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Fiscal federalism in Brazil: an overview

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Although the states and municipalities that comprise the Brazilian Federation have considerable autonomy in raising their own tax income and spending public funds, this is not the outcome of a planned decentralization process. The improvement in fiscal indicators at the subnational-government level since the promulgation of the Fiscal Responsibility Act has made a major contribution to the success of the country's macroeconomic stabilization policy. Nonetheless, the Federation is seen as a major stumbling block for reform of the tax system. As a contribution to the debate on federative balance in the division of fiscal responsibilities, this paper makes a diagnostic study of the federative framework and recent institutional changes, and proposes a new federative agenda.

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I
Introduction

The fact that the Brazilian Federation is characterized by pronounced fiscal decentralization, has led to accusations that it hinders economic stabilization. Yet stabilization was finally achieved under the Real Plan, implemented in June 1994, without the federative structure being significantly altered.

The scant commitment shown by Brazil's subnational governments[1] towards formulating and implementing healthy macroeconomic practices (in which respect it differs little from other federations) has also also been seen as obstructing the consolidation of stability. Nonetheless, starting in the late 1990s Brazil embarked upon a profound reform of its public finances, in a process that culminated in a fiscal responsibility law that surpassed all other federations in the degree of transparency and austerity it demands of federated members. The situation has been reversed to such an extent that better primary and nominal results achieved by the states and municipalities (along with State-owned enterprises) have recently compensated for a deterioration of those indicators at the central (federal) government level.

In recent years, the Federation has ceased to act as a disrupting factor in the "economic order", and now actually contributes to the success of short-term macroeconomic policy (at least with regard to the management of surplus and debt targets). A structural issue remains unresolved, however, along with attendant difficulties and distortions: the Federation is still viewed by many as the chief obstacle to reforming the economy, as if the federative division of tax revenues had been frozen since implementation of the system defined by the 1988 Constitution. This idea is false, however, for financing and public expenditure trends have changed significantly in recent years.

II
Conditioning factors

1. Economic setting

Brazil is the world's tenth largest economy in terms of gross domestic product (GDP),[2] has the fifth largest population (184.2 million inhabitants) and is fifth also in terms of land area. Following a long period of stagnation in the nineteenth century, its economy grew faster than any other country in the world between 1870s and 1970s, while also undergoing far-reaching structural change. The pace of growth was particularly rapid after World War II, but it has slowed dramatically over the last 26 years. As a result, Brazil's per capita income (US$ 7,450) is still 86th in the world ranking,[3] it ranks 63rd in the Human Development Index (0.792),[4] and its income distribution is among the most unequal on the planet (a Gini coefficient of 0.544 in 2005).

Accustomed to vigorous output and employment growth and rapid structural changes, and wishing to bring about a substantial improvement in social conditions

☐ This article, which draws on data available up to September 2006, is based on a paper presented at the International Conference on Federalism at the Forum on Federations (Mont-Tremblant, Canada, October 1999). The opinions expressed herein are the exclusive reponsibility of the authors and not of the institutions to which they are affiliated. The economists Rafael Barroso, Beatriz Meirelles and Kleber Castro helped to prepare the analysis and update the statistical database.

[1] In this paper, the term "subnational governments" will be used to refer to government authorities both at the state level, including the Federal District, and at the municipal level.

[2] In 2005, GDP was US$ 796 billion, at current prices converted using the current exchange rate, according to the Organization for Economic Co-Operation and Development (OECD).

[3] According to the World Bank ranking of countries for 2002, using per capita GDP calculated on a purchasing-power-parity basis.

[4] Human Development Report (UNDP, 2005).

among the poorest segments of the population, Brazil, at the start of this new century, has been impatiently striving to regain the momentum of growth without compromising the price stability achieved at such cost 12 years ago.

For three fifths of the recent period of economic semi-stagnation (1980-2006), the country endured an acute process of hyperinflation, which was overcome only in the mid-1990s after at least eight unsuccessful attempts. Since then, reforms have been introduced to regain development with stability, and the State's role in economic life has been redefined. The economy has become more open to international trade and financial flows, and social and industrial policies have been retargeted —along with the fiscal and federative system, the topic of this article.

Improving fiscal federalism in Brazil is essential, both to maintain economic stability and to resume sustainable development, since the formulation and implementation of more appropriate economic policies depend, among other things, on the structure and harmonization of internal and external taxation.[5]

2. Historical setting

In a country without major cultural conflicts arising from linguistic, religious or even ethnic identities, the Brazilian Federation was created in 1891 as a response to regional differences and administrative needs spanning a continent-sized land area. This federation was not the outcome of any "bottom-up" coalition, but was created by a "top-down" decision to divide a unitary state. In terms of the tax system, the move to federation mainly benefited the more developed provinces of the south and southeast, especially São Paulo where the new export sector was concentrated. It is no coincidence that that state headed the republican movement and led the republic in its early days. One of the main objectives was to obtain greater freedom of movement to levy local taxes on foreign trade.[6] In return, the less developed regions were offered more-than-proportional representation in the National Congress.

Since its creation, the Brazilian federative system has experienced clearly defined cycles of central-government contraction and expansion.[7] Between 1891 and 1930, under the "Old Republic" and at the height of the primary-economy/coffee-exporting boom, the federal government was relatively weak, and its relative share of national public expenditure shrank from about three quarters to a half. At the same time, the proportion of total state government income generated by São Paulo expanded from just over 10% to nearly 40%.

This was followed by a cycle of centralization between 1930 and 1946, which began with the revolution of 1930 *(Revolução de 30)*. This phase accompanied the global economic depression and culminated with the Getulio Vargas dictatorship (the "New State"). Centralization of power in the hands of the federal government made it possible to complete the unification of the domestic market and strengthen the foundations of industrialization. In that period, the federal authorities' share in the inter-governmental division of public expenditure increased from 50% to 55%.

At the end of the World War II, the redemocratization of the country and new democratic Constitution of 1946 inaugurated a new decentralization phase; and central government once again absorbed about 50% of total national public expenditure in the following decade.

The advent of the military regime in 1964 ushered in a two-decade phase of resource centralization (table 1), which was useful both for fiscal reform —in the first half of the period, with the concentration of income and control of expenditure in the hands of central government— and for the political and social control that the regime needed. In 1983, at the height of centralization, the federal government share in disposable tax revenue peaked at almost 70%, broadly matching its share in the federative division of national public expenditure.

The weakening of the military regime combined with the winds of political openness to moderate central power in the first half of the 1980s, and this trend was reaffirmed in the second half of that decade with redemocratization and the drafting of a

[5] See Oates (1999) for an up-to-date overview of fiscal federalism, covering both theoretical principles and international experiences.

[6] A feature of the Brazilian tax system that contrasts with that of the United States has been highlighted by Professor Alcides Jorge Costa: ever since the colonial period, the intermediate level of government in Brazil has always managed to uphold its own right to tax exports, including those of industrial products. In contrast, property taxation has always been derisory, especially in rural areas, which was usually assigned to the federal jurisdiction. For example, in 2005, the states raised about R$ 8.8 billion from vehicle property tax – 36 times more than the R$ 240 million that central government collected from rural land tax.

[7] The statistics on the division of revenue or expenditure between the different spheres of government discussed in the following paragraphs are based mainly on Goldsmith (1986).

TABLE 1

Brazil: Tax burden and its federative division, 1960-2005
(Percentages)

Year	Tax burden	Direct collection[a]				Disposable tax revenue[b]			
	(Percentage of GDP)	Central government	States	Municipalities	Total	Central government	States	Municipalities	Total
1960	17.41	64.0	31.3	4.7	100.0	59.5	34.1	6.4	100.0
1965	18.99	63.6	30.8	5.6	100.0	54.8	35.1	10.1	100.0
1983	26.97	76.6	20.6	2.8	100.0	69.8	21.3	8.9	100.0
1988	22.43	71.7	25.6	2.7	100.0	60.1	26.6	13.3	100.0
1991	25.24	63.4	31.2	5.4	100.0	54.7	29.6	15.7	100.0
2005	38.94	68.4	26.0	5.6	100.0	57.6	25.2	17.2	100.0

Source: Afonso and Meirelles (2006).

[a] Direct collection = Revenue collected directly by each sphere of government from its own tax jurisdictions in each state or region.
[b] Disposable tax revenue = Direct collection (own tax jurisdictions) plus or minus constitutionally mandated revenue transfers, including: (i) those granted by the central government, which include cash transfers from the State Revenue Sharing Fund (FPE), the Municipal Revenue Sharing Fund (FPM), the Export Compensation Fund (FPEx), the revenue-insurance generated by the Sales Tax on Merchandise and Services (ICMS), and complementation of the Fund for the Maintenance and Development of Basic Education and Professional Development of Teachers (FUNDEF); and (ii) transfers granted by the the states —25% of ICMS/FPEx and 50% of the Motor Vehicle Ownership Tax (IPVA), in addition to redistribution from FUNDEF. The municipalities' disposable income consists exclusively of federal and state transfers.

new Constitution (1987-1988). When the National Constituent Assembly began to operate, disposable tax income was no longer so highly concentrated in central government hands: the federal share had been reduced to about 60%,[8] contrary to popular belief prevailing both in Congress and among government authorities (including at the federal level) and the press.

Moreover, against a backdrop of prolonged hyperinflation and failed stabilization programmes, the weakness of the previous tax system became clearly visible, as the national tax burden shrank from about 25% of GDP in the early 1970s to 22% in 1988.

Since the 1970s, the banners of fiscal decentralization and a weakening of central power have held a prominent place in the ideology and process of the country's re-democratization. The movement achieved major success in the final phase of the authoritarian regime in the first half of the 1980s. In the second half, the new Constitution (1988) gave another vigorous boost to transfers. The share of the main federal taxes, i.e. Income Tax (IR) and the Industrial Products Tax (IPI), which was paid into the State and Municipal Revenue Sharing Funds (FPE and FPM) grew from 18% to 44% between 1980 and 1990. If all constitutionally mandated transfers are included, the portion transferred amounts to 47% of IR and 57% of IPI. The comparative figure in 1980 was just 20%.[9]

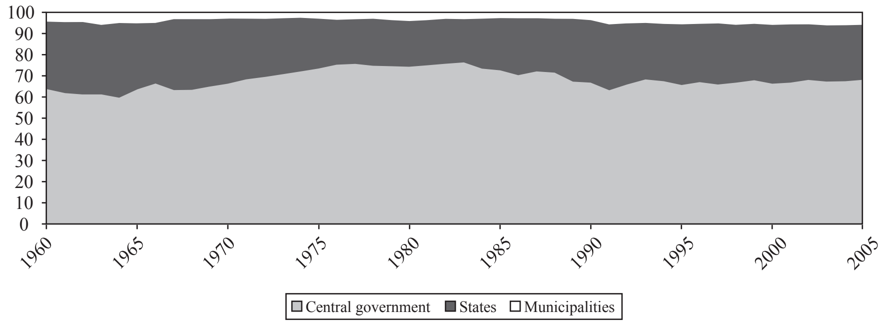
Following promulgation of the 1988 Constitution, subnational government tax capacity was also strengthened and consolidated (figure 1). In the case of the states, for example, the tax base of state-level ICMS was extended, with the new tax absorbing five old federal taxes. Rates were also made more flexible, as was the corresponding administration, which was entirely delegated to the states themselves. Revenue transfers from this tax to the municipalities were also increased by 25%. Revenue raised by the municipalities themselves also grew, and they more than doubled their share of the total tax revenue collected in the country: from 2.7% of the overall tax burden in 1989 to 5.6% in 2005 (figure 2).

[8] See Serra and Afonso (1991).

[9] Of this, 3% is channelled to regional banks in the north (Banco da Amazônia, BASA), northeast (BNB) and centre-west regions. In the latter case, as there is no regional bank, the account is managed as a sinking fund by Banco do Brasil, for regional loans; 10% of IPI revenue is paid into a state fund to compensate for the fact that ICMS is not levied on exported manufactured products.

FIGURE 1

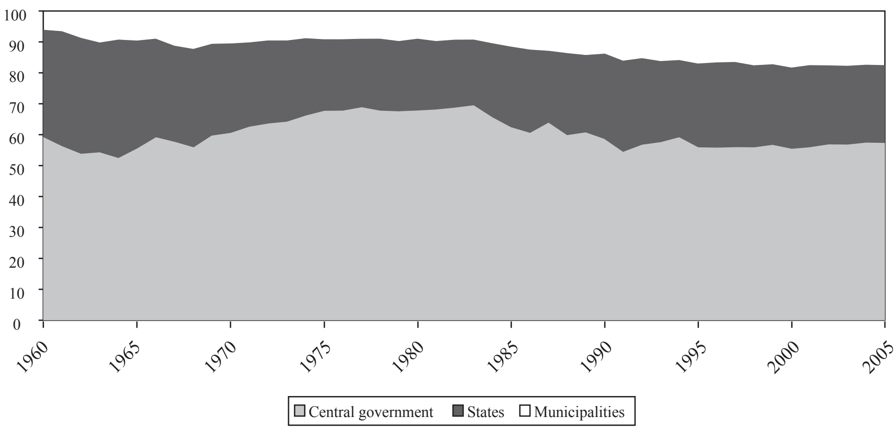
Brazil: Federative division of direct tax revenue, 1960-2005
(Percentages)



Source: Afonso and Meirelles (2006).

FIGURE 2

Brazil: Federative division of disposable tax revenue, 1960-2005
(Percentages)



Source: Afonso and Meirelles (2006).

This phenomenon was accompanied by an increase in the national tax burden, which was far more pronounced in the more developed regions: rising in 2005 to 36.7% of GDP nationally;[10] 48.7% and 42.2% in Rio de Janeiro and São Paulo, respectively; and 22.7% and 24% in the north and northeast (table 2).

In vertical terms, which is the main focus of fiscal federalism, nearly all relative gains have benefited the municipal sector, with the states' position altering little, especially in terms of disposable tax revenue (own tax revenue plus or minus constitutionally mandated transfers). In horizontal terms, the additional resources were mostly destined for state and municipal governments in the less developed regions, thereby reversing the heavy concentration of revenue and GDP pertaining to the more developed regions, in the distribution of disposable tax income and expenditure. Both trends will be shown in the next section.

[10] Statistics on the regionalization of tax revenues show a national consolidation that is slightly less than the amount of revenue indicated by the national accounts methodology, which includes federal revenue items for which there is no information by state of origin.

TABLE 2

Brazil: Regional distribution of own tax revenue, 2005

Regions and states	Total tax revenue		Direct tax revenue[a] (R$ million)							
	Percentage of GDP[b]	Per capita (*real* per inhabitant)	Total		Federal		State		Municipal[c]	
	A	B	C		D		E		F	
Brazil	**36.7**	**3 857**	**710 283**	**100.0**	**478 499**	**100.0**	**195 496**	**100.0**	**36 288**	**100.0**
More developed regions	***37.2***	***5 047.8***	***532 252.5***	***74.9***	***364 985.8***	***76.3***	***136 951.7***	***70.1***	***30 315.0***	***83.5***
Southeast	*41.2*	*5 613.4*	*440 486.4*	*62.0*	*310 118.2*	*64.8*	*105 593.6*	*54.0*	*24 774.6*	*68.3*
Minas Gerais	28.2	2 638.4	50 754.7	7.1	27 179.4	5.7	20 601.5	10.5	2 973.8	8.2
Espírito Santo	40.2	4 252.4	14 492.1	2.0	8 027.5	1.7	5 886.5	3.0	578.2	1.6
Rio de Janeiro	48.7	7 504.1	115 435.0	16.3	91 888.9	19.2	18 224.4	9.3	5 321.7	14.7
São Paulo	42.2	6 424.1	259 804.6	36.6	183 022.5	38.2	60 881.2	31.1	15 900.9	43.8
South	*25.5*	*3 402.3*	*91 766.2*	*12.9*	*54 867.6*	*11.5*	*31 358.1*	*16.0*	*5 540.5*	*15.3*
Paraná	25.5	3 066.9	31 469.6	4.4	19 415.1	4.1	10 087.5	5.2	1 967.0	5.4
Santa Catarina	26.2	3 455.7	20 271.4	2.9	11 758.3	2.5	7 196.4	3.7	1 316.7	3.6
Rio Grande do Sul	25.1	3 690.7	40 025.2	5.6	23 694.1	5.0	14 074.3	7.2	2 256.8	6.2
Less developed regions	***35.2***	***2 274.3***	***179 037.1***	***25.2***	***113 512.9***	***23.7***	***58 544.5***	***29.9***	***6 979.6***	***19.2***
North	*22.7*	*1 489.4*	*21 886.7*	*3.1*	*10 250.6*	*2.1*	*10 461.6*	*5.4*	*1 174.5*	*3.2*
Acre	23.3	1 177.0	787.4	0.1	291.9	0.1	459.0	0.2	36.5	0.1
Amazonas	26.4	2 858.5	9 238.8	1.3	5 152.4	1.1	3 677.3	1.9	409.1	1.1
Pará	18.6	971.1	6 768.3	1.0	2 963.0	0.6	3 327.4	1.7	477.9	1.3
Rondônia	22.3	1 539.0	2 360.9	0.3	742.4	0.2	1 513.4	0.8	105.1	0.3
Roraima	27.0	1 442.5	564.0	0.1	252.4	0.1	274.1	0.1	37.5	0.1
Amapá	17.4	1 121.5	666.2	0.1	289.6	0.1	341.1	0.2	35.5	0.1
Tocantins	28.8	1 150.3	1 501.1	0.2	558.8	0.1	869.4	0.4	73.0	0.2
Northeast	*24.0*	*1 258.3*	*64 182.6*	*9.0*	*30 333.2*	*6.3*	*29 774.1*	*15.2*	*4 075.3*	*11.2*
Maranhãó	24.9	709.5	4 330.1	0.6	2 073.9	0.4	1 968.8	1.0	287.4	0.8
Piauí	23.1	702.9	2 105.9	0.3	844.7	0.2	1 115.7	0.6	145.5	0.4
Ceará	26.8	1 169.0	9 469.1	1.3	4 592.2	1.0	4 118.8	2.1	758.1	2.1
Rio Grande do Norte	23.2	1 315.8	3 951.4	0.6	1 571.0	0.3	2 086.7	1.1	293.8	0.8
Paraíba	20.7	982.2	3 530.9	0.5	1 488.4	0.3	1 828.9	0.9	213.6	0.6
Pernambuco	26.2	1 641.2	13 807.4	1.9	6 392.2	1.3	6 478.1	3.3	937.1	2.6
Alagoas	20.8	887.7	2 676.3	0.4	1 080.4	0.2	1 366.3	0.7	229.6	0.6
Sergipe	25.5	1 890.8	3 719.3	0.5	1 213.0	0.3	1 479.9	0.8	1 026.4	2.8
Bahia	22.6	1 490.6	20 592.3	2.9	11 077.4	2.3	9 331.0	4.8	183.9	0.5
Centre-west	*64.3*	*7 140.9*	*92 967.7*	*13.1*	*72 929.2*	*15.2*	*18 308.8*	*9.4*	*1 729.8*	*4.8*
Federal District	150.8	30 379.5	70 875.3	10.0	64 285.3	13.4	5 689.4	2.9	900.6	2.5
Goiás	22.8	1 862.2	10 463.7	1.5	4 512.6	0.9	5 602.6	2.9	348.6	1.0
Mato Grosso	24.0	2 411.8	6 760.1	1.0	2 312.2	0.5	3 967.3	2.0	480.6	1.3
Mato Grosso do Sul	20.6	2 150.4	4 868.5	0.7	1 819.0	0.4	3 049.5	1.6		

Source: Prepared by the authors on the basis of data from the Treasury (STN, various years), the Ministry of Welfare and Social Assistance, the Federal Economic Fund, the National Economic Policy Council, and the Brazilian Geographical and Statistical Institute (IBGE).

[a] Direct collection = Revenue collected directly by each sphere of government from its own tax jurisdictions in each state or region.
- Central government revenue includes taxes (on foreign trade, capital and income, production); fees; social, economic and welfare contributions; and contributions to the Unemployment Insurance Fund (FGTS). The information per state is distorted for some taxes, because revenue collection is not the responsibility of an establishment or branch; and figures for the Federal District consolidates revenues obtained directly by the Federal Government or those of national scope.
- State revenue collection includes the state-level ICMS, IPVA, the Inheritance and Gift Tax (ITCD), fees and other items. Municipal revenue includes the Urban Real Estate Tax (IPTU), the Tax on Services (ISS), the Tax on Property Transfer between Living Persons (ITBI), fees and contributions for improvements.
- Municipal tax revenue pertaining to the Federal District corresponds to revenue obtained by the district government from IPTU, ISS, and ITBI.

[b] State-level GDP at current prices estimated on the basis of 2003 shares.

[c] Municipal revenue was reported by the Treasury on the basis of a 4,164-city sample, encompassing about 87% of the Brazilian population.

III

Analysis of the federative framework

An updated diagnosis of the situation of the Brazilian Federation[11] can be summarized in the following five points.

1. A system that is still evolving

The federative system in Brazil, a country whose economic frontier is still expanding, is still not physically complete, irrespective of the conflicts and conceptual issues that remain. Evidence for this is the fact that two new states were created in the 1970s (Mato Grosso do Sul and Rondônia), and another three following the National Constituent Assembly (Amapá, Roraima and Tocantins). All five of these new states are in less developed regions in the centre-north of the country. The National Constituent Assembly also put the Federal District in the same category as other states, by giving it full representation in the National Congress and its own legislative assembly, police and judicial system.

Moreover, the decentralising impetus of the 1988 Constitution gave the municipalities constitutional status as quasi-members of the Brazilian Federation. Initially, this encouraged the creation of new municipalities, as the total number rose from just over 4,000 to 5,564 in 2005.[12] In 1996, it was necessary to make a constitutional amendment to slow down this proliferation, by requiring that new municipalities be approved by popular plebiscite encompassing both territories —i.e. the territory being considered for emancipation and also the territory of origin.[13]

2. Vertical decentralization

In relation to the tax burden, the states and municipalities directly collected 31.6% of total taxes levied in Brazil in 2005. Once the constitutionally mandated distribution of revenues had been accomplished, subnational governments controlled 42.4% of national tax revenue, including social and pension fund contributions (table 1).

On the expenditure side, and contrary to popular belief about the Brazilian public sector, the states and municipalities exercise clear predominance in the government actions and services that most serve the population, apart from expenses in respect of financial charges and social benefits. According to the national accounts (the most recent official figures are for 2003), state and municipal governments accounted for 71% of the payroll of active civil servants in the country, in addition to 75% of other financing expenses and 85% of fixed investments (table 3 and figure 3).[14] Central government predominates only in the case of personal transfers, mainly consisting of pension benefits, and interest payments on the public debt, in which it accounted for about 85% of the consolidated government expenditure at all levels.

The trend of primary government expenditure in the period since the National Constituent Assembly dispels any doubts regarding decentralization, since it matches the redistribution of tax revenues even though the process has unfolded without proper planning or coordination. Whereas in 1988, central government absorbed 44% of all government demand for goods and services (including labour), by 2003 this proportion had fallen to 27% (table 3). In recent years, the distribution of overall expenditure reflects the reaction of central government to the rapid growth of expenditures on income transfers, particularly social benefits (pensions and social assistance), and interest on the public debt.

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[11] See Affonso (1994) for a more detailed analysis of fiscal decentralization in Brazil.

[12] A study made by the Industrial Development Studies Institute (IEDI, 2006) estimates the “political cost” of the municipalities (i.e. the minimum amount of expenditure required to operate the federated municipal entity) at around R$ 10 billion or 0.6% of GDP.

[13] Constitutional Amendment No. 15, of December 1996, succeeded in halting the creation of new municipalities, despite being generic and depending on the passing of a complementary law. From 1997 to 2005, only 57 were created, and these are covered by the previous legislation, since all of their processes had begun before the constitutional amendment was passed.

[14] This situation has been accentuated by a drastic downsizing of the State enterprise sector (not counted in the calculations made in this paper). This resulted from the rapid privatization process of the 1990s, particularly in the federal domain (e.g. telecommunications, mining, iron and steel, petrochemicals, electric power, rail transport and the road network).

TABLE 3

Brazil: Federative division of public expenditure in the national accounts, 1988, 2000 and 2003

Government level	Period	Main non-financial expenses: Intermediate consumption[a] – Percentage of GDP	Intermediate consumption[a] – Percentage of total	Remuneration of employees (active)[b] – Percentage of GDP	Remuneration of employees (active)[b] – Percentage of total	Gross fixed capital formation – Percentage of GDP	Gross fixed capital formation – Percentage of total	Total expenditure – Percentage of GDP	Total expenditure – Percentage of total
Federal[c]	1988	2.6	55.3	3.2	40.5	1.1	34.4	6.9	43.7
	2000	2.0	32.0	3.0	32.7	0.5	26.6	5.5	31.8
	2003	1.7	25.4	2.9	29.3	0.3	15.5	4.9	26.6
State	1988	1.2	25.5	3.3	41.8	1.2	37.5	5.7	36.1
	2000	1.9	31.4	3.9	41.7	0.6	32.8	6.4	37.1
	2003	2.3	33.3	4.1	41.4	0.7	39.2	7.1	38.2
Municipal	1988	0.9	19.1	1.4	17.7	0.9	28.1	3.2	20.3
	2000	2.2	36.6	2.4	25.6	0.8	40.6	5.4	31.1
	2003	2.8	41.3	2.9	29.2	0.8	45.3	6.5	35.1
Consolidated general government	1988	4.7	100.0	7.9	100.0	3.2	100.0	15.8	100.0
	2000	6.1	100.0	9.3	100.0	1.9	100.0	17.3	100.0
	2003	6.8	100.0	10.0	100.0	1.7	100.0	18.5	100.0

Source: Prepared by the authors on the basis of IBGE (2003). This is the latest year for which the final volume of national accounts is available.

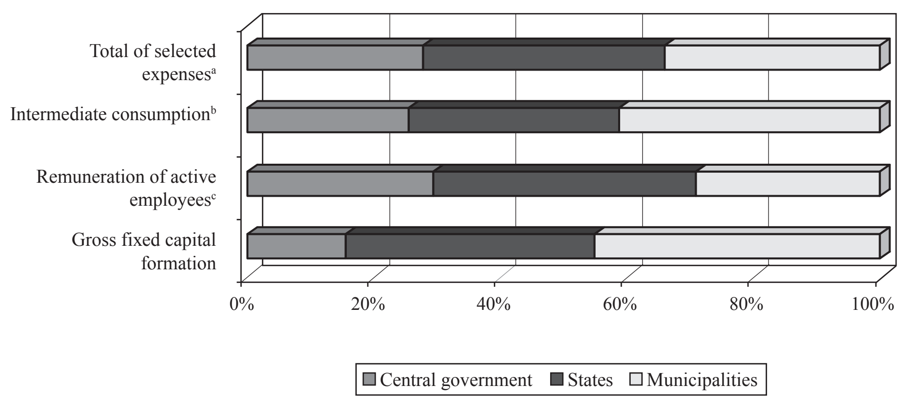
[a] Intermediate consumption includes direct purchases of goods and services for current operations.

[b] A deduction was made for what the IBGE refers to as "imputed social contributions", corresponding to the financing of civil servant pension contributions.

[c] Includes social security - general regime, managed by the National Social Security Institute (INSS) and the Unemployment Insurance Fund (FGTS).

FIGURE 3

Brazil: Federative division of primary public expenditure, 2003



Source: Prepared by the authors, using data from the Brazilian Geographical and Statistical Institute (IBGE).

[a] Governments include decentralized administrations, but not productive State enterprises. Central government includes social security.

[b] Intermediate consumption includes other direct purchases of goods and services.

[c] Excluding what the IBGE refers to as "imputed social contributions" corresponding to the financing of civil servant pension contributions.

TABLE 4

Brazil: Regional distribution of subnational disposable tax income,[a] 2005

Regions and states	States				Municipalities				Subnational = states + municipalities			
	Disposable income			Transfer. Federal/ disposable income	Disposable income			Federal transfers/ disposable income	Disposable income			Federal transfers/ disposable revenue
	% of GDP[b]	Real per capita	Millions of real and % of total[c]		% of GDP[b]	Real per capita	Millions of real and % total[c]		% of GDP[b]	Real per capita	Millions of real and % total[c]	
	A	B	C	D	E	F	G	H	I	J	K	L
Brazil	7.7	808.4	114.780 **100.0**	22.8	4.3	456.1	62.737 **100.0**	40.0	12.0	1 264.6	177.517 **100.0**	29.0
Brazil except São Paulo	8.1	606.8	72.3	29.8	4.8	441.7	75.6	46.3	13.0	1 191.1	73.5	35.9
More developed regions	***6.5***	***875.0***	***62.0***	***9.8***	***3.6***	***486.6***	***61.1***	***29.8***	***10.0***	***1 361.5***	***61.6***	***17.0***
Southeast	*6.5*	*884.8*	*46.6*	*7.9*	*3.5*	*476.3*	*44.5*	*26.3*	*10.0*	*1 361.0*	*45.9*	*14.3*
Minas Gerais	7.7	723.6	9.3	15.3	4.8	453.2	10.4	43.0	12.6	1 176.8	9.7	25.9
Espírito Santo	11.1	1 170.7	2.7	17.0	6.5	687.2	2.8	37.8	17.5	1 857.8	2.7	24.7
Río de Janeiro	4.4	672.1	6.9	7.8	2.4	376.5	6.9	17.7	6.8	1 048.7	6.9	11.4
São Paulo	6.7	1018.3	27.7	4.6	3.3	507.4	24.4	20.3	10.0	1 525.7	26.5	9.8
South	*6.3*	*846.4*	*15.3*	*15.7*	*3.9*	*516.5*	*16.6*	*76.7*	*10.2*	*1 363.0*	*15.8*	*24.6*
Paraná	6.4	774.1	5.3	18.3	4.1	491.4	6.0	42.5	10.5	1 265.6	5.6	27.7
Santa Catarina	6.5	862.6	3.4	14.6	4.0	530.6	3.7	38.6	10.6	1 393.2	3.5	23.7
Rio Grande del Sul	6.2	906.1	6.6	14.2	3.6	532.7	6.9	36.7	9.8	1 438.7	6.7	22.5
Less developed regions	***11.1***	***719.2***	***38.0***	***44.0***	***6.4***	***415.4***	***38.9***	***55.9***	***17.6***	***1 134.7***	***38.4***	***48.3***
North	*14.1*	*927.8*	*9.2*	*55.4*	*6.3*	*411.5*	*7.2*	*54.9*	*20.4*	*1 339.3*	*8.5*	*55.3*
Acre	36.6	1847.9	0.8	80.0	9.1	460.4	0.4	69.8	45.7	2 308.3	0.7	77.9
Amazonas	8.6	932.0	2.0	29.1	4.1	442.4	1.7	34.2	12.7	1 374.4	1.9	30.8
Pará	10.5	549.5	2.6	48.9	6.8	353.0	2.9	59.6	17.3	902.5	2.7	53.1
Rondônia	16.2	1,117.8	1.2	47.3	6.7	462.6	0.8	46.5	22.9	1 580.4	1.0	47.1
Roraima	44.8	2,395.1	0.6	79.7	10.3	550.9	0.3	70.2	55.2	2 945.9	0.5	77.9
Amapá	30.0	1,935.7	0.8	87.7	4.9	315.7	0.2	73.8	34.8	2 251.4	0.6	85.7
Tocantins	33.6	1345.2	1.2	71.4	14.1	563.4	0.9	72.1	47.7	1 908.7	1.1	71.6
Northeast	*11.6*	*606.5*	*20.8*	*48.4*	*7.6*	*399.7*	*24.3*	*62.1*	*19.2*	*1 006.2*	*22.0*	*53.8*
Maranhão	17.6	502.2	2.1	67.1	12.8	364.4	2.6	76.4	30.4	866.6	2.3	71.0
Piauí	20.0	607.8	1.2	65.4	13.5	411.8	1.5	74.3	33.5	1 019.6	1.3	69.0
Ceará	11.8	516.2	2.8	48.4	8.6	374.1	3.6	62.8	20.4	890.4	3.1	54.4
Rio Grande do Norte	13.9	786.5	1.6	51.0	8.1	460.7	1.6	61.7	22.0	1 247.2	1.6	55.0
Paraíba	13.6	647.9	1.6	59.1	9.0	425.6	1.8	71.3	22.6	1 073.6	1.7	63.9
Pernambuco	9.7	608.7	3.4	38.9	5.9	370.6	3.7	54.4	15.7	979.3	3.5	44.8
Alagoas	15.1	644.6	1.3	59.9	9.6	411.4	1.5	69.7	24.8	1 056.0	1.4	63.7
Sergipe	12.9	958.3	1.3	61.8	6.0	442.5	1.0	62.8	18.9	1 400.8	1.2	62.1
Bahia	9.0	595.6	5.5	33.9	6.3	416.6	6.9	53.8	15.4	1012.2	6.0	42.1
Centre-west	*8.3*	*925.5*	*8.1*	*19.7*	*4.3*	*481.6*	*7.5*	*36.5*	*12.7*	*1,407.1*	*7.9*	*25.5*
Federal District	5.5	1,117.6	1.8	9.4	1.9	385.3	1.1	6.6	7.5	1 502.9	1.5	8.7
Goiás	9.8	800.5	3.0	20.6	4.4	359.1	2.4	56.2	14.2	1 159.6	2.8	31.6
Mato Grosso	9.6	964.6	1.8	28.0	6.7	677.3	2.3	32.5	16.3	1 641.9	2.0	29.9
Mato Grosso do Sul	9.5	989.3	1.5	19.8	6.2	642.4	1.7	33.0	15.6	1 631.7	1.6	25.0

Source: Prepared by the authors on the basis of data from the Treasury (STN, various years), the Ministry of Welfare and Social Assistance, the Federal Economic Fund, the National Economic Policy Council, and the Brazilian Geographical and Statistical Institute (IBGE).

[a] Disposable tax revenue = Direct collection (own tax jurisdictions) plus or minus constitutionally mandated tax transfers, including (i) those granted by the central government, which include cash transfers from FPE, FPM, FPEx, the revenue-insurance generated by ICMS, and complementation of FUNDEF; and (ii) transfers granted by the the states – 25% of ICMS/FPEx and 50% of IPVA, in addition to redistribution from FUNDEF. The municipalities' disposable income consists exclusively of federal and state transfers.

[b] State GDP at current prices estimated on the basis of 2003 shares.

[c] For Brazil, first line, columns C, G and K, the amount is expressed in millions of real at current prices.

TABLE 5

Brazil: Regional distribution of population, income and political representation, 2005

Regions and states	Population		Gross domestic product (GDP)[a]		GDP per capita	Conditions of life	Distribution of seats		
	Millions of inhabitants	Percentages	R$ million	Percentages	R$/ Inhabitant	Index = 100	Chamber of Deputies	Senate	Congress
Brazil	**184.2**		**1 937 598**		**10 521**	**0.766**	**513**	**81**	**594**
							%	%	%
More developed regions	***105.4***	***57.3***	***1 429 341***	***73.8***	***13 556***	***0.799***	***49.9***	***25.9***	***46.6***
Southeast	*78.5*	*42.6*	*1 069 192*	*55.2*	*13 625*	*0.791*	*34.9*	*14.8*	*32.2*
Minas Gerais	19.2	10.4	179 972	9.3	9 356	0.773	10.3	3.7	9.4
Espírito Santo	3.4	1.9	36 083	1.9	10 588	0.765	1.9	3.7	2.2
Rio de Janeiro	15.4	8.4	237 046	12.2	15 410	0.807	9.0	3.7	8.2
São Paulo	40.4	22.0	616 091	31.8	15 234	0.820	13.6	3.7	12.3
South	*27.0*	*14.6*	*360 149*	*18.6*	*13 353*	*0.808*	*15.0*	*11.1*	*14.5*
Paraná	10.3	5.6	123 264	6.4	12 013	0.787	5.8	3.7	5.6
Santa Catarina	5.9	3.2	77 462	4.0	13 205	0.822	3.1	3.7	3.2
Rio Grande do Sul	10.8	5.9	159 422	8.2	14 700	0.814	6.0	3.7	5.7
Less developed regions	78.7	42.7	508 257	26.2	6 456	0.713	50.1	74.1	53.4
North	*14.7*	*8.0*	*96 415*	*5.0*	*6 561*	*0.725*	*12.7*	*25.9*	*14.5*
Acre	0.7	0.4	3 382	0.2	5 055	0.697	1.6	3.7	1.9
Amazonas	3.2	1.8	34 941	1.8	10 811	0.713	1.6	3.7	1.9
Pará	7.0	3.8	36 375	1.9	5 219	0.723	3.3	3.7	3.4
Rondônia	1.5	0.8	10 573	0.5	6 893	0.735	1.6	3.7	1.9
Roraima	0.4	0.2	2 088	0.1	5 340	0.746	1.6	3.7	1.9
Amapá	0.6	0.3	3 839	0.2	6 462	0.753	1.6	3.7	1.9
Tocantins	1.3	0.7	5 217	0.3	3 998	0.710	1.6	3.7	1.9
Northeast	*51.0*	*27.7*	*267 195*	*13.8*	*5 238*	*0.676*	*29.4*	*33.3*	*30.0*
Maranhão	6.1	3.3	17 411	0.9	2 853	0.636	3.5	3.7	3.5
Piauí	3.0	1.6	9 120	0.5	3 044	0.656	1.9	3.7	2.2
Ceará	8.1	4.4	35 392	1.8	4 369	0.700	4.3	3.7	4.2
Rio Grande do Norte	3.0	1.6	17 053	0.9	5 679	0.705	1.6	3.7	1.9
Paraíba	3.6	2.0	17 072	0.9	4 749	0.661	2.3	3.7	2.5
Pernambuco	8.4	4.6	52 619	2.7	6 254	0.705	4.9	3.7	4.7
Alagoas	3.0	1.6	12 857	0.7	4 264	0.649	1.8	3.7	2.0
Sergipe	2.0	1.1	14 573	0.8	7 409	0.682	1.6	3.7	1.9
Bahia	13.8	7.5	91 099	4.7	6 594	0.688	7.6	3.7	7.1
Centre-west	***13.0***	***7.1***	***144 647***	***7.5***	***11 110***	***0.737***	***8.0***	***14.8***	***8.9***
Federal District	2.3	1.3	47 006	2.4	20 148	0.844	1.6	3.7	1.9
Goiás	5.6	3.1	45 863	2.4	8 162	0.776	3.3	3.7	3.4
Mato Grosso	2.8	1.5	28 158	1.5	10 046	0.773	1.6	3.7	1.9
Mato Grosso do Sul	2.3	1.2	23 619	1.2	10 433	0.778	1.6	3.7	1.9

Source: Prepared by the authors, on the basis of data from the Brazilian Geographical and Statistical Institute (IBGE) (population and GDP); the United Nations Development Programme (UNDP) (Human Development Index for 2000); and Congress (number of parliamentarians).

[a] State GDP at current prices, estimated on the basis of 2003 shares.

Indicators of tax decentralization in Brazil, measured by indices of the share of subnational governments in total income and expenditure, in addition to their autonomy in collecting taxes and preparing their budgets, places the country in a similar position to the most developed federations; among developing countries it is definitely the furthest ahead in terms of autonomy.[15]

It is worth noting that Shah (1994) developed an index subnational government autonomy that measures the proportion of expenditure financed with internal resources or with funding received from third parties, but without earmarking. In a group of 10 countries, including both rich and poor, Brazil displays the highest index, surpassing even those of the United States, Germany and Canada.

3. Horizontal decentralization

Alongside vertical decentralization in the distribution of public funds, a far-reaching process of horizontal deconcentration of revenue has been instigated.

The concentration of federal tax revenue in the more developed regions is matched by a scheme for distributing federal taxes in which the subnational governments of less developed regions receive proportionally more (see the updated position as at 2005 in table 4). This does not take account of the larger share of direct social spending on basic social measures obtained by those regions.

The regional deconcentration of tax revenue is well illustrated by the case of São Paulo. This is the most populous and developed unit of the federation; it holds 22% of the country's population and produces 31% of national output, thereby generating a per capita income that is 45% higher above the national average (table 5). The State of São Paulo collected about 37% of all tax revenue in Brazil in 2005; its smallest share was state taxes (31%), which reflects the partial adoption of the destination principle in the incidence of ICMS in inter-state transactions; its largest shares (38% and 44%) correspond to federal and municipal taxes, respectively.

As a result, the tax burden in São Paulo represented 42% of state GDP, compared to a national average burden of 36.7%. This difference also shows through in the measurement of per capita tax revenue, since the average collected in São Paulo was about R$ 6,500, compared to the national average of R$ 3,900 (see again table 2).

Shifting the analysis away from direct tax revenue and on to effectively available income —i.e. once the constitutionally mandated redistribution of taxes between governments has been calculated— shows that São Paulo had 26.5% of the disposable revenue of all state and municipal governments across the country in 2005 (table 4) —nearly 5 percentage points less than that state's share in the generation of national GDP. This difference precisely illustrates the degree of regional deconcentration promoted by the Brazilian tax system.[16]

The relative importance of state and municipal income, measured as a proportion of the income of each state, also reveals the progress of regional deconcentration. In 2005, the available income of subnational governments in São Paulo was just 10% of the state's GDP, whereas the average in the three least developed regions was equivalent to 18% of regional output (table 4).

The same analysis can be extrapolated from the isolated case of São Paulo to the distribution between geographic macro-regions, in which the comparison between the division of the population and the economy on the one hand, and tax revenues on the other, further highlights the decentralizing nature of the system (figure 4).[17]

Subnational governments in the three least developed macroregions account for 38% of all disposable tax revenue (own revenue, plus or minus mandated tax transfers) in those spheres of government, i.e. 12 percentage points more than their 26% share in national GDP. In the southeast region, these percentages are 46% and 55%, respectively.

To visualise decentralization more clearly, it is possible to compare the actually disposable revenue of the governments of each federated unit with their respective GDP (see the regions in figure 5 and the breakdown by state in table 4 above). The national

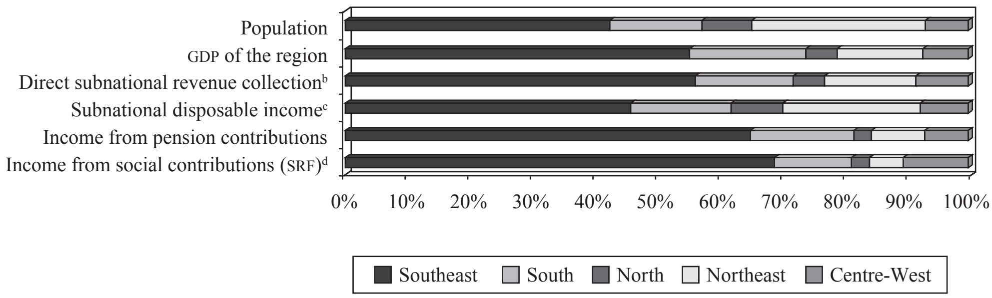
[15] The index of the share of subnational governments in direct tax collection is unprecedented among like-sized economies. It is similar to the indicators displayed by the world's most developed federations such as Canada, Australia, Germany and the United States; and it exceeds those of unitary states with administrative decentralization strategies such as France and England.

[16] This difference will shrink somewhat once the direct revenue collected from other state taxes and municipal taxes has been calculated, the amount of which in São Paulo should exceed that of the rest of the country.

[17] See breakdown in table 2, table 4, and further on in table 5.

FIGURE 4

Brazil: Regional distribution of population, gross domestic product and subnational tax revenue, 2005[a]



Source: Prepared by the authors, using data on population and GDP at basic prices from the Brazilian Geographical and Statistical Institute (IBGE); and tax revenue data from the Treasury, Federal Internal Revenue Department (SRF), Ministry of Welfare and Social Assistance and the National Economic Policy Council. Data on the population, GDP and direct tax revenue are from 2005, while other data relate to 2004.

[a] Tax revenues: aggregates of the states and municipalities in each region.
[b] Direct revenue includes taxes within own jurisdiction.
[c] Disposable income also includes tax transfers granted by Central government.
[d] SRF = Data from the Federal Internal Revenue Department.

index in 2005 was 12%; in the two most developed regions, the share was equivalent to just 10 percentage points of GDP, whereas in the centre-west it rises to about 13%, and in the northeast and north, 20%. Dispersion between states is even more pronounced and exceeds 30% of GDP in some states in the northeast and north. The extreme case of Roraima has a tax income equivalent to 55% of local GDP (see again table 4).

The pronounced regional redistribution of disposable tax income reflects federal revenue transfers to the states and municipalities. In 2005, for example, almost R$ 740 per person was transferred to governments in the north region, whereas those in the southeast received just R$ 195 per person (figure 6). In the latter region, and in the south, for every *real* collected through IR or IPI, 14 cents were returned through revenue sharing funds (FPM and FPE).[18]

[18] In the State Revenue Sharing Fund (FPE), the south-southeast share was limited to 15%, under the law (approved in 1989) that adopted a fixed prorating scheme instead of a formula weighted by the inverse of income per capita. The updating of this parameter threatened to reduce the relative weight of the least developed regions which, by growing proportionally more in the 1970s and 1980s, had closed the gap between them and the higher-income regions.

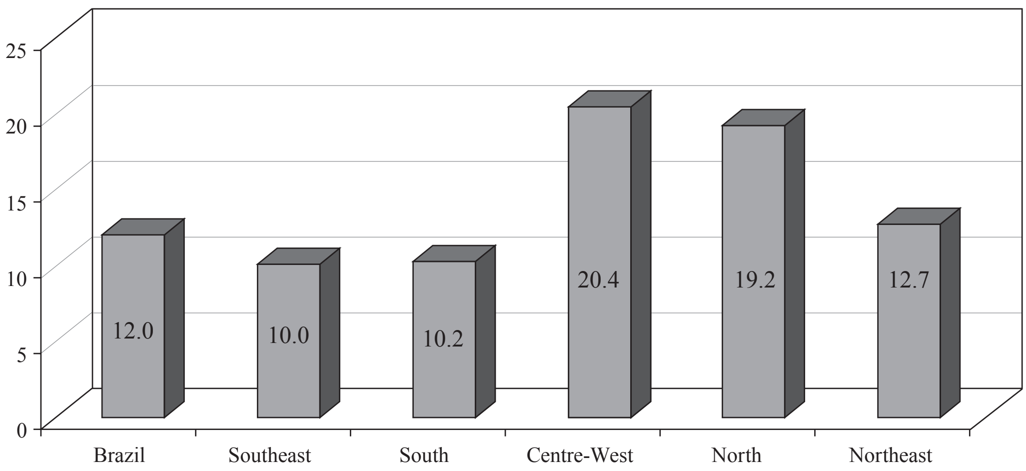
In the specific case of São Paulo, for every *real* of revenue earned from IR and IPI, just six cents flow back to the state through the FPM and FPE. In absolute terms, São Paulo collected R$ 53.2 billion from IR and R$ 12.3 billion from IPI in 2005, and received back R$ 3.6 billion from the FPM and just R$ 255 million from the FPE in that year.

Lastly, it is worth mentioning the trend of disposable tax revenues in subnational governments during the post-National Constituent Assembly period. The available data confirm the more favourable trend in the less developed regions. Considering only revenue from the main taxes and federal transfers (on the same basis as presented in table 4 above) it is possible to compare real growth rates in the period 1988-2005: the disposable resources of subnational governments increased by 4.3% per year, with the south growing more or less at the national rate. Regions with disposable resources that outpaced this annual rate were the northeast where growth was 5%, the centre-west (6%) in the north (7.6%); in contrast, growth in the southeast was just 3.3%. The wealthiest of the country's 27 states (São Paulo) recorded the smallest growth of just 2.7% per year, while, at the other end of the spectrum, Maranhão and Piauí saw their resources increase by roughly 6% per year.

FIGURE 5

Brazil: Subnational disposable tax revenue[a] by region, 2005

(As a percentage of gross domestic product)



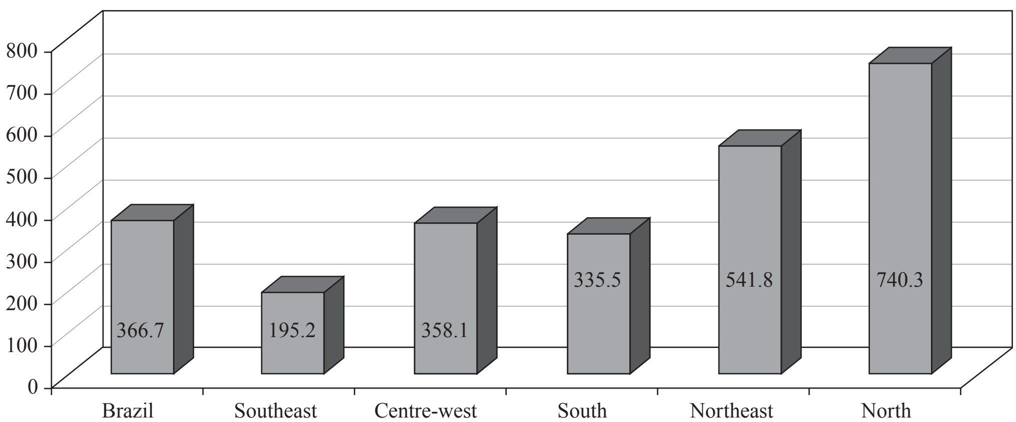
Source: Prepared by the authors using data from the Treasury, National Economic Policy Council (tax revenue) and the Brazilian Geographical and Statistical Institute (IBGE) (GDP at basic prices).

[a] Disposable tax revenue includes the revenue raised directly by the states in each region plus the respective transfers of federal and state taxes.

FIGURE 6

Brazil: Transfers of federal taxes per capita to the regions,[a] 2005

(In real)



Source: Prepared by the authors, using data from the Treasury and the Brazilian Geographical and Statistical Institute (IBGE).

[a] Includes constitutionally mandated revenue transfers from central government to the states and municipalities in each region.

4. Government powers

Although the chapter of the Federal Constitution that deals with the tax system and the complementary laws that regulate it is very precise and highly detailed in terms of the jurisdictions and the distribution of tax revenues at each of the three levels of government, the chapter on governmental powers is much vaguer and fails to establish a clear distribution of tasks between the different spheres.

Measures overlap in certain areas (such as the environment) and are lacking elsewhere (e.g. security). Central government has not managed to satisfactorily fulfil its coordination function, and subnational governments adopt autonomous policies. Although, on the one hand, central government and even certain states are curtailing their participation in investments and ongoing programmes, they are not transferring staff or assets to state or local units. Among other effects, this generates an unforeseen increase in aggregate public expenditure.

Another constitutional factor that served to make fiscal relations more rigid within the federation were provisions that imposed the unified labour regime for civil servants in the three spheres of government, together with the guarantee of early and comprehensive retirement pensions in the public sector, and the granting of statutory status to all civil servants covered by private-sector labour laws (Consolidated Labour Laws). The latter responded to the proposal and effort made at the time by *Centrão*, a grouping that encompassed some of the more conservative members of parliament during the Constituent Assembly of 1987-1988. The proposal naturally attracted support from left-wing parties (linked to civil servant unions).

In any event, the structure of federal government financing and expenditure continued to redistribute resources between regions —as revealed by comparing the regional distribution of the sources and uses made of federal government resources, especially those earmarked for basic social measures. A pronounced regional redistribution of resources can also be seen in the direct execution of federal expenditure: suffice it to compare data on the regional composition of the collection of social contributions and those of the main social programmes funded from those sources. For example, the southeastern region collected roughly two thirds of all contributions, but receives significantly smaller percentages of total central government expenditure on certain basic social measures: 21% of rural pension payments and 34% of ongoing benefits both from social assistance and primary health care programmes. In the northeastern region which collects just 6% of social contributions nationwide, the share in the aforementioned programmes amounts to 37% in the case of pensions, 47% in social assistance, and 36% in health.

The same pattern occurs in social security overall (the private-sector workers regime), in which the income derived from payroll levies is concentrated in the most developed states, while the distribution of pension benefits is regionally much more disperse.[19] In 2004, the northeast absorbed 8.3% and 20.2% of revenue and expenditure, respectively, while the equivalent figures for the state of São Paulo were 43.2% and 30.7%. In the overall calculation, the highly redistributive role of the current social security regime is revealed by the average benefit paid as a proportion of per capita GDP. While this is currently equivalent to about 49% in the southeast, it soars to 80% in the northeast. In some states, the average benefit even exceeds their respective per capita income: 132% and 122% in the states of Maranhão and Piauí, respectively.

5. Redistribution in parliamentary representation

In the political domain, the Brazilian federative system also promotes considerable redistribution of power in terms of parliamentary representation.

The Federal Senate, based on the United States model, consists of equal representation of three senators per state. A group of states that account for 43% of the Brazilian population (in the north, northeast and centre-west) holds 74% of the seats (table 5). The Brazilian Senate reviews and votes on all legal bills and constitutional amendments passed by the Chamber of Deputies, and has power of veto. It also has a number of exclusive powers, such as approving ambassadors and the heads of several government organizations, and setting borrowing limits for states and municipalities (and exceptions therefrom). The Senate, which is considered the upper chamber, only has less power than the lower chamber in one respect: government bills enter Congress through the Chamber of Deputies, which then has the final word when the Senate returns

[19] The main sources of these data are *Anuario Estadístico de la Previsión Social* and *Boletín Estadístico de la Previsión Social*, both published by the Ministry of Welfare and Social Assistance (MPAS).

them with amendments. Representation in the Chamber of Deputies is also not proportional to the population of the states, since the maximum number of deputies per state is capped at 70 and the minimum is eight. Over-representation is concentrated in sparsely populated states in the north, while underrepresentation occurs in the southeast. In the extreme cases, to elect a deputy in the most populous state requires 16 times more votes than in the country's least populous state.

According to Stepan (1997), these representational imbalances are a key component of democracy-constraining federal systems, of which Brazil is the most notable case. Although they date back to the founding of the Republic, the imbalances became more pronounced in the post-World War II period and even more so following the creation of six new states and promotion of the Federal District into a state for all practical purposes.

IV
Recent institutional changes

To contextualise the analysis more clearly, it needs to be borne in mind that in Brazil, as in all federations, the subnational spheres of government have less of an obligation to concern themselves with macroeconomic variables relating to price stability, the fiscal deficit, external trade or the balance of payments.[20] The major challenge that the Brazilian Federation faced following the Real Plan was how to reconcile greater or lesser fiscal decentralization with rational economic policy goals at the national level.

Following the Real Plan, the newly won stability and the need to project a positive image of the Brazilian economy abroad meant that economic policy focused on controlling the public deficit, and hence on federative relations. Until the mid-1990s, there was major concern about the role of the states and municipalities in the lack of control over the fiscal deficit, given their large weight in the public sector, asymmetry in the distribution of rights and duties between the three spheres of government, the existence of state banks that financed the deficits, and the possibility of issuing debt bonds for the same purpose. Another contributory factor was the direct political influence exerted on the National Congress by governors and mayors, in an electoral and party system such as the one that prevails in Brazil. Despite having exclusive constitutional power to control public borrowing, in practice the Senate has seldom acted to restrain this area.

Moreover, unlike what happens in federations such as the United States, the Brazilian central government has always acted (without exception) as lender of last resort, thereby encouraging subnational governments to behave more permissively in the fiscal domain. The roots of this phenomenon date back to the tradition of the centralized State, and reflect cultural and political factors such as the party system and congressional representation.

Attempts to improve the federative system in the 1990s led the federal government to adopt a series of conciliatory measures, without ever losing sight of the historical recommendation made by Tocqueville (1957, p.156): *"The federal system was created with the intention of combining the different advantages which result from the magnitude and the littleness of nations."* Those measures included changes in arrangements for renegotiating subnational debts, reform of the state-level ICMS (under the "Kandir Law") and the passing of the Fiscal Responsibility Act, among others. All of these initiatives were ways of dealing with the most urgent federative problems, within a gradual and prudent strategy for action, albeit one that is costly in financial terms.

With regard to the renegotiation of subnational debts, the expired and unpaid external debt dating back to the 1980s, together with domestic bank debt and debt in bonds, were all consolidated and taken over by the National Treasury in a succession of refinancing programmes. The last round of debt refinancing ended in 1999; the central government took over the debt of the states, which amounted to R$ 132 billion (Law 9.496/97),[21] and, on the eve of the publication

[20] For a discussion on fiscal decentralization, price stability and macroeconomic policy, including the Brazilian case, see Afonso (1996) and Dillinger and Webb (1999); and for an international perspective see Spahn (1999).

[21] For further details on state debt refinancing agreements, see Mora (2002).

of the Fiscal Responsibility Act in May 2000, it took over the debts of 180 municipalities, totalling R$ 16.4 billion real (Provisional Measure 1.811/99). As counterpart, the states and municipalities assumed debts with the Treasury that would be financed over a minimum 30-year period, with interest ranging from 6% to 9% per year, and monthly instalments capped at 13% of net income. Fulfilment was guaranteed by a constitutional amendment allowing the Treasury to withhold and offset any due and unpaid amounts from the constitutional transfers to which debtor subnational governments would be entitled, and to withdraw funds directly from the bank account that centralizes the financial transactions of the government in question. In exchange:

(i) the federal government intervened in, liquidated, or sold most state banks to the private sector —as from 1994, all large states privatised, liquidated, or placed their banks under central bank administration;[22]
(ii) the issuance of new debt in state or municipal bonds was suspended, under restrictions contained in refinancing contracts; and
(iii) a wide-ranging process of State downsizing occurred at the subnational government level, particularly in the transport and electric power areas. From 1996 to 2003, stakes in 55 State enterprises were either privatised or sold, generating a total of US$ 34.7 billion (of which US$ 27.9 billion corresponded to the sale and US$ 6.8 billion represented transferred debt).[23]

The design and approval of the Fiscal Responsibility Act was only possible following a refinancing and fiscal adjustment process in the main subnational governments.[24] One of the most far-reaching changes produced by this legislation was to prevent new lending between governments or the refinancing of past debts, thereby breaking with a secular tradition of the Brazilian Federation. Only the final reckoning with the past could justify and permit the adoption of a new radical law that restricted all forms of borrowing between governments (even Treasury guarantees on external operations henceforth required real guarantees).

Implementation of the Fiscal Responsibility Act has been a gradual process, particularly in terms of correcting possible breaches of the limits. In the case of payroll expenditure, a period of over two years was allowed to reduce these to the permitted ceiling, and in the case of the consolidated debt, the limit for which is set by the Federal Senate, a 15-year period was envisaged for governments that had refinanced their debts with the Treasury to bring them in line. Moreover, following the practice adopted since the start of negotiations for debt refinancing, the federal government made credit lines available to support state and municipal investments in the modernization of revenue administration and also in fiscal management.

Another front in the process of institutional change in the federation involved the decentralization of responsibilities and powers.

In the education sector, for example, a systematic channelling of resources through FUNDEF was approved.[25] This was a temporary constitutional measure, passed in 1996 and enforced up to 2006. Its main purpose was to universalise the coverage of basic education,[26] and induce municipalities to take over an ever larger share of the public school network; and the inter-governmental revenue sharing system was amended for this purpose (in proportion to the number of students enrolled). The resources came to be earmarked to FUNDEF, based on the traditional allocation of taxes to education. A stimulus for setting up the fund was provided by central

[22] From 1997 to 2005, when the last state bank was privatized, 12 state banks were sold, including the two largest – Banco do Estado de São Paulo (Banespa) and Banco do Estado do Rio de Janeiro (Banerj) —in an operation that generated a total of US$ 6.8 billion. The state banks of Piauí and Santa Catarina are still under central bank administration.

[23] Between 1991 and 2003, the total value of privatizations in the federal government domain amounted to US$ 70.8 billion, of which US$ 59.5 billion corresponded to direct proceeds and US$11.3 billion to transferred debts (for further information see BNDES, 2004).

[24] The Fiscal Responsibility Act introduced a number of innovations in public governance, such as the obligation to keep expenditure and income in balance, and to include an annex of fiscal targets; in addition to the requirement to provide an emergency reserve in the budget law. Public-sector spending was also capped, the refinancing of state debts was disallowed, and it was decided that operations to anticipate budgetary income would be paid in the year in which they occurred.

[25] Under Constitutional Amendment No. 14, a fund was created in each state for a 10-year period, which would receive 15% of the amount of transfers from revenue sharing funds and the respective ICMS collection. In 2005, FUNDEF resources amounted to R$ 32.7 billion. Unlike the criteria normally used in tax legislation for distributing these resources between the state and its set of municipalities, and in the municipal domain between the different municipalities, the prorating of each state fund is proportional to the number of students enrolled in the respective basic education network, with a view to promoting better distribution of spending capacity. In practice, governments that collected a lot but spent little on each student had part of their incomes redistributed to other governments.

[26] In Brazil, basic education is what is provided to children from seven to 14 years of age.

government, which transferred around R$ 500 million per year in supplementary funding for states that spend less on basic education per student than the national minimum.[27]

In the health sector, the federal government firstly attempted to stimulate a strengthening of primary care programmes (e.g. those relating to nutritional deficiencies and basic pharmacy), leaving execution in the hands of state, and particularly municipal, authorities. A fund was set up to finance basic municipal measures, which made direct transfers under per-capita criteria through the Minimum Basic Care (PAB) programme. Subsidies were also given for the formation of family health teams, and full management of resources including their allocation, from primary through to tertiary care, was given to municipalities that have undergone training in public health. Transfers in basic health care programmes cost about R$ 6 billion in 2005, of which the PAB alone received R$ 2.3 billion.[28] Secondly, the most important institutional change required a constitutional reform (Amendment No. 29, of September 2000), with a view to requiring central, state and municipal governments to spend a minimum amount of tax revenue on the Unified Health System (SUS). Unlike what happens in the education sector, where the funding allocation is constitutionally mandated, in this case the issue was relegated to a complementary law. Until this legislation is published (which has not yet happened), the temporary regulation of the constitutional amendment requires the central government to adjust its expenditure on the SUS each year according to the nominal variation in GDP; and states and municipalities are required to invest at least 12% and 15%, respectively, of their tax revenue in the system.

The third issue concerns the approach to taxation, which in Brazil is closely linked to the federative issue. It is an age-old tradition in the country for the Constitution to establish exclusive tax jurisdictions for each sphere of government and provide highly detailed regulations on the subject. This defines the "federative pact", with little concern for the effect on the magnitude and distribution of expenditure that results from the predefined financing pattern.

The first significant reform project proposed by the federal government in 1995 explicitly rejected the idea of recentralizing revenues. The basic aim was to unify national value-added tax legislation, halt the "tax war", and create a federal tax identical to its state counterpart (with the same base, generating factor and legislation); and also to unify current social security contributions on the basis of value-added rather than total sales, again to avoid undermining the competitiveness of the economy. In the perspective of a value-added tax (VAT) model, with collection shared between the federal and state governments, the simultaneous application of two rates was envisaged, which would make it possible to implement the destination principle in inter-state transactions. This would avoid the evasion arising if the rate on merchandise destined for other states were merely eliminated; and it would also put an end to the bitter tax war between Brazilian states.[29] Nonetheless, the urgent need to generate a fiscal adjustment to address the grave external crisis caused the federal government to retreat in its reform initiative in Congress.

In 2003, the new federal government submitted a reform bill that essentially pursued the same long-term objectives. Once again, the changes failed to pass, because the economic authorities targeted their efforts on short-term measures, such as extending the Provisional Financial Transactions Tax (CPMF) and the de-linking of federal revenues.

Nonetheless, there have been significant changes in infra-constitutional legislation since the implementation of the *real*. Following major alterations such as the end of monetary correction in company balance sheets and the creation of a simplified federal taxation system for microenterprises and small businesses, the federal government supported changes to the state-level ICMS promoted by the "Kandir Law" and, subsequently, in social levies on sales (for the Social Integration Programme (PIS) and the Contribution to the Financing of the Social Security System (COFINS)).

[27] In addition, the states that suffer the largest losses from "municipalization" of the earmarked revenues promoted by FUNDEF were compensated with exceptional loans granted by the National Treasury.

[28] The impact of this measure was even greater in the municipal sector. With a guaranteed transfer of the minimum (PAB-fixed) of R$ 10 per person per year for all Brazilian municipalities, many began to receive between two and nine times more from the federal government than they had previously been receiving under the normal system of the Unified Health System (SUS), which corresponded to the invoice value of services provided.

[29] This idea is in line with the ideals of the "dual VAT", defended by Bird and Gendron (1997). The detailed system of the shared ICMS project, a subject of debate in Brazil and Argentina (also known as the "Little boat model" because of its treatment of interstate transactions), appears in Varsano (2000), and has been commented on and defended by McLure (1999) and Bird (2000).

From the federative standpoint, the measure with the most direct impact was Complementary Law No. 87 of September 1996, the "Kandir Law", which abolished direct application of state ICMS to all exports, including primary and semi-manufactured products. State-level taxation of foreign sales was a centuries-old tradition in the country, dating back to inherited authorities, or *capitanias*; and the states only agreed to renounce their power to tax exports in exchange for financial support from the federal government. This was agreed upon at the time as a temporary system (lasting up to 12 years) in the form of a "revenue insurance" (i.e. funds would be transferred only to states that had suffered a loss of revenue, and in an amount that was proportional to the loss). This subsequently became a compensatory federal transfer (of about R$ 4 billion per year), with pre-established prorating.

The "Kandir Law" ended up generating permanent points of friction that soured federative relations and undermined the competitiveness of the economy. Year after year the negotiation on transfers was left pending, since its approval in the federal budget requires clear principles for defining the overall amount of the transfers and also appropriate criteria for distributing the resources among the states that most needed them.[30] Secondly, the fact that the exemption was not automatic (without transfer to third parties or restitution in kind) meant that, depending on the state authorities in question, exports could accumulate large credit balances in respect of the state ICMS, which was contrary to the spirit of the law and also unconstitutional (since a partial reform in 2003 had incorporated into the Constitution the concept previously set out in the Kandir Law). Furthermore, the idea spread among state governments that exporting was harmful, because it failed to generate revenues yet involved expenses. Some state governors not only delayed or rejected the reimbursement of credits, but sometimes also resisted giving incentives and infrastructure support to new projects that mainly targeted the external market.

In the tax domain, it should also be noted that the federative arrangement of 1988 was amended as a result of a continuous drive by all federal governments in the period since the National Constituent Assembly, aimed at raising social security contributions and other levies that did not involve sharing income with states and municipalities. This was due to the fact that the amount collected by the taxes was overstated in the constitutionally mandated distribution. Central government sought to exploit the same tax bases through levies that are not subject to revenue sharing, and which are also subject to fewer restrictions on the power to establish taxes (such as the annuality principle, which does not affect social security contributions).

The fact that roughly half of all revenue obtained from the two main federal taxes (IR and IPI) is transferred to other levels of government, led the central government to impose a social levy on enterprise profits (at a lower rate, but on a broader base than that of income tax levied on the same taxpayers). It also maintained and continuously and significantly increased taxes on sales and other revenues, which, prior to the National Constituent Assembly, were applied through the federal Social Investment Fund (FINSOCIAL). Subsequently, a tax on financial transactions, which had been in force in 1994 only, was reimplemented as the Provisional Financial Transactions Tax (CPMF). As these social levies are cumulative, they are generally harmful to the competitiveness of the economy. The recent attempt (in 2002-2003) to alleviate the accumulation of contributions to PIS and COFINS ended up adding to the tax burden because the new rate was incorrectly calibrated, either through the change in regime or through the expansion of the base for taxing imports without reducing taxation in the local market.

The historical trend of the structure of the Brazilian tax burden shows, firstly, a drastic reduction in the burden imposed by the only federal VAT-type tax: the Industrial Products Tax (IPI). Whereas in 1970, this tax raised an amount equivalent to 4.4% of GDP, in 1980 and 1990 the percentage had dropped to half; 10 years later (in 2000) it was no more than 1.6% of GDP, and in 2005 it was 1.2%, one of its lowest ever levels. In contrast, social contributions levied on income in general and sales (such as PIS or the Civil Servant Assistance Plan (PASEP), created in the early 1970s, and also COFINS, established in the early 1980s as the Social Investment Fund (FINSOCIAL)) grew vigorously following the 1988 reform. In 1980, revenue from PIS amounted to just 1% of GDP; in 1990, the two contributions (PIS and COFINS) collected 2.7% of GDP; in 2000, the joint burden was 4.4% of GDP, and in 2005 it attained the record level of 5.6% (of which 4.4 percentage points corresponded to COFINS). Including the 1.5% of GDP obtained from CPMF and the 1.3 percentage points raised with the levy on net

[30] Originally, an annex to the Kandir Law contained a detailed and innovative transfer scheme, known as "revenue insurance", which ultimately was eliminated at the request of the states.

profits (CSLL),[31] the tax burden generated by the four contributions (PIS, COFINS, CSLL and CPMF) amounted to 8.4% of GDP in 2005. That was equivalent to over six times the revenue obtained from the federal IPI and exceeds that earned from state ICMS, or the federal IR.

The remarkable transformation described above, suggests that the process of gradual change and reasonable flexibility in federative relations has been abandoned, intentionally or otherwise. Public, macroeconomic and social policies clearly display fiscal recentralization —among other things to absorb the growing pressure of huge expenses generated by income transfers, which range from social benefits through to interest on the public debt.

The reality of recentralization also shows through in the control over state and municipal public borrowing. Despite the achievement of growing primary surpluses, the reduction and virtual elimination of subnational bank borrowing and, more importantly, the payment of all overdue monthly instalments, at April 2006 the net debt of states and municipalities and their respective debts with the central government amounted altogether to the equivalent of 19.1% of GDP, according to central-bank figures. Of that total, over 95% represented refinancing contracts with the Treasury.

The maintenance of such a high debt stock – not to say growing in recent years, depending on the year that is taken as a base for the evaluation – stems from a problem that was not foreseen when the refinancing programmes were designed. The exchange-rate regime in force immediately after the adoption of the *real* was fixed, or semi-fixed, and there was no hesitation in adopting the general price index (IGP-DI) as an indicator of the refinancing. Nonetheless, when the floating exchange-rate regime was established, the IGP fluctuated greatly and accumulated a much larger variation than the official index adopted in the inflation targeting regime —the extended national consumer price index (IPCA)— between 2000 and 2004. From that year onwards, the problem diminished with a new cycle of *real* overvaluation, but its reappearance seems inevitable when the exchange rate returns to its habitual levels.

In any event, the equilibrium in the refinancing contract has been lost, in particular because, in addition to over-indexation, the balances are also subject to real interest rates that annually have surpassed the economy's average real growth rate at least threefold. Consequently, although between 2001 and 2005, state and municipal governments paid the National Treasury a cumulative amount of R$ 70.1 billion solely in respect of the three main refinancing operations (Laws 9.496/97 and 8.727/93 and Temporary Measure 2.185), at 31 December 2005 they owed the absurd sum of R$ 336.8 billion —R$ 137.5 billion more than five years earlier.

As the monthly service on the outstanding state and municipal debt is calculated by the maximum set in proportion to current income (most of the time), the imbalance in the debt valuation mechanism produces an artificial capital and accounting effect, rather than an immediate financial impact. This compromises the transparency and governance of fiscal and macroeconomic policy in a way that tends to go unnoticed by those who are unaware of the details and subtleties of the settlement of the net debt and primary and nominal results. The fact that it alters stocks without affecting flows explains why it does not elicit more vehement protests from the state and municipal authorities. The federal economic authorities take advantage of the "over-correction" of credits to the states and municipalities, to disguise a more rapid expansion of federal debt, particularly in the form of bonds —in this case, without artificial effects, because it stems from the application of absurdly high real interest rates, particularly in comparison to international parameters.

A good illustration of this is the recent trend of fiscal outturns – given that the most important concept is the nominal deficit, since increasing the federal primary surplus while federal interest payments were growing even faster served little purpose. Between 2000-2002 and 2003-2005, the central government primary surplus grew from 2% to 2.8% of GDP, while nominal interest expenditure rose from 3.7% to 5.9%. Thus, the nominal deficit of that sphere of government almost doubled from 1.7% to 3.1% of GDP between the two three-year periods.[32] Nonetheless, taking the

[31] Social Contribution on Net Profits (CSLL).

[32] In other words, having been responsible for just 44% of the nominal deficit of the public sector between 2000 and 2002, central government has generated 84% of the deficit over the last three years. This is basically due to the federal share of expenditure on public debt interest, which rose from 49% to 71%. The interest rate variable is fundamental in explaining this trend. These central government expenses fell by 1.9 percentage points of GDP between 2000 and 2002, while growing by 3.56 percentage points of GDP between 2002 and 2005. In short, the role of central government has changed. Between 2000 and 2002 it bore the main burden of reducing the nominal deficit as a proportion of GDP (while the nominal deficit of subnational governments increased), but in the last three years this trend has been reversed.

public sector as a whole, there is a small reduction in the nominal deficit (from 3.9% to 3.7% of GDP between the two periods analysed), which is explained by a significant improvement in the results of State-owned enterprises and, especially, state and municipal governments (the subnational deficit fell from 3.1% to less than 0.3% of GDP between 1999 and 2005, and is approaching zero for 2006). In other words, the nominal deficit of the central government grew while those of subnational governments declined, which reinforces the impression that the Fiscal Responsibility Act was introduced for the sole purpose of bringing the states and municipalities into line.

Federative discoordnation has also been growing over the division of responsibilities and jurisdictions. In the field of public social policies, the federal authorities have preferred to expand targeted benefit programmes, to the detriment of universal-type expenditures such as basic education and healthcare. Expenditure on pensions and social assistance is growing rapidly. In addition to the effects of the increase in the minimum wage, the number of new social benefits (granted to pensioners and beneficiaries of public social security systems) have far outpaced any measure of demographic growth, particularly in the cases of sickness subsidies and welfare benefits for income maintenance, including the merger in the *Bolsa-Familia* programme of the financial assistance granted earlier to families through the *Bolsa-Escola*, *Bolsa-Alimentação*, Eradication of Child Labour and *Vale-Gas* programmes. This orientation in itself would not generate major problems if, initially, there had been no demand for a new round of tax increases, especially through changes in COFINS. Secondly, the budgetary dilemma was aggravated, since maintenance expenses increased at growing rates and outstripped the growth in incomes, thereby further reducing room for productive investments, particularly in infrastructure.

The tendency of the Federal Government to provide direct assistance and benefits to the population has significant repercussions for federative relations —firstly because assistance was previously a typically local expense, but is now financed increasingly out of the federal budget. Although the municipalities act as partners (in registering and monitoring beneficiary families), they obviously do not perform this task with the same diligence or efficacy as when they are spending their own funds. The greatest problem, however, has been the lack of priority in universal social programmes, where state and municipal governments have a decisive role to play in expenditure execution, particularly in the education and health sectors. Federal contributions to such programmes have not increased, and in some cases have shrunk (health). There are also serious risks in the very short term: FUNDEF will expire at the end of 2006, and Congress has not yet approved the budget for setting up another fund, the Basic Education Development Fund (FUNDEB). This new fund promises to increase the federal transfers since the Constitution establishes the *nominal* amount of the transfers without indicating where the resources will come from —i.e. retracing the path of conflict of interests that dogged the “Kandir Law”. In the health sector, the federal authorities have attempted to get around the mandatory spending defined by a constitutional amendment in 2000, by including in the accounts expenditures that are not in the health category, such as benefits paid by the *Bolsa-Familia* programme. At the same time, states and municipalities have increasingly been required to finance expenses in that area out of their own resources.

In the tax domain as such, the basic symptom of federative discoordination has already been noted: recent tax measures have maximized the option of increasing unshared contributions and benefits have been concentrated in taxes that are shared with the states and municipalities.

Between 2002 and 2005, the overall tax burden rose by 2.3 percentage points of GDP. The state-level ICMS accounted for 12% of that increase, and the weight of COFINS/PIS tripled this. Although the increase in tax revenue alleviated the budgetary effects, the federative division of disposable income (after taking constitutionally mandated transfers into account) shows a sharp increase in the federal share, which over the last five years has grown by 1.8 percentage points from 55.8% to 57.6% of total national tax revenue. Taking 1991 as the base (the year of the smallest federal share since the National Constituent Assembly), the total federal share increased by 2.9 percentage points and the municipal share by 1.5 percentage points, while the states’ proportion shrank by 4.4 percentage points (see table 1 and figure 1 above).

From a longer-term perspective, after four decades the municipalities now hold the position that the states previously occupied as the dynamic hub of Brazilian federalism, to judge by the trend of the federative distribution of disposable tax revenue. The state government share has declined by 10 percentage points —in 1965, before the reform promoted by the military governments, the states received 35% of the overall tax revenue; four decades later, this figure had fallen to roughly 25%. Over that lengthy period, the municipal government's share of total revenue increased from 10% to 17%.

As was to be expected, state governors detected the problem but chose to support solutions that ultimately proved ineffective. In the constitutional amendment promulgated in late 2003, subnational governments obtained the transfer of one quarter of the amount collected through the Contribution for Intervention in the Economic Domain (CIDE), although earmarked for investments in transport, given that the federal government had created this tax and was using it on a large scale. The revenue from this levy then dropped to one of the lowest levels of all federal taxes (possibly part of its incidence was shifted to COFINS, which is held entirely in the National Treasury). With regard to the project that is still underway from the same reform, the supporters of municpalism chose to lobby for a one-percentage-point increase in IR and IPI destined for the Municipal Revenue Sharing Fund, payable in the last month of the year. Nonetheless, the bill has not yet been voted on and is being blocked by the federal government. When the latter published the temporary measure in 2005 to exempt investments, most of the incentives were provided to Income Tax on Legal Entities (IRPJ), which is not shared. Disagreements have also resulted in a delay and even cuts in transfers under the "Kandir Law", as noted above.

In short, the main objective of the framers of the 1988 Constitution, of promoting fiscal decentralization, ultimately produced an unmistakeable trend towards municipalization and, most recently, a recovery in the relative importance of the federal government, while the states have been the major losers.

V

Towards a new federative agenda

The Brazilian fiscal federation is a faithful projection of the general framework of the country's economy, society and political system. It firstly displays high indices of subnational government participation in the direct generation and spending of tax revenues; in the execution of payroll, goods and services expenditure; and the administration of budgets with minimal interference from central government. Yet there is no planned and organised fiscal decentralization process to reconcile the redistribution of revenues and division of burdens. This serves to accentuate the complexity of federative relations, while conspiring against economic efficiency and undermining the quality of public services. Moreover, the difference in the tax burden between the more and less developed states of the federation is enormous.

The Brazilian Federation wil have to face an extensive agenda of issues over the next few years. While longstanding "structural" problems remain unresolved, new challenges have arisen in recent years, including gradual recentralization. This has been most evident in the exercise of tax jurisdictions, where federal transfers are progressively being eroded (undermining the bases of revenue sharing funds and reducing transfers under the "Kandir Law"). The process has also affected expenditure execution, demoting a number of programmes of structural measures implemented in partnership with local governments (e.g. health care), while promoting direct measures (such as popular pharmacy and hospital care). Because of these structural distortions and emerging fiscal problems, conflicts within the federation have increased.

Nonetheless, any recentralization of power in federal government hands, which would inaugurate a new cyclical phase in the historical course of the Brazilian Federation, is not supported by the federal government agenda. Such a process would be unviable from the political standpoint and also undesirable in terms of administrative efficiency and social welfare in a such a large, heterogeneous and populous country. Similar reasoning, with greater emphasis on the political conditions, would also prevent attempts to change the regional distribution of federal public resources of tax origin from being included in that agenda.

Where little or no progress has been made is in diminishing the "tax war" between the states, by manipulating the respective ICMS and granting benefits (particularly the return of the portion of the tax corresponding to other states) under the guise of subsidised loans and even shareholdings. The main effect of this manipulation was and is to effectively reduce disposable state income, as a whole, and increase fiscal pressures from state governments on the central government —without considering the fact that the unregulated dispute over ICMS was certainly a decisive factor in reversing the historical trend towards regional deconcentration of the economy. The recent case of automobile assembly plants is emblematic: once the widespread granting of incentives was declared, the most developed states ended up exploiting the obvious advantages, such as their position in the market and better economic and social infrastructure.[33]

The consequences of the war over ICMS extend beyond the fiscal domain, because they are closely related to the course of industrial policies and external trade.[34] These in turn are essential for a robust revival of economic growth. It should be noted here that the economic and financial openness of the Brazilian economy in the 1990s, following at least six decades of inward-looking economic growth (protectionism and vigorous state intervention) have actually made federative relations more complicated. In a more open economy, there is less solidarity and greater divergence of interests and views on trade and industrial policy between the more and less developed regions.[35]

Another important area where there has been no initiative at all concerns the politics of federative relations. Both the previous and current governments have abstained from proposing either reform proposals for the electoral and party system —to make it easier to build majorities and make parliamentarians less dependent on state governors— or proposals to correct the imbalances in state representation in the Chamber of Deputies. This omission resulted from a fear of disturbing the functioning of the government majority in Congress at a time of successive votes on constitutional amendments relating to the economy. Nonetheless, there is no doubt that those reforms will have to be included in the national agenda sooner or later.

As a final observation, until now, unlike what happens in other countries, the Brazilian Federation, while still a work in progress, has been showing signs of reasonable stability. This has been assisted by the legacy of the unitary state and the moderation of ethnic, linguistic and religious differences among the Brazilian people. Cycles of contraction and expansion in central power and the conciliatory tradition of Brazilian politics have also eased the necessary adjustments through time. Specifically, in the case of the tax and fiscal systems, redistributive mechanisms are used to reconcile divergent and contradictory regional interests by transferring public resources between the different spheres of government and between more and less developed regions, with an intensity and rapidity that few federations have matched without dramatic political and civil upheavals. It is no coincidence that the ideals of fiscal federalism are always evoked to defend localised interests and public policies of regional impact.

Despite this framework, the flexibility of Brazilian federalism will face demanding tests in the near future, given the challenges of development policy and political reform. It is therefore essential to anticipate events to consolidate Brazil in a strong, united and democratic federation.

[33] A symptom of the slowdown in the historical and natural trend towards economic deconcentration is provided by a comparison between *real* GDP growth rates in the period following establishment of the real (in which the tax war intensified). Between 1994 and 2005, national GDP grew by a cumulative 29.7%, while the GDP of the state of São Paulo expanded by 31.5% (according to data from IBGE and the Data Analysis System Foundation of the State of Sao Paulo (SEADE), respectively). The economy of São Paulo far outpaced the national economy in the upswing phases (such as 2004 and 2005), and this more than compensated for the inverse situation of falling faster than the national rate in the downswing of short business cycles.

[34] There has also been vigorous lobbying by parliamentarians and governors from less developed regions in favour of expanding federal incentives to bring them closer to the standards of the free zone existing in Amazônia. Unlike others in the world, this free zone operates basically with imports and sales on the domestic market.

[35] For a detailed analysis of the prospects and problems of federalism in Brazil from a regional perspective, see Affonso and Silva (1995).

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