Brazil: An Evolving Federation[*]

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I. Introduction

Brazil is a highly decentralized federation. The 27 states (including the Federal District) and 5,559 municipalities together account for over one-third of total government spending and revenue collection. States and municipalities also account for almost 40 percent of the public sector's net debt stock. Revenue mobilization capacity is concentrated in the more prosperoud states and municipalities of the South and Southeast, and some equalization of expenditure capacity has been pursued through mandated revenue sharing. Political and administrative decentralization are also sizable. Each subnational jurisdiction has its own directly-elected legislature and executive branches, as well as an independent judiciary. The federal government has limited control over subnational tax administration; budget formulation, execution, and oversight; and wage and investment policies.

The 1988 Constitution is considered a benchmark in Brazilian federalism. The new Constitution deepened the process of decentralization, rather than mere deconcentration, of revenue mobilization and expenditure functions. Greater autonomy was granted to states and municipalities in debt and expenditure management and control. Reflecting the return to democracy, and the ensuing strengthening of regional political forces, important tax bases were devolved to subnational governments, and the country's revenue-sharing system was reformed. Brazilian federalism had oscillated between decentralization and centralization, reflecting to a large extent the political forces at play throughout the country's recent history.[3]

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[3] See Shah (1990, 1994), Serra and Afonso (1991), Ter-Minassian (1997) and de Mello (1999a), among others, for more information. In Ter-Minassian's words (1997, p. 438), "The democratization process, culminating in the enactment of the 1988 Constitution, was accompanied by a resurgence of decentralization trends. These tendencies have been especially marked on the revenue side, resulting in a relatively high degree of control over revenue sources by the state and local governments, compared with other large federations around the world."

Nearly 12 years after the promulgation of the 1988 Constitution, **a detailed analysis of the recent developments in Brazilian federalism is overdue**. Most of the recent literature on Brazilian federalism has focused on the impact on macroeconomic governance of decentralization following the promulgation of the 1988 Constitution.[4] This is because, in the absence of strict budgetary oversight and fiscal discipline at the subnational level, the implementation of decentralization in the late 1980s and early 1990s was not conducive to macroeconomic stability.

The paper will shed some light on a few aspects of Brazilian federalism that have been overlooked in recent literature. The main recent developments in Brazilian federalism have been threefold. First, the need to improve the quality and efficiency of government spending has placed municipal governments at the forefront of service delivery, particularly in the social area. Second, recognition of capacity bottlenecks has motivated a number of government-sponsored programs to strengthen tax administration and expenditure management and control at the subnational level. Third, emphasis has been placed on institutional developments ensuring that decentralization is compatible with, and supportive of, the implementation of recently achieved fiscal adjustment and macroeconomic stability, as well as improving governance. Recently passed legislation, such as the Fiscal Responsibility Act, is emblematic of these developments.

The paper is organized as follows. Section II provides an overview of Brazilian federalism. Section III focuses on the growing emphasis on municipal governments in service delivery and capacity building. Section IV focuses on the federal dimension of fiscal adjustment and on the recent legislation. Section V concludes.

II. An Overview of Brazilian Federalism

A. The Stylized Facts

Brazil is a very decentralized federation by international standards. The share of subnational government spending in total government expenditures in Brazil is comparable with the OECD average and that of other large, decentralized federations, such as the United States, Germany, Canada, India, the Russia Federation, and Australia, and far exceed those of most Latin American countries (Table 1). Other decentralization indicators, such as tax autonomy ratios, are also in line with those of other decentralized federations. Collection of nontax revenues, such as royalties, user charges, and fees, is limited in Brazil. This suggests *prima facie* that there is some scope for strengthening mobilization of these revenues at the subnational level.[5]

[4] For more information, see Afonso (1994, 1996), Lobo and Afonso (1996), Ter-Minassian (1997), Dillinger and Webb (1999) and Kopits, Jiménez and Manoel (2000).

[5] See de Mello (1999b, 2000a) for a cross-country analysis of intergovernmental fiscal relations.

Table 1: Brazil: Fiscal Decentralization Indicators, 1972-1998.
(Period averages in percent)

	Tax Autonomy 1/		Nontax Autonomy 2/		Vertical Imbalances 3/		Government Size 4/		Expenditure Share 5/		Number of
	Avg.	St. Dev.	Avg.	St. Dev.	Avg.	St. Dev.	Avg.	St. Dev.	Avg.	St. Dev.	Countries
Brazil	54.6	6.3	13.0	3.9	31.8	2.9	12.4	3.4	34.3	3.6	1
Latin America	46.1	11.8	22.1	10.5	25.5	10.6	2.5	1.0	12.2	3.2	17
OECD	40.8	7.5	16.7	2.9	39.1	5.9	13.3	1.5	31.6	2.3	27
Large federations 6/	52.1	3.3	16.1	2.6	31.3	3.2	17.5	1.7	47.4	2.4	6
World	46.6	9.1	19.3	5.6	33.5	8.3	7.0	1.1	20.9	3.0	99

Source: Government Finance Statistics.
1/ Defined as the share of own tax revenues in total subnational government revenues.
2/ Defined as the share of nontax revenues in total subnational government revenues.
3/ Defined as the share of transfers and grants from the central government in total subnational government revenues.
4/ Defined as the share of subnational government spending in GDP.
5/ Defined as the share of subnational government spending in total government spending.
6/ Comprises Australia, Canada, Germany, India, Russian Federation, and United States.

The 1988 Constitution introduced important changes in revenue mobilization assignments. Federal excises on fuel, electricity, telecommunications, and transport were eliminated. The states were assigned a broad-base, high-yield value-added tax (ICMS), which they collect and administer. They were also granted autonomy to set their VAT rate and over tax expenditures, particularly tax deferrals and incentives. At the same time, the new Constitution limited the base of the federal VAT to industrialized goods and increased the share of federal revenues (income tax and the federal VAT) to be transferred to the state and municipal revenue-sharing funds. On the other hand, to compensate for at least some of these revenue losses at the federal level, the new Constitution widened the base of social security contributions, and increased the tax burden on payroll and earnings, and subsequently on financial transactions. These revenues are not shared with subnational governments.[6] Finally, the municipalities were granted a tax on services (telecommunications and intermunicipal transport are exempted) and property, in addition to a wide range of nontax instruments (user charges, licenses, among others).

Decentralization has been characterized by a mismatch in the assignment of revenue and expenditure functions to subnational governments. In sharp contrast with the assignment of revenue sources across different levels of government in the 1988 Constitution, expenditure functions were not always devolved in a clear and systematic fashion to subnational governments. For instance, there is no clear division of responsibilities across government levels on health care and education, social security and welfare, agriculture and food distribution, sanitation and housing, policing, public transport, and

[6] More recently, the *Fundo de Estabilização Fiscal* was created to withhold a percentage of the federal tax revenues that are shared with the states and municipalities.

natural resources and the environment, often leading to a duplication of spending assignments across different levels of government. More importantly, because of significant disparities in institutional capacity at the subnational level, even in cases where expenditure mandates are clearly defined, the states, and sometimes the federal government, hesitated to devolve the relevant expenditure functions to lower tiers of governments for fear of disruption in service delivery.

Brazilian federalism is characterized by institutional rigidities. Constitutional provisions on revenue sharing favor subnational governments to the detriment of the federal government without a clear devolution of expenditure functions to lower levels of government. The federal government has little jurisdictional power over expenditure management and control at the subnational level. These rigidities in revenue sharing arrangements also contributed to delaying subnational fiscal adjustment, since federal government efforts to increase revenues have also led to an increase in total subnational revenues via revenue sharing.

B. An Overview of Expenditure Functions and Revenue Mobilization

Subnational governments play a key role in service delivery. The share of subnational spending in total government outlays has increased over time since the promulgation of the 1988 Constitution (Table 2). The increase in subnational spending shares is due mainly to the rise in subnational outlays on payroll, public consumption, and investment. The federal government's share in total non-financial spending is only higher than that of subnational governments in social security outlays.

Revenue mobilization has been strengthened at the municipal level. The municipalities were the main beneficiaries of the decentralization of tax bases after 1988, through the assignment of wider tax bases and increases in revenue-sharing transfers (Table 3).[7] States and municipalities together collect nearly 32 percent of total tax revenues. Municipal tax revenues are relatively low as a share of GDP, reflecting primarily the narrowness of municipal tax bases, but have almost doubled since 1980 as a share of total revenues. More importantly, municipal revenue collection, excluding revenue sharing, now exceeds the mandated federal transfers to the municipal governments allocated to the Municipal Revenue-Sharing Fund (FPM). Nevertheless, revenue mobilization capacity is unequal across municipalities and the number of local governments for which local revenues exceed transfers from higher levels of government—typically large municipalities and state capitals—is small.[8]

[7] See Serra e Afonso (1991) for more information on the tax reform of 1988.

[8] Only in 6.2 percent of the municipalities that collect their local taxes do own revenues exceed transfers (Afonso and others, 1998).

Table 2: Public Non-Financial Spending by Jurisdiction, 1991-98 1/

	Federal			State			Municipal		
	1991	1998	Change	1991	1998	Change	1991	1998	Change
				(In percent of GDP)					
Consumption	2.1	1.7	-0.4	1.5	2.3	0.8	1.4	2.1	0.6
Payroll	2.6	2.9	0.3	4.2	4.1	0.0	1.8	2.4	0.6
Investment 2/	0.8	0.5	-0.3	1.1	0.6	-0.5	0.9	1.1	0.2
Social security and assistance 3/	7.0	11.5	4.6	1.3	2.4	1.1	0.6	0.4	-0.2
Total	16.5	25.2	8.7	9.2	12.2	3.0	5.3	5.8	0.5
				(In percent of total non-financial spending 1/)					
Consumption	41.8	28.3	-13.5	29.7	37.4	7.7	28.5	34.3	5.8
Payroll	30.7	30.7	0.0	48.6	43.7	-4.8	20.7	25.6	4.8
Investment 2/	27.7	22.5	-5.2	39.3	27.8	-11.6	32.9	49.7	16.8
Social security and assistance 3/	78.3	80.1	1.9	14.8	16.9	2.1	6.9	3.0	-3.9
Total	53.2	58.4	5.1	29.6	28.3	-1.3	17.2	13.4	-3.8

Sources: IBGE (*Regionalização das Transações do Setor Público 1991-1998* and *Contas Nacionais do Brasil 1991 - 1998*).

1/ Non-financial spending excludes debt service and amortization.

2/ For 1998, available from IBGE (*Contas Nacionais do Brasil*).

3/ Includes outlays on pensioners and retirees, family support, other INSS benefits, and withdrawals from FGTS and PIS/PASEP.

In contrast with the municipalities, the relative share of the states in total government revenues has fallen since 1988, reflecting developments in revenue mobilization at the federal and municipal levels. The states now transfer to the municipalities in their jurisdictions more than they receive from the federal government through revenue sharing. Excluding revenue-sharing transfers, the share of state tax revenues in total tax revenues has remained virtually unchanged since the promulgation of the 1988 Constitution. The fall in the relative share of state tax revenues, excluding the mandated transfers to the municipalities, is due, at least in part, to poor performance of the state VAT, which was adversely affected by the deceleration in economic activity in recent years, and because of tax competition among the states. At the same time, to boost its revenue collection, the federal government created a high-yield levy on financial transactions and increased the rates on the existing taxes on enterprises payroll and earnings, which are not shared with the states and municipalities, as discussed above. Likewise, more recently, the earmarking of revenues for primary education has benefited the municipal governments. By increasing the coverage of their primary education system, the municipalities became eligible for the funds that had hitherto been transferred to the states to finance the provision of primary education services (to be discussed below).

Table 3: Tax Revenues by Jurisdiction, 1960-99 1/

	Gross tax revenues 2/				Net tax revenues 3/			
	1960	1980	1988	1999 (prelim.)	1960	1980	1988	1999 (prelim.)
				(In percent of GDP)				
Total	17.4	24.6	22.5	31.8	17.4	24.6	22.4	31.8
Federal government	11.1	18.5	15.8	21.7	10.4	17	14	18.2
States	5.5	5.4	6.0	8.4	5.9	5.5	6.0	8.1
Municipalities	0.8	0.7	0.7	1.7	1.1	2.1	2.4	5.5
				(In percent of total revenues)				
Total	100	100	100	100	100	100	100	100
Federal government	64	75.1	70.6	68.2	59.4	69.2	62.3	57.2
States	31.2	22	26.5	26.3	34	22.2	26.9	25.4
Municipalities	4.8	2.9	2.9	5.5	6.6	8.6	10.8	17.4

Sources: IBGE, FGV, STN (*Balanço Geral da União, Finanças do Brasil*), SFR, Ministry of Social Security and Assistance, CEF, CONFAZ and ABRASF.

1/ For 1960, available from IBGE. Revisions added. For 1980-88, available from IBGE. For 1999, estimated by SF/BNDES.

2/ Refers to tax revenues collected by each jurisdiction.

3/ Excludes constitutional revenue-sharing transfers.

Vertical imbalances in intergovernmental fiscal relations have worsened. The share in GDP of revenue-sharing transfers rose by nearly 1.5 percent in the 1990s and now account for 6.5 percent of GDP (Table 4). The federal government transfers approximately 4.0 percent of GDP to the states and municipalities, and the states transfers approximately 2 percent of GDP to the municipalities in their jurisdictions. Revenue sharing is the main source of revenues at the municipal level: municipal revenues account for approximately 17 percent of total revenues; but, excluding revenue-sharing transfers from the states and the federal government, municipal revenues account for 5.5 percent of total revenues. Federal transfers to subnational governments account for approximately one-fifth of federal revenues and for 30 percent and 70 percent of total state and municipal spending, respectively. Although vertical imbalances are lower at the state level, intergovernmental transfers are instrumental in financing public spending in poorer states, where revenue mobilization is low.

Revenue mobilization indicators vary significantly among the states. Total revenue collection (excluding revenue-sharing transfers) amounts to approximately 36 percent of state GDP in the most prosperous states, against less than 27 percent of state GDP in the less prosperous states of the North, Northeast and Center-West (Appendix Table). Limited ability to collect taxes is associated with high dependency ratios, defined as the share of intergovernmental grants and transfers in revenues (net of intergovernmental transfers). Dependency ratios vary between approximately 38 percent in richer states to nearly 64 percent in the poorer states.

Revenue-sharing arrangements are rigid and equalization of expenditure capacity among the states has not been pursued vigorously. Three basic characteristics can be singled out in Brazilian revenue-sharing arrangements. First, most transfers are of the constitutionally-mandated, revenue-sharing type, rather than discretionary. This reduces the scope for nontransparent, politically-motivated transfers in the form of discretionary grants.[9] Second, the 1988 Constitution deepened vertical imbalances in intergovernmental fiscal relations by requiring the federal government to share with the states and municipalities the revenues of two of its main tax bases: the income tax and the federal VAT.[10] Because of excessive earmarking of sharable revenues, the federal government has increased emphasis on mobilizing revenues that are not earmarked for sharing with the states and municipalities. This has led to a heavier tax burden on enterprise payroll and earnings, which encourages informality in the labor market and affects competitiveness adversely. Third, the 1988 Constitution also changed fiscal relations among the states to correct horizontal imbalances and some spending equalization was pursued. As a result of an agreement among the states in 1989, 85 percent of the state participation fund (FPE) is transferred to the poorer states of the North, Northeast and Center-West, with the more prosperous states in the South and Southeast relying to a much lesser extent on revenue sharing.[11]

[9] Until the 1980s, discretionary grants were more common and highly correlated with the electoral cycle. See de Mello (1999a), for more information.

[10] These resources are allotted to two revenue-sharing funds: the State Participation Fund (FPE) and the Municipal Participation Fund (FPM). The 1988 Constitution mandates that 22.5 percent of the revenues from the income tax and the federal VAT be transferred to the states and that 21.5 percent of the revenues from these federal taxes be transferred to the municipalities. Taking into account all mandated transfers to states and municipalities, 47 percent of income tax revenues and 57 percent of the revenues from the federal VAT are transferred to subnational governments.

[11] The 15 percent ceiling on revenue-sharing transfers to the more prosperous states in the South and Southeast replaced the revenue-sharing formula used until 1989 in which revenues were shared in direct proportion to the resident population and the inverse of income per capita.

Table 4: Revenue-Sharing Transfers, 1991-98. 1/

	Total		Federal		State		Municipal	
	1991	1998	1991	1998	1991	1998	1991	1998
	(In percent of GDP)							
To other jurisdictions	5.1	6.5	3.3	4.3	1.8	2.1	0.0	0.0
From other jurisdictions	5.1	6.5	0.0	0.0	2.2	2.4	3.0	4.1
	(In percent of total)							
To other jurisdictions	100.0	100.0	64.0	66.8	36.2	32.2	0.0	0.6
From other jurisdictions	100.0	100.0	0.0	0.0	42.2	36.9	57.8	63.1
	(In percent of total gross revenues 2/)							
To other jurisdictions	20.9	22.1	20.1	21.3	25.6	27.8	0.1	2.5
From other jurisdictions	20.9	22.1	1.1	1.1	29.9	31.7	298.3	277.8
	(In percent of total net revenues 3/)							
To other jurisdictions	20.9	22.1	25.2	27.7	22.7	26.4	0.0	0.6
From other jurisdictions	20.9	22.1	1.4	1.4	26.6	30.1	87.6	70.8

Source: IBGE (*Regionalização das Transações do Setor Público 1991-1998*).

1/ Refers to constitutional revenue-sharing transfers plus other current transfers.

2/ Refers to tax revenues collected by each jurisdiction and excludes debt revenues, civil servants' social security contributions, certain nontax revenues, and civil servants' income tax.

3/ Excludes revenue-sharing transfers.

III. The Emphasis on Municipalization

A. Background

Local governments, in recent years, rather than the states, have become important elements in Brazilian federalism. The role of municipal government is changing significantly, not only due to their increased revenue mobilization capacity, as discussed above, but also in terms of their more active role in service delivery, particularly in the social area. It has been argued that the fiscal decentralization provisions in the 1988 Constitution was essentially a process of *municipalization* of revenue mobilization and service delivery.

The **main challenges currently facing municipal governments** are (1) to avoid the rise in payroll expenditures relative to outlays on more productive programs, particularly in the social and urban infrastructure areas; (2) to improve the efficiency of public spending by, for instance, reducing outlays on the legislature and administration; and (3) to boost local revenue mobilization, particularly in light of growing demands for social security spending at the local level.[12]

Municipal governments have progressively taken on the expenditure functions assigned to them by the Constitution, particularly in the social area. This has often required financial assistance from the federal government, in addition to the existing mandated revenue-sharing arrangements. Additional federal assistance has not only reduced the risk of disruption in service delivery in the cases where capacity was limited at the local level, but also ensured the timely transfer of funds to service delivery agents. This has been the case in health care, for example, to be discussed below. More importantly, transfers on the basis of minimum per capita spending levels have been a key incentive in many programs, particularly in the areas of primary education and preventive care. As local governments strengthen their role in service delivery, it is expected that federal outlays will be reduced on those programs where spending assignments overlap across government levels.

B. Incentives for Local Revenue Mobilization

Sizable vertical imbalances had discouraged revenue mobilization at the municipal level. For some time, it was argued that municipal governments had weak incentives to fully exploit their tax bases, particularly after the promulgation of the 1988 Constitution, given the increased reliance on mandated transfers from the federal and state governments. The absence of a tax effort parameter in the revenue-sharing formulas has not encouraged local revenue mobilization in Brazil. Also, generous revenue-sharing provisions have been cited as an important factor leading to a rapid increase in the number of municipalities. Between 1984 and 1997, 1,405 municipalities were created in Brazil (Serra and Afonso, 1999); thereby increasing subnational outlays on personnel and administration, in addition to transfers to their legislatures, at the expense of more productive spending on, for instance, social programs and urban infrastructure.[13] Lack of specific criteria for the creation of municipalities has been an additional contributing factor to the proliferation of municipalities in the early 1990s. Because the state share in the revenue-sharing funds are fixed, the creation of municipalities led to a net loss in revenues through state government transfers in those municipal jurisdictions that were divided.[14]

[12] States and municipalities taken together already spend more on pensions and other social security benefits than on health care or housing, urbanization, and sanitation.

[13] See also Gomes and MacDowell (1999) for more information on municipal finances in Brazil.

[14] Preliminary estimates show that, between 1993 and 1997, 534 new municipalities were included in the sharing formula for FPM resources, leading to a re-distribution of over R$ 600 million in favor of these new jurisdictions (Afonso and others, 1998).

To boost local revenue mobilization, recent reforms have focused on the modernization of municipal tax administration. In the absence of more detailed information on municipal finances and better national accounts data, it is difficult to estimate the compliance gap of Brazilian municipal revenues.[15] Nevertheless, it has often been argued that municipal revenue mobilization can be improved, particularly through better local tax administration.[16] The federal government has sponsored a number of programs in this area, but technical assistance was discontinued during most of the 1980s and early 1990s. It would have been crucial to strengthen these programs at the time of implementation of the decentralization provisions of the 1988 Constitution, which, as discussed above, devolved important tax bases and tax administration functions to subnational governments. More recently, the federal government has provided financial, rather than technical, assistance to state and municipal governments to improve their tax administration capabilities. Other programs are now available reflecting the wider diversity in local demands and capacity building needs (Box 1).

Improvements in municipal tax administration are needed for municipal governments to fully exploit their tax bases. Municipal tax collections are sometimes low because of poor tax administration, rather than widespread tax delinquency. Despite regional discrepancies in tax bases, local demands and needs are best met through local revenue mobilization, rather than grants and transfers from higher levels of government, so as to close the gap between the costs and benefits of local government provision and service delivery. Also, by reducing vertical imbalances in intergovernmental fiscal relations, central government finances will tend to be preserved from fiscal imbalances at the subnational level. Moreover, local revenue mobilization is also associated with social capital development at the local level and stronger accountability in local government.[17]

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[15] According to Araújo and Oliveira (2000), the gap between the potential and effective revenue collection in Brazilian municipalities is in the neighborhood of 20 percent. Closing this gap would therefore raise the ratio of municipal revenues, excluding intergovernmental transfers, from approximately 1.7 percent of GDP to nearly 2.0 percent of GDP. See also Afonso and others (1999).

[16] Lack of information on subnational finances is particularly acute in the case of municipalities and in the area of tax administration. As suggested by Tanzi (Bird and Jantscher, 1992, p. iii) "(...) taxation is the art of the possible. A tax system that is not administrable is not worth much."

[17] Municipal governments have also used participative budget formulation processes to encourage accountability in expenditure management. The municipality of Porto Alegre is a case in point, where consultations with residents and subsequently local lawmakers are commonplace in the formulation of public investment budgets. See Souza (2000), for more information on participative budgeting at the municipal level. To strengthen accountability and to improve public governance, the federal government has launched a program (*Brasil Transparente*) aimed at encourage civil society control over budget formulation and expenditure management. The internet will be the main vehicle for dissemination of information and civil society control of government actions, including procurement activities and tenders, among others. For more information, see www.redegoverno.gov.br. Also, see de Mello (2000b) for more information on the relationship between social capital development and decentralization in a sample of developing and developed countries.

Better municipal tax administration will reduce the regional concentration of revenue collection.[18] Despite the improvements in revenue performance in recent years, collection is concentrated in large municipalities, particularly state capitals, and those local governments located in the most prosperous states. Although large municipalities tend to be less dependent on grants and transfers from higher levels of government, they also face a growing demand for local goods and services. Expenditure needs are high in large metropolitan areas, where the main municipalities often cater for the residents of neighboring jurisdictions, particularly in the case of provision of regional public goods such as health care.[19] Rather than aiming at a rapid increase in municipal revenues in the short term, improvements in tax administration should focus on longer-term, permanent, self-sustained increases in revenue mobilization capacity, particularly in those municipalities that are more dependent on revenue sharing to finance local spending. Municipal revenue mobilization capacity should also be resilient to changes in local governments and interruption of federal technical and financial assistance. The experience of the municipality of Rio de Janeiro is noteworthy in this area (Box 2).

Progress has been remarkable in the implementation of information technology systems at the local level of government. It is interesting to note that the more prosperous jurisdictions are not necessarily the ones that use the best systems and have the highest standards in tax administration and expenditure management and control.[20] Some poorer subnational jurisdictions also use state-of-the-art systems and equipment. A variety of e-government systems have also been implemented not only for the dissemination of information and public relations initiatives, but also for service delivery and quality control.[21] Tax administration has also benefited from the dissemination of modern IT systems to municipal governments. For instance, Brazil has been acknowledged for having one of the most advanced systems of electronic filing of income tax returns in the world. Various states are also processing ICMS tax returns through the internet, including the on-line provision of services to large taxpayers. More recently, the federal government and the state of São Paulo

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[18] A recent study by ABRASF (Brazilian Association of Finance Secretaries of the State Capital Municipalities) shows that, in a sample of the 19 largest municipalities (home to 19 percent of the country's population and 53 percent of total municipal tax revenues), 17 municipalities use bar-coded tax return forms; 15 municipalities use state-of-the-art integrated systems; 12 municipalities collect all taxes through the banking system; 11municipalities provide training and re-training courses for civil servants; and 10 municipalities provide services to taxpayers through the internet.

[19] Based on data for the municipalities of São Paulo and Rio de Janeiro, Rezende (1998) shows that, in these metropolitan regions, outlays on urban investment often exceed their revenue mobilization capacity and the financing gap is not always bridged through grants and revenue-sharing transfers.

[20] See Instituto Polis (2000), for more information on municipal tax administration.

[21] For instance, electronic voting was implemented for the municipal elections held in October/November 2000 in all municipalities in the country benefiting 108 million registered voters in both rural and urban areas. Voters and candidates have been registered electronically, and electronic ballots have been used for a speedier counting of votes.

have not only started to register suppliers electronically, but also implemented procurement systems through the internet via electronic auctions.[22]

C. Recent Developments: Social Spending and Policies

Greater autonomy in policymaking and emphasis on municipal governments in service delivery are necessary steps toward improving performance indicators in key social areas such as health care, education, and social assistance, as well as urban planing and infrastructure. Local governments have been enjoying greater autonomy in service delivery, particularly in the provision of social services such as health care and education.

Social spending

Subnational spending on social programs is characterized by extensive earmarking of revenues. In particular:

- The 1988 Constitution requires subnational jurisdictions and the federal government to earmark, respectively, 25 percent and 18 percent of their revenues to finance outlays on **education**. However, these targets were not always met at the subnational level due to financing shortfalls, particularly in poorer states and municipalities. In 1998, a fund (FUNDEF) was created to finance subnational spending on education. A key objectives of the fund is to reduce shortfalls in financing at the subnational level and to increase the coverage of the municipal, rather than state, primary education system. States and municipalities are required to earmark 15 percent of their revenues to finance outlays on primary education.

- Earmarking has also been used extensively to fund **health care**. The 1988 Constitution consolidated the national health care system, and ensured universal access to publicly-provided services.[23] The system combines centralized financing with decentralized service delivery, as the federal government reimburses private health care providers and subnational governments, particularly municipalities, for the provision of health care and maintenance of public hospitals and clinics (Table 5). As in the case of education, the municipalities were not always able, or willing, to perform the functions assigned to them by the Constitution for fear of shortfalls in

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[22] See Fernandes (2000) for more information on the use of IT systems in state capitals and state governments. A recent study on tax administration shows that Brazilian states and municipalities offer a wider range of services on-line than in their European and North American counterparts.

[23] The national health care system created by 1988 Constitution replaced the old system, which provided health insurance only to formal-sector workers and their families. The new system was implemented in the early 1990s to extend publicly-provided health care services to the poorer states of the North, Northeast, and Center-West, where the coverage of the old system was limited, and to informal-sector workers and their families.

transfers from the federal government.[24] To deal with this problem, a new federal levy on financial transactions (CPMF) was created with revenues earmarked for financing health care spending, and the states and municipalities are now required to earmark 12 percent and 15 percent, respectively, of their revenues (net of intergovernmental transfers) to finance outlays on health care.

Equalization of expenditure capacity has been pursued recently. In particular:

- In **education**, the equalization of expenditure capacity across and within the states has been an additional objective of FUNDEF. To this end, a floor was introduced for municipal outlays per student and the federal government is required to top up spending in the case where subnational jurisdictions cannot afford the minimum spending requirement. Also, to reduce pay inequality across the states and within the education sector, 60 percent of the resources spent on primary education are earmarked to wages and salaries, leaving 40 percent to finance capital outlays and operations and maintenance. Motivation for these measures is that the quality of education services depends on teachers' compensation. Also, emphasis on capital, rather than current, spending in the education sector had been associated with pork-barreling, particularly at the municipal level.

- In **health care**, transfers from the federal government to the states and municipalities are based on the costs of the services provided at the municipal level, rather than needs, and past trends in state budget allocations. As a result, the health care system does not ensure equalization of spending across municipal jurisdictions. More prosperous municipalities—where a wider range of more sophisticated, costly health care services is provided—receive more transfers on a per capita basis than poorer municipalities.[25] Better equalization has nevertheless been pursued in recent years through increases in budget allocations for poorer states, where coverage has been extended. Funding for basic and preventive health care programs has also increased; thereby benefiting poor municipalities. More importantly, minimum per capita transfers have been implemented for a number of preventive care programs, including pre-natal care, oral hygiene and immunization.

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[24] Shortfalls became commonplace because financing for health care is linked to that of the social security system. Therefore, increased demand for funding in the social security system, as a result primarily of growing pension liabilities, has crowded out financing for health care. This led to uncertainty in the allocation of funds at the federal level, delays in transfers from the federal government to the providers of health care services at the subnational level and in the private sector, and a reduction in the number of private sector providers associated with the public health care system.

[25] Input-based funding does not rely on performance targets to encourage efficiency in service delivery and creates incentives that distort spending towards more expensive in-patient care.

Table 5: Consolidated Spending on Health Care and Education, 1995-97/99
(In units as indicated)

	1995				Latest 1/			
	Federal government	States	Municipalities	Total	Federal government	States	Municipalities	Total
				(In percent of GDP)				
Total (net of intergovernment transfers)	4.1	2.9	2.5	9.4	3.5	2.9	2.3	8.8
Total	2.6	3.3	3.5	9.4	2.3	3.2	3.3	8.8
Education, culture, and science	1.8	2.3	1.4	5.5	1.4	2.3	1.4	5.1
Health and nutrition 2/	0.9	0.9	2.1	3.9	0.8	0.9	1.9	3.7
				(In percent of total government spending)				
Total (net of intergovernment transfers)	43.3	30.5	26.2	100.0	40.4	33.0	26.7	100.0
Total	27.9	34.8	37.4	100.0	25.9	36.5	37.6	100.0
Education, culture, and science	32.0	42.2	25.8	100.0	28.0	44.8	27.1	100.0
Health and nutrition 2/	22.1	24.3	53.6	100.0	23.0	24.9	52.0	100.0

Sources: BGU, SIAFI, SIAFEM, *Balanços dos Estados e Municípios*, and Ministry of Health.

1/ Refers to 1997 for education and 1999 for health care.

2/ Includes subnational spending in addition to revenue-sharing transfers.

These reforms have yielded encouraging results. Since 1998, the coverage of the municipal primary education system has increased significantly, pay differentials have been reduced across and within the states, and the municipalities have become the main providers of primary education, even in the states where the coverage of the municipal primary education system was limited (Table 6). In the health sector, reforms in funding arrangements have been implemented more recently and their impact on service delivery remains to be assessed more carefully. Preliminary evidence shows that the introduction of explicit targets for coverage and a progressive funding schedule for increased coverage in certain programs has increased access to health services in poorer regions. A better match between the supply and demand for health services has also been achieved through greater involvement of civil society in program design and implementation.

Subnational governments, particularly the municipalities, have enjoyed greater autonomy in program design and implementation. This is unprecedented in Brazil, given that policymaking had been concentrated at the federal government level, often with little concern over differences in regional preferences and needs. In **education**, concomitantly with the expansion of the municipal primary education system, more policymaking autonomy has been exercised at the local level with increased use of demand-driven, result-oriented, participatory administration in public schools, particularly after 1995. These entities are involved in the school’s administrative, financial, and educational decision-making process. Schools are enjoying more autonomy in the organization of curricula and pedagogical projects (subject to minimum standards set by the federal government), personnel management, teaching planning and methods, and procurement.

Table 6: Brazil : School Enrollment Indicators by Government Level, 1996-99

	1999					1996				
	Public schools			Private Schools	Total	Public schools			Private Schools	Total
	Federal	State	Municipal			Federal	State	Municipal		
Total enrollment (in thousands)	122	23,111	19,245	5,557	48,034	149	23,365	13,722	5,904	43,141
Pre-schools	0	380	2,799	1,055	4,234	2	759	2,489	1,019	4,270
Primary education	0	16,589	16,164	3,277	36,031	34	18,469	10,921	3,708	33,131
Secondary education	122	6,142	281	1,224	7,769	113	4,137	312	1,177	5,739
(In percent of total enrollment)										
Total enrollment (in thousands)	0.3	48.1	40.1	11.6	100.0	0.3	54.2	31.8	13.7	100.0
Pre-schools	0.0	9.0	66.1	24.9	100.0	0.1	17.8	58.3	23.9	100.0
Primary education	0.0	46.0	44.9	9.1	100.0	0.1	55.7	33.0	11.2	100.0
Secondary education	1.6	79.1	3.6	15.8	100.0	2.0	72.1	5.4	20.5	100.0

Source: IBGE (*Base de Informaçoes Municipais*).

Recent initiatives have addressed some of the limitations of decentralized provision of health care. Municipal governments are often too small to reap the benefits of economies of scale in health care provision and cannot finance more specialized curative care services. To overcome these difficulties, intermunicipal administrative ventures have been created within the national health care system. These ventures also perform functions such as personnel management, including hiring new staff, licensing private health care providers, and procurement. Early experience with these joint ventures dates back to the late 1980s. More recently, efforts have been made to strengthen the institutional framework within which these ventures are set up.[26] In addition to dealing with economies of scale in service delivery, intermunicipal ventures are also important given the regional externalities associated with the provision of health care.

Human development

Most existing social programs in Brazil are not designed to deal with regional disparities in human and social development indicators. More prosperous states often oppose increases in federal spending in poorer states for fear of losing federal funds. Regional development programs are often designed to benefit regions that are considered poor relative to the state where they are located, rather than in relation to a national benchmark. As a result, poorer regions in richer states often benefit form regional development programs although they may be more prosperous than richer regions in poorer

[26] See Ribeiro and Costa (1999), for more information. According to the Ministry of Health, as of July 1999, there were 143 intermunicipal ventures in Brazil, covering a total of 1,740 municipalities. These intermunicipal ventures have been particularly active in the South and Southeast, with 126 ventures in 1,587 municipalities.

states. Past experiences with reducing regional inequalities in social and economic development have proven unsuccessful.

Recent initiatives have favored joint ventures between the federal government and the municipalities. These initiatives consist of focusing social policies and public outlays on existing social programs in poorer states and municipalities.[27] The priority programs are in the areas of preventive health care, primary and secondary education, and income support. These initiatives also focus on output-oriented service delivery. Targets have been set for each program to facilitate monitoring and evaluation. These targets are defined in terms of output indicators such as coverage of the sanitation and water network, school enrollment rates, and number of beneficiaries of income support programs.

IV. Multi-Level Fiscal Adjustment

A. Background

Macroeconomic stabilization has exposed the fragility of subnational finances. After 1994, high real interest rates and the imposition of harder budget constraints at the subnational level in the context of state debt renegotiations with the federal government have exposed the fragility of subnational finances. In the absence of arm's-length relations between state governments and their banks in the high-inflation period prior to 1994, many state governments had financed their deficits by borrowing from state banks, without regard for normal commercial standards of creditworthiness or loan recovery, and in anticipation of federal bail-outs. States and municipalities recorded an operational surplus of 0.6 percent of GDP in 1991, when decentralization was fully implemented, followed by persistently rising deficits until 1997, when their fiscal position deteriorated sharply (Table 7). The subnational domestic debt almost tripled as a share of GDP in the 1990s. Recently, some key legislation was passed to impose hard budget constraints and restore budgetary discipline at lower levels of government, as well as to strengthen federal control over subnational borrowing and indebtedness.

Subnational debt renegotiations have acted as a catalyst for subnational fiscal adjustment. Subnational debt rescheduling involved the consolidation of foreign and domestic liabilities of the state and major municipal governments. The federal government assumed these liabilities through successive debt rescheduling agreements since the late

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[27] A case in point is the *Alvorada* Program, was originally named IDH-14 Program, given its focus on the 14 states with scores in the UNDP's Human Development Index (HDI) below the national median. The program was subsequently enlarged to benefit poorer regions within richer states that would not be eligible for assistance under the IDH-14 program. These states have HDI scores above the national median but, nevertheless, contain 81 micro-regions and 389 municipalities with HDI scores below the national median. Another initiative in this area is the on-going *Comunidade Solidária* Program, which focuses on poor municipalities and facilitates joint ventures with the private sector and the federal government in social programs.

1980s.[28] The National Treasury has therefore become the main creditor of subnational governments. These agreements are legally binding and provide for a fixed repayment schedule based on the jurisdiction's revenue mobilization capacity. Subsidized interest rates have imposed costs on the federal budget. Nevertheless, the agreements also involved federal intervention and subsequent liquidation and/or privatization of most state government banks.[29] Also, new state and municipal debt issuance has been limited through restrictive clauses in debt-rescheduling contracts. Continued enforcement of these contracts and limited access to financing have required considerable fiscal adjustment at the state level to generate the needed primary surpluses to service their outstanding debt obligations. A broad subnational privatization program, particularly in the sectors of transportation and energy, was also strengthened in support of the accompanying fiscal adjustment effort.

B. New Institutions: The Fiscal Responsibility Law

The enactment of the Fiscal Responsibility Law has been instrumental in imposing hard budget constraints at the subnational level.[30] It has been widely accepted that state debt negotiations with the federal government could be interpreted as a bail-out operation unless accompanied by institutional changes aimed at imposing hard budget constraints at all levels of government. These regulations include provisions for borrowing, indebtedness, tax expenditures (e.g., tax exemptions, deferrals, etc.), and governance.[31] The law forbids further rescheduling of subnational debts contracted after May 2000.

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[28] The subnational government debt is held almost entirely by residents. State governments account for 87 percent of the subnational debt of R$ 247 billion (as of July 2000) and the National Treasury accounts for 85 percent of the debt. Including debts to federal financial institutions and the social security system, the ratio rises to 93 percent. The subnational foreign debt accounts for less than 5 percent of the total subnational debt stock. It is guaranteed by the federal government and concentrated on multilateral institutions. See Kopitz, Jiménez and Manoel (2000), for more information on subnational debt rescheduling.

[29] At the end of 1994, the largest state bank in the country (BANESPA, belonging to the government of the State of São Paulo) was taken over by Central Bank management and it is now scheduled to be privatized over the short-run. Since 1996, at least four large state banks have been privatized (Rio de Janeiro, Pernambuco, Paraná, and two institutions in Minas Gerais) and another four state banks have been liquidated. At the same time, a federal program (PROES) was created to coordinate financial restructuring in these institutions prior to privatization or liquidation.

[30] Brazil's first experience with fiscal responsibility legislation was the *Código de Finanças Públicas* of 1920. The code, comprising over 900 articles, provided the legal framework for multi-level public finances. A precursor of the recently enacted Fiscal Responsibility Law was Senate Resolution No. 78 of July 1, 1998, which re-defined the legal framework for subnational borrowing by, for instance, restricting new borrowing unless the subnational government's ratio of debt to revenues was equal to 1, and it did not have a primary deficit. It also promoted transparency in the relationship between subnational governments and the National Treasury, and banned borrowing before local elections.

[31] The Fiscal Responsibility Law is a complementary law approved by absolute majority in Congress. It cannot be amended by the Executive. See Tavares and others (1999), for more information.

Table 7: Subnational Budget Indicators, 1990-99
(In percent of GDP)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999 (prelim.)
Net debt	38.8	39.9	38.2	32.8	28.5	29.9	31.1	35.4	42.2	53.8
of which : Subnational governments	7.1	7.5	9.5	9.3	9.5	10.4	10.8	15.1	16.3	20.4
Consolidated public sector borrowing requirements 5/										
Nominal	29.6	28.3	47.3	65.0	26.5	7.1	5.9	6.1	7.9	10.0
Operational	-1.3	0.5	2.0	1.4	-2.0	4.9	3.8	4.3	7.4	3.4
Primary	-4.6	-2.9	-1.6	-2.3	-5.1	-0.3	0.1	1.0	-0.01	-3.2
Subnational public sector borrowing requirements 5/										
Nominal	...	10.3	17.5	27.2	11.9	3.5	2.7	3.0	2.0	3.2
Operational	0.4	-0.6	0.7	0.4	0.4	2.3	1.8	2.3	1.8	0.5
Primary	...	-1.5	-0.1	-0.6	-0.8	0.2	0.5	0.7	0.2	-0.2
				(In percent of net revenues 1/)						
Net debt	134.8	158.1	152.7	127.2	95.8	101.7	107.5	121.8	143.3	168.9
of which : Subnational governments	409.0	432.4	451.1	406.0	297.7	298.8	314.2	363.6	439.2	530.8
Consolidated public sector borrowing requirements										
Nominal	102.8	112.1	189.0	252.1	89.0	24.3	20.3	21.0	26.9	31.4
Operational	-4.5	2.0	8.0	5.4	-6.7	16.7	13.0	14.8	25.1	10.6
Primary	-16.0	-11.5	-6.4	-8.8	-17.2	-0.9	0.3	3.5	0.0	-10.2
Subnational public sector borrowing requirements										
Nominal	...	111.6	206.7	336.7	124.3	35.1	27.3	31.1	21.0	31.4
Operational	4.2	-6.5	8.3	5.0	4.2	23.3	18.3	23.2	18.5	4.8
Primary	...	-16.3	-1.2	-7.4	-8.4	1.8	5.5	7.6	2.0	-2.2
Memorandum items:										
Real percentage change in GDP (IBGE)	...	1.03	-0.54	4.92	5.85	4.22	2.66	3.60	-0.12	0.8
Inflation (IGP-DI, period average)	1,476.6	480.2	1,157.9	2,708.6	1,093.8	14.8	9.3	7.5	1.7	20.0

Source: Central Bank, IBGE, FGV, STN (*Balanço Geral da União, Finanças do Brasil*), SFR, Ministry of Social Assistance, CEF, CONFAZ e ABRASF.
1/ Includes constitutional intergovernmental transfers.
2/ SF/BNDES calculations.

The key provisions of the legislation are:

1. **Limits on current spending**. Outlays on payroll (including social security benefits, pensions, and payments to subcontractors) cannot exceed 50 percent of net revenues for the federal government (60 percent for subnational governments). Separate sub-ceilings apply to personnel outlays in the executive, the legislature, and the judiciary.

2. **Ceilings on borrowing** are also provided for but the actual ratios will be set by the Senate for each level of government in a separate piece of legislation. Authorization for subnational borrowing is required by the Senate, subject to prior technical approval by the Central Bank. In addition, to avoid the rise in subnational spending in line with the electoral

cycle, borrowing is banned in the 180-day period before the end of the incumbent's mandate. The ban applies to all subnational jurisdictions, including the Federal District.

3. On governance, the Law requires **multi-year budgets** with three-year targets for revenues, expenditures, and indebtedness. The Law does not set these limits but governs the procedures for monitoring compliance and sanctions to the noncompliant jurisdiction (such as a ban on voluntary transfers) and the incumbent (fines, loss of office, ban on re-election, and legal prosecution). In addition, civil society participation is required in the budgetmaking process at all levels of government.

4. Additional provisions include ceilings for borrowing in relation to the total capital expenditures approved by the budget law ("**golden rule**"). Additional ceilings are also required by the law, subject to complementary legislation, on debt service and outstanding debt stock in relation to revenues. Limits on **loan guarantees** granted by subnational governments have also been proposed.

A key policy question is whether Brazil achieved a cooperative federalism solution.[32] The recent changes in the legislation have laid the foundations for a rules-based system of decentralized federalism that leaves little room for discretionary policymaking at the subnational level. It has been motivated by the recognition that market control over subnational finances should be replaced, or strengthened, by fiscal rules as well as appropriate legal constraints and sanctions for noncompliance at all levels of government. More importantly, top-down coordination in intergovernmental fiscal relations has been preferred to more horizontal, collegial forms of multi-level fiscal policymaking.

Tax Reform

With the purpose of modernizing the tax system, a number of proposals of constitutional amendment are being discussed. The main objectives of tax reform are to reduce tax evasion and to strengthen local revenue mobilization, particularly at the municipal level, within the broad parameters of the current tax legislation. As discussed above, emphasis on local revenue mobilization reflects the efforts to reduce dependency of lower levels of government on grants and transfers from higher levels of government, and to foster transparency and accountability of public finances, with greater social control and civil society participation in service delivery.

The need for tax reform is stronger at the state level. Emphasis on the municipalities as the key agents of service delivery and the fall in the share of state government spending and

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[32] On reviewing the law and economics literature, Inman and Rubinfeld (1997) refer to cooperative federalism as the situation in which decentralized policies are agreed upon through bargaining. In this case, policies that are unanimously approved by all parties in a central legislative body or through intergovernmental agreements are likely to be Pareto-improving.

revenue mobilization have highlighted the need for reform in the Brazilian tax system. Collection of the state VAT—the main source of revenues at the state level—at the origin, rather than destination, has penalized the less prosperous states that are net importers of taxable goods and services. The states that are net exporters of electricity and petroleum products have been particularly penalized. More importantly, tax competition among the states to attract investment, particularly FDI, has eroded their tax bases through the proliferation of tax incentives. The federal government has submitted a tax reform package to Congress calling for, among other things, a level playing field for state VAT taxation, thus reducing the scope for predatory tax competition among the states, and for replacing the existent cascading social security contributions levied by the federal government by federal VAT-type tax.[33]

V. Conclusions and Future Reform

The innovation of the on-going decentralization trend in Brazil is the emphasis on the municipalities, rather than the states, as key agents of service delivery, particularly in the areas of social services and public investment. This is particularly important given that local governments are in principle best able to extract information on local preferences and needs. Reform in Brazilian federalism had been motivated by the need to improve macroeconomic governance and little attention had been devoted to allocative efficiency and equity in service delivery. To strengthen subsidiarity, municipality-oriented decentralization has been favored in the recent developments in social policies, where emphasis has been placed on poverty reduction and human development through a concerted policy effort at local levels of government. It is widely accepted that accountability has been strengthened in the process. However, recent reforms in funding arrangements for social programs are likely to reduce financing shortfalls at the subnational level, but further rigidities in subnational budgets may be at odds with the on-going efforts to grant policymaking autonomy to the states and municipalities.

The states have lagged behind the federal government in fiscal adjustment. Despite the political influence of state governors in Congress, and the regional fragmentation of the Brazilian political system, recent reforms in intergovernmental fiscal relations have affected state government finances adversely. Both the increase in mandated transfers from the states to the municipalities in their jurisdictions and the increased emphasis on the municipalities in the provision of social services have reduced the state share in total government spending and, therefore, revenues. Against this background, most states now spend more on payroll, as a share of their net revenues, than on the provision of social services. This situation is likely to deteriorate in light of the states' growing pension liabilities and, therefore, more ambitious

[33] The joint VAT to be levied by the states and the federal government would be applied on a destination basis. The proposal is motivated by the Dual VAT defended by Bird and Gendron (1997). More information on the shared ICMS projects currently under discussion in Brazil and Argentina (also known as the "little boat model" as a result of the treatment it gives to interstate transactions) is available in Varsano (1999). See also Bird (1999).

reform of state finances will become imperative. The provision of services that is funded through revenue sharing with the federal government, such as health care and education, is not likely to be affected. However, the provision of those goods and services that have regional externalities will certainly suffer from the reduction in the states' ability to finance their own expenditures.

Recent reforms have focused on strengthening vertical, rather than horizontal, intergovernmental fiscal relations. Solution to the problem of underprovision of regional public gods, as well as to other problems related to multi-level policymaking, could involve closer coordination among the states and municipalities. In the absence of more cooperative federalism, institutional rigidities have worsened. To avoid shortfalls in transfers from the federal government, extensive earmarking has been used to encourage subnational jurisdictions to take on the expenditure functions assigned to them by the Constitution. At the same time, earmarking of subnational revenues has been used to avoid financing shortfalls at the subnational level, once the expenditure functions have been accepted. To circumvent these rigidities and to allow for swifter fiscal adjustment at the federal level, more earmarking has been used to withhold a percentage of the federal revenues that are shared with subnational governments. More importantly, there are few formal channels for this type of horizontal, cooperative federalism, in addition to CONFAZ, which deals primarily with the administration of the state VAT. If Brazil is to adopt a more cooperative system of fiscal federalism, efforts are needed to strengthen horizontal cooperation among the subnational governments and to create the necessary fora for discussions.

Recent legislation has also favored rules-based policymaking. The key provisions in the Fiscal Responsibility Law and complementary legislation preclude, at least in principle, discretion in fiscal policymaking, particularly at the subnational level. The legislation contains the key incentives for fiscal probity at all levels of government, as well as formal sanctions for non-compliance. Important challenges remain. On the one hand, the implementation of the new legislation may prove difficult, given the technical capacity required for the states and municipalities to make the new fiscal rules operational and for the federal government to monitor compliance. On the other hand, the new legal framework may not be conducive to, and supportive of, horizontal coordination in multi-level policymaking. Instead, it may strengthen an already rigid, predominantly vertical system of intergovernmental fiscal relations.

Appendix Table: Social and Fiscal Indicators by Region and State, 1999 1/

	Development Indicators			Tax Revenues 5/		Dependency
	Population 2/	Human Development Index 3/	GDP per capita 4/	Total	Subnational 6/	Ratio 7/
Brazil	100.0	0.72	100	34.0	15.0	46.6
More Developed Regions	57.3	0.77	131	36.4	13.3	37.9
Southeast	42.4	0.77	138	38.8	13.3	34.9
Minas Gerais	10.6	0.73	92	24.5	14.7	49.9
Espirito Santo	1.8	0.74	83	40.6	20.7	45.8
Rio de Janeiro	8.3	0.79	133	40.1	12.4	34.4
São Paulo	21.8	0.81	167	42.2	12.8	29.7
South	14.8	0.78	110	27.6	13.4	48.4
Paraná	5.7	0.75	102	28.8	13.9	50.2
Santa Catarina	3.1	0.80	106	27.1	14.1	47.9
Rio Grande do Sul	6.0	0.80	120	26.9	12.8	47.0
Less Developed Regions	42.7	0.64	58	26.7	20.0	64.1
North	7.5	0.62	64	18.5	20.8	71.4
Acre	0.3	0.58	64	14.2	38.1	82.5
Amazonas	1.6	0.63	82	31.2	17.5	50.9
Pará	3.6	0.61	59	12.8	15.9	74.0
Rondonia	0.8	0.66	84	12.3	15.5	69.0
Roraima	0.2	0.67	77	17.3	42.9	85.4
Amapá	0.3	0.67	62	15.8	40.3	86.6
Tocantins	0.7	0.56	22	29.2	78.5	82.0
Northeast	28.4	0.57	46	22.4	22.9	68.7
Maranhão	3.3	0.50	29	15.1	29.9	84.5
Piauí	1.7	0.55	27	21.0	36.8	80.7
Ceará	4.4	0.56	41	27.0	25.9	67.0
Rio Grande do Norte	1.6	0.61	54	19.5	24.3	71.3
Paraíba	2.1	0.57	33	25.2	32.9	74.4
Pernanbuco	4.7	0.62	50	27.6	21.8	60.7
Alagoas	1.7	0.54	50	14.4	20.8	75.9
Sergipe	1.0	0.61	53	22.4	26.8	71.8
Bahia	7.8	0.59	57	21.2	17.4	61.8
Center-West	6.8	0.74	105	39.9	14.3	43.8
Distrito Federal	1.2	0.82	217	72.8	8.6	14.9
Goiás	2.9	0.72	69	25.7	19.1	50.4
Mato Grosso	1.5	0.69	76	23.0	21.0	53.7
Mato Grosso do Sul	1.2	0.72	118	14.1	12.4	52.0

Sources: IPEA, IBGE, FGV, STN (*Balanço Geral da União, Finanças do Brasil*), SFR, Ministry of Social Assistance, CEF, CONFAZ and ABRASF.
1/ Preliminary results for fiscal indicators.
2/ In percent of total population of 165.4 million.
3/ Refers to the 1998 UNDP Human Development Index (HDI).
4/ In percent of the national average.
5/ In percent of state GDP.
6/ Excludes constitutional revenue-sharing transfers.
7/ Ratio of intergovernmental transfers in total net revenues.

Box 1: Technical Assistance Programs: A Brief Survey

CIATA (*Convênio de Incentivos ao Aperfeiçoamento Técnico-Administrativo das Pequenas Municipalidades*) was one of the first technical assistance programs implemented by the federal government in the area of tax administration. Small municipalities were targeted. The program was implemented in the period 1973-81 and benefited 769 municipalities (one-fifth of the Brazilian municipalities at the time). In the case of local property taxation, for instance, over 3,5 million properties were cadastred with an unprecedented impact on local revenue collection. [34] More recently, attention has been focused at the Ministry of Finance on capacity building at the state, rather than municipal level. A core program—PNAFE (*Programa Nacional de Apoio à Administração Fiscal para os Estados Brasileiros*), implemented in December 1996, was motivated by the need to improve local revenue mobilization in the context of the state debt renegotiation process. Given the success of PNAFE, a program (PNAFEM, *Programa de Modernização das Administrações Tributárias Municipais*) will be launched in 2001 to foster capacity building at the municipal level.

Past experience suggests that the most important obstacles to improving revenue mobilization at the municipal level are (1) the maintenance and upgrading of the cadastre of properties for the collection of local property taxes and the selection of appropriate property evaluation mechanisms, and (2) weak municipal tax administration capacity, particularly in auditing. Inadequate municipal tax codes have also been singled out as an important institutional weakness impeding improvements in local revenue mobilization.

In line with the programs implemented by the Finance Ministry, the National Development Bank (BNDES) launched in 1996 a program to strengthen tax administration at the municipal level—PMAT (*Programa de Modernização das Administrações Tributáriais Locais e de seus Setores Sociais Básicos*). Financial support is provided through PMAT for upgrading information technology equipment, software, and infrastructure; human capital development and training; and contracting-out of technical assistance, among others. Initially, the programs focused on tax administration activities (institutional capacity building, systems and legislation; filing, payment, audit and enforcement; and taxpayers services). At the request of municipal governments, the services were extended to encompass expenditure management and control (budget formulation, accounting, and auditing), as well as public administration in the areas of education, health care, social assistance, among others. Currently, PMAT's portfolio is in the neighborhood of US$ 200 million, benefiting 92 municipalities, home to 24 percent of the country's population and 55 percent of total municipal tax revenues. The program is under way in 26 municipalities with a loan portfolio of US$ 75 million. In small municipalities not eligible for assistance under these programs, capacity building has been pursued through the distribution of manuals (FGV/EAESP, 2000) with basic legislation and provisions for a local tax code. The increase in collection in the period covered by the program is on average 60 percent. The program is also cost effective in that the increase in revenues during the program exceeds the total cost of the program in most beneficiary municipalities. Efforts have also been made by BNDES to disseminate successful experiences and best practices, especially through the internet (see internet site www.federativo.bndes.gov.br).

[34] See Ministry of Finance (1981), for more information on these programs. For a more detailed analysis of more recent efforts in improving tax collections at the local level, and information on specific programs, see Afonso and others (1998).

Box 2: Strengthening Tax administration: The Case of Rio de Janeiro

With a population of 5,6 million, the municipality of Rio de Janeiro has the eight largest subnational budget in Brazil. Among the large state capitals, Rio de Janeiro has the highest share of own revenues in total municipal spending, or approximately 60 percent. This is due, at least in part, to efforts to strengthen tax administration, to improve the cadastre of properties, and the upgrading of integrated tax administration systems and interfaces with taxpayers. However, further improvements in municipal tax administration are needed because of the increased demand for public services and the need for fiscal adjustment needed in support of the consolidation of macroeconomic stabilization.

At end-1998, a three-year program (PROMAT) was implemented to strengthen municipal tax administration.[35] The program underscores the view that improvements in tax administration should be permanent and self-sustained; and strengthens synergies between tax administration and other institutions such as urban planning, audit and collection enforcement authorities, budget formulation and information technology. The focus is on institutional capacity building in organization and administration, including reform of functional structures and systems, as well as labor training and re-training, particularly in the provision of services to taxpayers; and on improvement in the cadastre of properties, development of monitoring and control systems for collection, including the recovery of arrears, standardization of systems and procedures, and the creation of new services to taxpayers. The latter have involved, for example, setting up centers in shopping areas and extension of services to weekends. Preliminary results have shown show speedier resolution of disputes regarding the payment of local property taxes (IPTU), the updating of cadastres for 166,000 properties and the collection of arrears relative to the municipal VAT (ISS).

[35] Total program costs are estimated at US$ 14,5 million; 60 percent of which is financed by BNDES.

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