government spheres of government. Insofar as the states were concerned, the coverage base for the tax on the circulation of merchandise (V.A.T.) was expanded to include all types of merchandise. It absorbed five former federal taxes, including tax on gas, communication and transportation services. At the same time more flexible rates and management systems were adopted for ICMS and transferred to state control. Transfers to municipalities of the revenues generated by this tax were increased by 25%.

Figure
TAX REVENUES BY GOVERNMENT LEVEL – EVOLUTION
(National Accounts)

	Central	State	Local	Total	Central	State	Local	Total
	As % of GDP				Composition - % of Total			
DIRECT REVENUE								
1960	11,1	5,5	0,8	17,4	64,0	31,3	4,8	100,0
1980	18,5	5,4	0,7	24,6	75,1	22,0	2,9	100,0
1988	15,8	6,0	0,7	22,4	70,5	26,5	2,9	100,0
1998/e	20,9	8,1	1,6	30,6	68,2	26,6	5,3	100,0
DISPOSABLE REVENUE								
1960	10,4	5,9	1,1	17,4	59,4	34,0	6,6	100,0
1980	17,0	5,5	2,1	24,6	69,2	22,2	8,6	100,0
1988	14,0	6,0	2,4	22,4	62,3	26,9	10,8	100,0
1998/e	17,6	7,9	5,1	30,6	57,5	25,7	16,8	100,0

Social security contributions included in the calculation base.
Sources: IBGE, FGV and Finance Ministry.

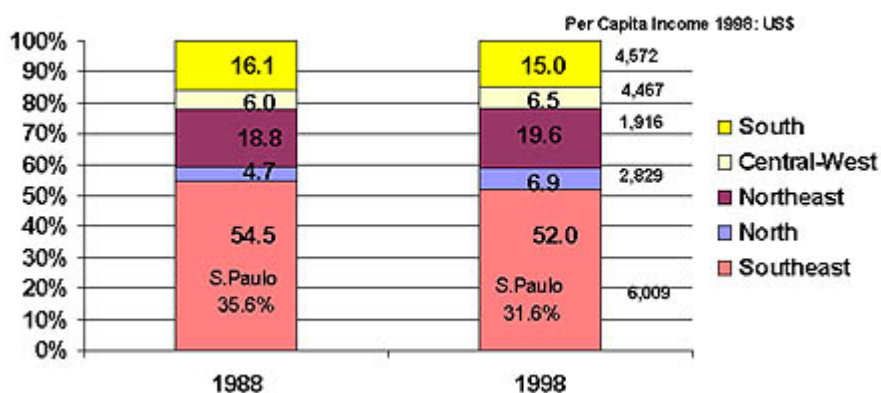
(e) Preliminary

The general trend toward decentralization in the last two decades has been backed by well-defined movements of redistribution of public resources. In vertical terms, almost all gains were concentrated at the municipal level while the position of state governments changed very little – particularly as regards the concept of disposable tax revenues (own tax revenues plus and/or minus

constitutional transfers).

In horizontal terms, most of the additional funding was channeled to state and municipal administrations in less developed regions of the country. In terms of the distribution of disposable tax revenues and spending, this more than reversed the process of strong concentration of tax generation and internal production in the more developed areas of the country.

Figure
DISPOSABLE TAX REVENUES OF SUBNATIONAL GOVERNMENTS:
REGIONAL DISTRIBUTION, 1998



Subnational Governments = 27 States and the Federal District (intermediary government) and more than 5.5 thousand Municipalities (local government). Disposable tax revenues = the inflow generated by states and municipalities plus and/or minus constitutional transfers (revenue sharing).

Source: Finance Ministry and IBGE.

4. The situation of the Brazilian federation can be summarized in five topics:

(i) In a country of continental dimensions that is still expanding its economic frontiers into the interior, the Brazilian federative system has still to be physically concluded, independently of any underlying conceptual conflicts and questions. Proof of this is the creation of two new states (Mato Grosso do Sul and Rondônia) in the 1970s and another three (Amapá, Roraima and Tocantins) following the Constituent Assembly, all five concentrated in the central-northern area, one of the least developed regions of Brazil. As a result, the nation now has 27 states and the Federal District which, after the Constitution of 1988, obtained, in practical terms, identical political status as the states, with full representation in Congress, a local Chamber of Deputies, and its own police and judiciary.

In its drive toward decentralization, the 1988 Constituent Assembly went so far as to raise the constitutional status of municipalities to that of quasi-members of the Brazilian federation while, at the same time, facilitating the creation of new

municipalities. The result is that Brazil now has more than 5.5 thousand⁴.

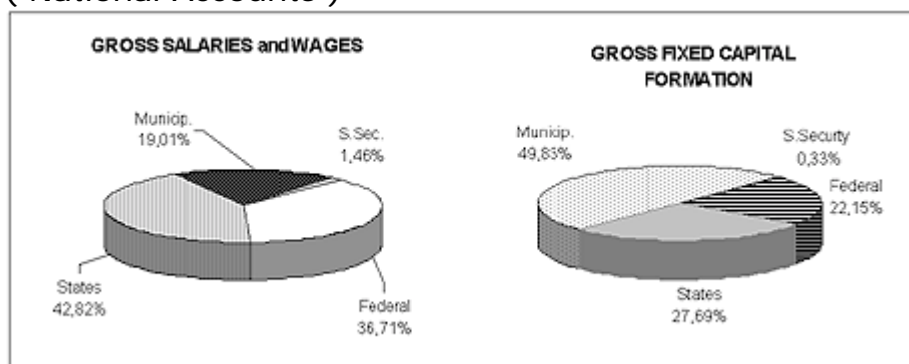
⁴ Between 1984 and 1997, 1,405 new municipalities were created in the country, half of them with less than five thousand inhabitants (a process stimulated by an out-dated system of distribution of Municipal Revenue Sharing Funds (FPM) – proportionate to the population, but restricted to a minimum of 10 thousand and a maximum of 150 thousand inhabitants). GOMES and MacDOWELL (1999) point out some of the many distortions generated by the proliferation of very small municipalities, including negligible self-financing capacity, per capita revenue inflows much higher than in medium and even large size cities, and per capita legislative outlays far above social spending in such areas as health.

(ii) From the fiscal point of view, decentralization takes on even greater importance when one analyzes the importance of subnational governments in public financing and spending. They are directly responsible for collecting a full 32% of overall taxes levied in the country and, once constitutional distribution of tax revenues is completed, are entitled to 43% of national tax revenues (social security contributions included in the calculation base). On the expenditure side, subnational governments account for 62% of payrolls for active civil servants, 71% of other current expenditures and, what is most important, 78% of fixed investments. The only areas in which the central government ranks in first position are transfers to persons (basically, social security benefits) and public debt interest, accounting for respective levels of more than 80% and 90% of consolidated outlays.

⁵ For a monthly update on the evolution of national tax flows and the principal intergovernmental revenue sharing funds and, consequently, the distribution of disposable revenues among the three spheres of government, by region and state, one should consult the monthly series of indicators and spreadsheets for all government spheres (direct collection and disposable tax revenue concepts) in The Federal Fiscal Databank site (<http://federativo.bndes.gov.br>).

Figure

GOVERNMENT SPENDING -- COMPOSITION, 1998
(National Accounts)



Source: IBGE.

Reductions under these two outlays within the calculation base would further emphasize the relative loss of central government command over the civil service, current expenditures in goods and services, as well as fixed public investments. The reason for this is that outlays on interest and social security in the 1960s and 1970s were considerably lower than in recent years⁶.

⁶*This circumstance becomes even more obvious when one takes due account of the drastic reduction in the sector of state companies (not considered in the calculations underlying this paper) caused by the accelerated process of privatization in the 1990s. These companies were predominantly federal (telecommunications, mining, steel, petrochemicals, electric energy, rail transportation and highways).*

One should also underscore the growing importance of municipal governments. To demonstrate this, it is enough to say that, in all of Brazilian history, the municipalities had never reached their current relative volume of revenues. Municipal governments alone now invest just as much as the sum total of federal government gross capital formation plus that of the twenty eight state governments.

When fiscal decentralization is measured in terms of the subnational governments' participation in total revenues and expenditures, as well as the enormous autonomy with which they levy taxes and elaborate their budgets, Brazil comes quite close to the more developed federations⁷. Among developing nations, there is no doubt that Brazil has made the greatest progress in terms of subnational governments' autonomy.

⁷*The participation index of subnational governments in direct tax inflows is unmatched among economies of similar size and is quite close to the indices registered in the more developed federations of the world, such as Canada, Australia, the United States and Germany, and surpasses the levels found in France and England – See TANZI (1992) and LEVIN (1991).*

SHAH (1994) calculates an autonomy index of subnational governments based on the proportion of expenditures financed through the use of the unit's own funds or resources received from third parties without being earmarked to specific ends (pg. 42). In a grouping of ten rich and poor nations, the highest autonomy index was that of Brazil, even surpassing the United States, Germany and Canada by a few points.

(iii) Simultaneously to vertical decentralization in the distribution of public resources, there has been an equally important and intense process of horizontal decentralization of revenues. The concentration of federal tax revenues in the more developed regions of the country⁸ is offset by a system of federal tax

distribution designed to benefit the less developed regions⁹ – without mentioning the greater participation of these regions in the division of direct federal spending in basic social programs.

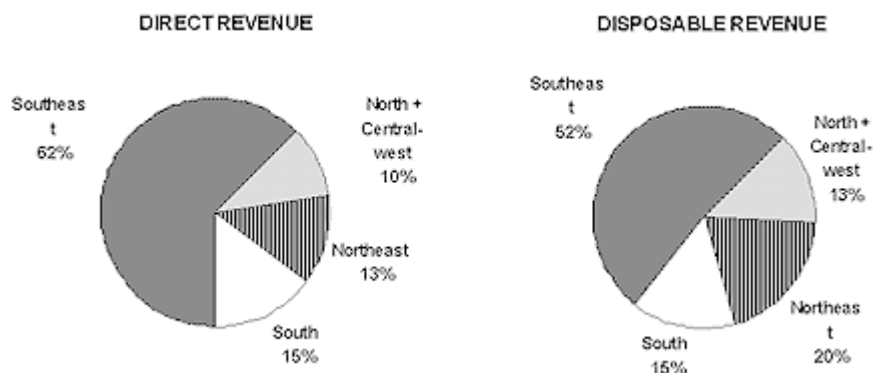
⁸ *São Paulo, the most developed state in the Federation (per capita income is 71% higher than the national average) has 22% of the nation's population and generates 37% of national production. At the same time, it accounts for 40% of all state taxes collected in the country, 53% of federal taxes and 44% of total national tax collections by the three spheres of government. These figures represent a tax load of 35% of the state GDP as against an average of 26% of GDP in the other states. Per capita taxation comes to \$ 2.6 thousand per inhabitant in São Paulo as compared to just under one thousand dollars in the rest of the country. Consequently, São Paulo (State and local governments) accounts for only 30% of the consolidated tax revenues of Brazilian states and municipalities, one fifth less than its participation in national GDP.*

⁹ *Regional distribution of the state tax inflow is much less concentrated than in the case of federal taxes, since the ICMS on interstate transactions follows a mixed and sui generis principle, even though it does not adopt the principle of single destination. In the wake of the 1988 Constitution, rate differentiation became more accentuated with the objective of benefiting the less developed regions of the country -- 12% rate on their sales to the more developed regions, as against just 7% in the opposite direction (the standard rate on internal operations is 17%, with the tax becoming a component of the calculation base).*

Thus, thanks to constitutional transfers, the sub-national governments of the three less developed macro-regions hold 33% of total disposable tax revenues (internally generated and tax transfers) of those spheres of government -- quite more than their participation in the Brazilian economy: 22% of GDP. In much the same way, disposable revenues of the most developed area of Brazil (Southeast) correspond to less than 10% of the region's GDP. In the least developed region (Northeast), this coefficient is double that amount. In some less developed states, disposable revenue comes to a level between 30% and 50% of local GDP¹⁰.

¹⁰ *As a matter of fact, disposable tax revenues of the sub-national governments of the less developed regions (Northeast, North and Central-West) in 1998 were 70% higher than in 1990 in real terms. In the same period, the increase in the south and southeast came to 60% (in São Paulo the increase closed at 55%).*

Figure
REGIONAL DISTRIBUTION OF SUBNATIONAL
GOVERNMENT REVENUE, 1998



Source: Finance Ministry.

The accentuated regional redistribution of disposable tax revenues is explained to a great extent by federal revenue sharing funds. In the south and southeast, just US\$ 0.18 of each dollar collected in the form of income tax and industrialized products tax revenues makes its way back to those regions through revenue sharing funds. In the case of State Revenue Sharing Funds (FPE), legislation approved ten years ago restricted the participation index of the south-southeast to just 15%. The law in question uses a fixed distribution table instead of the previous formula that weighted the inverse of per capita income¹¹.

¹¹This previous formula threatened to reduce the relative weight of the less developed regions, which had been closing the gap separating them from the higher income regions.

iv) While the chapter in the Federal Constitution on the tax system is highly precise and detailed regarding taxation jurisdiction and revenue distribution of each one of the three levels of government, that dealing with government responsibilities is vague and fails to define a clear and well-structured distribution of responsibilities among these spheres.

In practical terms, there are specific areas in which more than one sphere of government is charged with responsibility, while other activities are not clearly assigned to any sphere. Aside from these difficulties, and facing any sort of political and bureaucratic resistance, the central government has not been able to perform its role of coordination satisfactorily, and subnational governments tend to adopt autonomous policies. More over, if the federal government or even some states reduce their participation in investments and programs of a continuous nature, they fail to transfer personnel and properties to state or local units, thus generating, *ceteris paribus* an unforeseen increase in aggregate public spending.

One should also cite another constitutional factor that has contributed to making fiscal relations within the federation more rigid: provisions that impose a single employment regime on personnel hired by the three spheres of government while, at the same time, guarantying civil servants very early retirement with full payment pensions.

An accentuated process of revenue redistribution also occurs under the heading of direct federal spending, particularly in the social area. The social security system is a case in point (private sector workers): while payroll levies are concentrated in the more developed states, benefit distribution is much less concentrated¹².

¹² For example, the Northeast region accounts for 8% and 20% of revenues and expenditures, respectively; the same variables for the state of São Paulo are 47% and 31%. In 1997, the most developed state generated a surplus under this item that was similar to the national deficit.

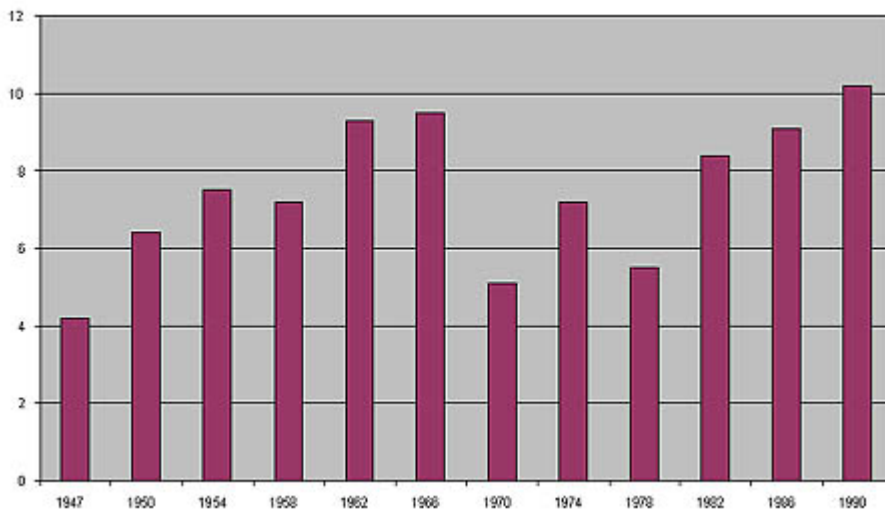
(v) The redistribute phenomenon cannot be divorced from the political characteristics of the Brazilian federative system. Thus, in the Federal Senate, which was founded according to the American model of equal representation for each state (three senators each, in the case of Brazil), a group that represents 43% of the population controls 74% of the seats. This fact takes on greater importance when one considers that the Senate is responsible for analyzing and voting all bills and constitutional amendments that come out of the Chamber of Deputies and, consequently, has veto power over these measures. The Senate also holds such powers as approving nominations of ambassadors and directors of first line government agencies, while authorizing debt margins for the states and municipalities. The Chamber of Deputies does not have similar powers. The Senate has less power than the Chamber in only one aspect: bills sent to the Congress by the executive enter through the Chamber, which has the last word in those cases in which the Senate alters a bill and sends it back to the Chamber.

Parallel to this, representation in the Chamber of Deputies is not proportional to the population of the state, since there is a ceiling of seventy representatives per state and a minimum of eight. Consequently, some of the less populous states of the north are overrepresented, while the more populous states of the southeast are underrepresented. In extreme cases, a congressional candidate from São Paulo may need 16 times more votes than in Roraima, the state with the smallest population.

In the opinion of Prof. Alfred Stepan, these imbalances are an important component of the demo-constraining federal systems, of which Brazil may well be the most glaring example. Though these imbalances date to the early days of the Republic, they were sharpened in the wake of World War II and were further aggravated by the creation of six new states and the transformation of the Federal District into a state, for all practical purposes. The graph below is

important for understanding the Chamber of Deputies: the average deviation refers to the difference between the theoretical number of deputies (one man/one vote) and the real number. With this system, the states with 43% of the population wind up with half plus one of the total number of Deputies.

Figure
EVOLUTION OF DISTORTIONS ON STATE
REPRESENTATION IN CONGRESS (LOWER HOUSE)
Average Deviation Index during Election Years



Source: SERRA (1997).

5. At the start of President Fernando Henrique Cardoso's first term in office in 1995, stability had only recently been reconquered and had to be consolidated; at the same time, there was an urgent need to project a positive external image of the nation's economy. Consequently, economic policy was targeted primarily to controlling the public deficit and, as a result of this orientation, to deal with fiscal federative relations.

As a matter of fact the tremendous weight of states and municipalities within the public sector, the asymmetrical distribution of rights and duties among the three spheres of government, state government banks that facilitated financing of deficits and the possibility of issuing security debt for the same purpose, were – and still are -- factors with the potential for undermining the government's control over the public deficit. Evidently, in a party system as fragmented as Brazil's, one should understand this potential in terms of the political sway that governors and mayors exert over members of Congress. At the same time, one should emphasize that, while the Senate is constitutionally charged with controlling and restricting the indebtedness of states and municipalities, it has rarely adopted a consistently restrictive posture.

There are three other questions that have contributed to imbalances within the federative system.

The first of these is state interference in foreign trade – a typical national economic policy variable – through levying of the state value added tax on exports of primary and semimanufactured goods.

Secondly, the ongoing fiscal war being waged by various states as they manipulate the rates of their own taxes in order to attract companies to their regions. The ultimate effect of this phenomenon from the fiscal point of view has been to reduce the tax inflow as a whole and increase fiscal pressures on the federal government generated by subnational spheres.

Thirdly, the fact that 47% and 57% of the income tax and industrialized products tax are transferred to the states and municipalities has sharply restricted the federal government's leeway in seeking revenue adjustments. As a result, it is forced to resort to tax increases or creation of overlapping social contributions that, though their revenues are not shared with the states and municipalities, have a negative impact on the competitiveness of the economy as a whole.

6. In evaluating this diagnosis, one should give due consideration to a characteristic of the Brazilian federation common to all federations: the subnational spheres of government have a much more tenuous commitment to such macroeconomic variables as the fiscal deficit, foreign trade or the balance of payments. Consequently, the number one question before the federation is how to reconcile greater or lesser fiscal decentralization with national (and rational) economic policy objectives? In the Brazilian case, there is one peculiarity that makes any response to this question more complex than in most other countries: differently from what occurs in federations like the United States, the Brazilian federal government has always played the role of lender of last resort for states and municipalities threatened with insolvency. And this is an attitude that generates more permissive fiscal behavior.

7. The roots of this phenomenon are historic and date to the tradition of a centralized State, as well as cultural and political considerations, as exemplified by the nation's party structure and system of congressional representation. However, one should here underscore the fact that there is no possibility of a recentralization of political power within the central government, initiating a new cycle in the historical evolution of the Brazilian federation: not only would it be politically unfeasible, it would also be undesirable from the point of view of administrative efficiency and social well-being in a highly heterogeneous country of such vast physical and demographic dimensions. In much the same way, when political considerations are taken into account, no truly serious thought is given to the possibility of altering the regional distribution of resources.

For all these reasons and in light of the diagnosis stressed above, the federal government's attempts to streamline the federative system have been marked by conciliatory measures. Though the government has effectively sought to resolve existing problems, it has done so in a gradual and patient manner, always ready to assume the principal cost burden.

With this in mind, in recent years, President Fernando Henrique Cardoso's administration has adopted the following line of action with respect to the federative system:

(i) While setting aside any notion of recentralizing revenues, the government has introduced bills into Congress calling for reform of the national tax system. This would be achieved by unifying national legislation on the value added tax, thus making it impossible for one state to wage a tax war against another, and creating a federal tax identical to the state tax. Another measure would be to unify current social security contributions collected by the federal government and substitute the calculation base of the tax on sales with a value added tax, with an eye to eliminating its negative impact on the competitiveness of the economy. It should be stressed that the model of a value added tax that would be jointly levied by federal and state governments was originally proposed by the President in 1995 and is now defended by the rapporteur of the bill before Congress. It was designed in such a way that two rates would be simultaneously levied, making it possible to introduce the principle of destination into interstate transactions, avoid the tax evasion that occurs when the classic system reduces the rate to zero and, furthermore, put an end to the predatory tax war among Brazilian states. In other words, it is a proposal that follows the principles of the Dual VAT, defended by Professors Richard BIRD and Charles MacLURE Jr¹³.

¹³The system specified in the Shared ICMS bill now being discussed both in Brazil and Argentina (also known as the little boat model as a result of the treatment it gives to interstate transactions) is presented by VARSANO (1999), while BIRD and GENDRON (1997) and McLURE (1999) also comment and defend the idea.

(ii) Just as in the case of the matured and unpaid foreign debt, the internal securities and banking debts of the states and major municipalities were consolidated and assumed by the federal government through a series of successive refinancing programs that date to the end of the 1980s. Though this effort has not been fully concluded (it is just getting under way at the level of the municipal debt), the federal government is already a creditor of state governments of at least US\$ 56,3 billion, with real interest well below the going market rate and fixed installments (a proportion of the subnational government's internally generated current revenues). In exchange for this agreement, the federal government:

a) has intervened, liquidated and sold most of the state government banks to the private sector: since 1994, all of the banks belonging to the large states have

been privatized, liquidated or transferred to Central Bank management¹⁴.

¹⁴At the end of 1994, the largest state bank in the country -- BANESPA, belonging to the government of the State of São Paulo -- was transferred to Central Bank of Brazil management and it is now scheduled to be privatized over the short-run. Since 1996, the stock control of at least four large state banks was transferred (two in Minas Gerais, Rio de Janeiro and Pernambuco) and another four state banks were liquidated. At the same time, federal monetary authorities organized a financing program (PROES) with the objective of encouraging these institutions to implement definitive asset adjustments into the state financial sector, more or less along the lines implemented in the program for private financial institutions.

In the same period (1991-1999), federal government privatization included 88 state companies and generated a direct fiscal impact of US\$ 57.9 billion, of which US\$ 46.6 billion involved sale revenues and US\$ 11.3 billion reflected transferred debt. (Note: for more information on the Brazilian privatization program, consult the homepage of the federal bank charged with managing the national privatization program: www.bndes.gov.br)

b) was able to suspend issues of new state or municipal security debt by including restrictive clauses in refinancing contracts;

c) managed to provoke a wide-ranging privatization program at the level of subnational governments, particularly in the sectors of transportation and electricity: since 1996, 29 state government companies have been privatized, generating a total of US\$ 29 billion (US\$ 23.7 billion in sales revenues and US\$ 5.3 billion in transferred debt).

(iii) Efforts have also been made to exert pressure in favor of a process of decentralization of responsibilities following a pattern in which the federal government would assume the major share of costs:

a) in the case of education, for example, a constitutional amendment was approved that, subject to fiscal penalties, induces municipalities to assume a larger share of basic education services. In this case, the costs of the "rewards" to those that take on a larger share of this burden are to be borne by the federal government.

b) in the health sector, the government created a fund for basic municipal health programs and has fostered direct transfers based on the per capita criteria. In much the same way, it subsidizes the training of family health teams and has transferred full management responsibilities to those municipalities considered to have reached an adequate level of public health capacity (primary to tertiary treatment), including responsibility over financial resources and their allocation.

(iv) After more than a century of uninterrupted charging of state taxes on export operations, the federal government managed to approve legislation in 1996 that effectively eliminates state taxation on exports of primary products and semimanufactured industrial goods. To offset losses to the states, the federal government will transfer a total estimated at over US\$ 2 billion/year to state

governments.

(v) The federal government has sent a Fiscal Responsibility Law to the National Congress, imposing maximum limits on the debts and personnel outlays of the federal government, states and municipalities. At the same time, the new law would require the different levels of government to formulate three year targets, while prohibiting the federal government from formalizing new operations that would roll over state and municipal debt, and applying sanctions to those responsible for diverting government monies from their specified objectives.

8. In summary, the Brazilian federation is a mirror image of the nation's economy, a reality marked by accentuated structural heterogeneity. On the one hand, subnational governments participate to a very high degree in direct generation of resources and, even more so, in tax revenue allocation and outlays on personnel, goods and services, while also managing their own budgets with only minimum central government interference. On the other hand, there is no organized and carefully planned fiscal decentralization program capable of reconciling revenue redistribution with shared responsibilities. The result is a highly complex system of federative relations that undermines attempts to achieve economic efficiency and quality in the rendering of public services, coupled with enormous tax load differences among the more and less developed states of the Federation.

It should be stressed that the current administration has opted to face the most severe problems head-on within an action strategy characterized by gradualism and prudence.

The area in which progress has been most difficult to achieve is the so-called fiscal war among states, since its implications go well beyond purely fiscal dimensions and involve industrial and foreign trade policy considerations¹⁶ that are essential to a sustained and solidly-based upturn in economic growth. The process of economic and financial liberalization that has marked the Brazilian economy in the current decade, following at least six decades of introverted economic expansion (based on protectionism and a high degree of state intervention), has, in fact, introduced an element of added complexity into federative relations. In a more open economy, the sense of solidarity tends to lessen and the differences in interests and visions among the more and less developed regions of the country with regard to trade and industrial policy become all the more blatant.

¹⁶Here, it is important to understand that there has been a strong movement among members of Congress and governors from the less developed regions of the country to expand fiscal incentives to such an extent as to bring them close to the standards practiced in the Manaus Free Zone that already exists in the State of Amazônia. One should note that, in contrast to those that exist in other parts of the world, the aforementioned Free Zone operates basically with imports and sales to the internal market.

Insofar as the political aspects of federative relations are concerned, in the administration's first term (1995-1998), it concentrated on ensuring majority congressional support. Consequently, it refrained from initiatives that would have reformed the electoral and party system, weakened the bonds of dependence that tend to subordinate members of Congress to their governors, or attempted to correct imbalances in the system of state representation in the Chamber of Deputies. This position taken by the administration was designed to avoid any possibility of upsetting majority support at a moment in which the Congress was voting on successive constitutional amendments of great importance to the economy. However, there is no doubt that these reforms will sooner or later be placed on the congressional agenda.

Differently from what has happened in other countries of the world and despite the fact that the Brazilian federation is still in the process of construction, it has attained a reasonable degree of stability. Among the factors that have contributed to this, one must mention the legacy of the unitary State and the only moderate differences to be found in terms of race, language and creed within the Brazilian population.

In much the same way, the cycles of centralization and decentralization and the tradition of conciliation that has marked Brazilian politics are factors that facilitate compromises over the course of time. In the specific case of the tax and fiscal system, redistributive mechanisms based on public resources transfers are being utilized to blend divergent and contradictory regional differences among more and less developed regions. And this is being done at a pace that very few other federations have been able to match without generating grave political and civil turmoil. It is certainly not by chance that the ideals of fiscal federalism are always evoked in defense of local interests and public policies that generate no more than regional impact.

Notwithstanding these factors, the flexibility of Brazilian federalism will, in the near future, be put to the test and will have to demonstrate its capacity to cope with the challenges of development policy and political reform. Events will have to be foreseen and resolved early on if the nation is to consolidate a strong, united and democratic federation.

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