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FISCAL DECENTRALIZATION AND SUBNATIONAL FISCAL AUTONOMY IN BRAZIL: SOME FACTS OF THE NINETIES

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SUMMARY

RESUMO

Este artigo examina algumas facetas da experiência recente da descentralização fiscal no Brasil. Para tanto, descreve-se inicialmente a evolução da descentralização fiscal desde os anos 60. Na sessão subseqüente são tratados alguns eventos que afetaram as relações fiscais intergovernamentais nos anos 90.

Historicamente, o federalismo brasileiro foi marcado por movimentos diastólicos e sistólicos no grau de descentralização, geralmente em consonância com o regime político em vigência, fosse ele mais ou menos democrático. O objetivo de conciliar a autonomia fiscal dos entes da Federação, por um lado, e a necessidade de coordenar os instrumentos fiscais com a finalidade de resguardar interesses nacionais, por outro, ainda não foi alcançado.

Na análise dos eventos dos anos 90, observa-se que o modelo federativo ainda não está consolidado, mas em processo de transição. A consolidação de um modelo, com a estabilização das relações fiscais intergovernamentais, dependeria da definição da descentralização fiscal possível. Observa-se que a preservação da descentralização fiscal pode redundar em restrições à autonomia dos governos subnacionais.

ABSTRACT

This paper considers some facets of the recent Brazilian experience in fiscal decentralization. For this purpose, it describes the pattern of fiscal decentralization in Brazil and, subsequently, discusses some events of the nineties pertaining to fiscal relations in the federation.

Historically, Brazilian experience with fiscal federalism has been marked by ups and downs in the degree of fiscal decentralization. Satisfactory conciliation between the need to ensure a reasonable degree of financial autonomy for subnational governments, on one hand, and the requirement of coordinating fiscal instruments in order to serve national interests, on the other, has not yet been attained.

The analysis of events of the nineties does not reveal a consolidated model of federalism but a transition process characterized by attempts to correct the aftermath of both excessive centralization and immoderate decentralization experienced in sequence in the past. The paper concludes that preservation of fiscal decentralization may require the imposition of restrictions on the autonomy of subnational governments, this time for economic rather than for political reasons.

1 - INTRODUCTION

Federations constitute an important set of countries no matter the gauge is their population, area, economic weight or political importance. The set includes, among others, Russia and Germany in Europe, United States and Canada in North America, Brazil and Argentina in South America, India in Asia and Australia in Oceania. One may say that these countries have in common the fact that federalism was adopted — using Tocqueville's words — "with the intention of combining the different advantages which result from the magnitude and the littleness of nations" [see tocqueville (1945)]. Yet, even casual observation reveals that their federative practices are very dissimilar. Each case is a unique experience.

Theories on federalism — both the political science and the economic approaches to the question — do not provide a model that could serve as a standard to compare the practices of the several federations. None of the existing institutional arrangements can be said to be better or worse than another. Specifically, the theory of fiscal federalism, though providing a general normative framework for the assignment of functions and revenues to the different levels of government, does not intend — and would not be able — to specify the optimum degree of decentralization or the best institutional arrangements that should exist in a particular country. Each society must look for its own solutions. Notwithstanding, a country's experiences, positive or negative, may be helpful for the improvement of other federal systems.

This paper considers some facets of the recent Brazilian experience in fiscal decentralization. Section 2 describes the pattern of fiscal decentralization in Brazil. Section 3 discusses some events of the nineties pertaining to fiscal relations in the federation.

Historically, Brazilian experience with fiscal federalism has been marked by ups and downs in the degree of fiscal decentralization, which tended to match the sequential political regimes, more democratic or with less diffusion of power. Satisfactory conciliation between the need to ensure a reasonable degree of financial autonomy for subnational governments, on one hand, and the requirement of coordinating fiscal instruments in order to serve national interests, on the other, has not yet been attained.

The analysis of events of the nineties does not reveal a consolidated model of federalism but a transition process characterized by attempts to correct the aftermath of both excessive centralization and immoderate decentralization experienced in sequence in the past. One important conclusion (section 4) is that preservation of fiscal decentralization may require the imposition of restrictions on the autonomy of subnational governments, this time for economic rather than for political reasons.

2 - THE PATTERN OF DECENTRALIZATION

2.1 - A Brief Historical Review

Brazilian public sector had undergone in the sixties, under authoritarian rule, a thorough reform, which objectives were to restore fiscal equilibrium and to prepare it to be the instrument of a strategy of growth. The strategy contemplated concentration in the central government of decisions on investment, both public and private. Subnational government decision-making power was subtracted by means of political imposition, limitation of revenue raising capacity and earmarking of transfers.[1] The role attributed to these units, besides the provision of assigned public services, was, essentially, to invest where and when demanded by the central government.

The reform created a state that, financed by a suitable tax system, was able to lead the process of hastened economic growth — the so-called "Brazilian miracle" — that the country had experienced for almost a decade, up to the mid-seventies.

One of the costs of the "miracle" was the imposition of severe restriction on the fiscal autonomy of subnational units. Centralization was further aggravated in 1968 by a cut, practically to half, in the amount of federal government transfers. State governments, to bypass fiscal restrictions, compensated their treasure's low fiscal capacity with increased state enterprise expenditures, partly financed by external borrowing, and with intensive use of state banks, both as sources of loans and as government bonds bearers.

The international financial crisis of the late seventies, associated with controls on domestic credit, blocked states' financing channels. State banks were used as last resort lenders far beyond their capacity. Many end up bordering insolvency and being rescued by the Central Bank.

To complete the picture, recession started in the beginning of the 80's and, with it, the fiscal crisis that still persists. Afflicted by the absence of financial sources, on one hand, and by the rigidity of their current expenditures, on the other, Brazilian states had to contract their investments and restrict their social policies. Pressed by the subnational units, the federal government had to start, by 1983, an effective revenue decentralization process, which culminated at the time when the new Constitution was elaborated.

The National Constituent Assembly, installed in 1987, was a landmark in the re-democratization of the country. Not surprisingly, the climate was one of reaction to the 20 years of political and fiscal centralism. Therefore, strengthening the federation was a major goal. This would require, with respect to public finance,

[1] Power on private investment decision-making was acquired through the concession of a wide variety of fiscal incentives.

that the degree of fiscal autonomy of states and municipalities be enhanced and that decentralization of revenue and expenditures be promoted.

2.2 - Fiscal Federalism in the 1988 Constitution

The 1988 Constitution ensured, in fact, a higher degree of fiscal autonomy to subnational governments. States were conferred the power (which they had not) to set the rates of their respective value added taxes, the ICMS; federal government power to grant exemptions from state and municipal taxes was eliminated; and the imposition of conditions or restrictions on the distribution and on the use of shared revenue was forbidden.

Decentralization of revenue was promoted. State tax base was enlarged by the inclusion of some goods and services — fuel, electric energy, minerals, and transportation and telecommunication services — previously subject exclusively to federal taxes. The parcel of the revenues of the income tax (IR) and of the tax on industrialized products (IPI) transferred to states and municipalities — the States' and the Municipalities' Participation Funds (FPE and FPM) — was gradually increased, amounting, from 1993 on, to 21.5% and 22.5% of those tax revenues, respectively. Moreover, 10% of the IPI revenue was allotted to states in proportion to the value of their manufactured exports (FPEX).

States repass 25% of the FPEX to their respective municipalities. Grants from states to municipalities also grew considerably, both because of the enlargement of the ICMS base and of the increase, from 20% to 25%, in the percentage of ICMS revenue transferred to municipal governments.

The reduction of federal government disposable revenue, which resulted from the increase in transfers and the elimination of taxes on the above-mentioned goods and services, would require some adjustment. The obvious one, compatible with the objective of strengthening the federation, would be decentralization of responsibilities. As decentralization is not an instantaneous and costless process, an institutional framework and financial means should be provided to bring about the change.

The National Constituent Assembly did not foresee the institutional framework and the financial means. The consequence, instead of decentralization, was a disorderly process — the so-called "operação desmonte" (dismantlement operation) — in which the Union, unilaterally, discontinued programs and provision of some services in order to adjust its budget.

Decentralization of responsibilities was further hindered by the fact that social security (defined by Brazilian Constitution as the set of actions pertaining to health, social assistance and social insurance) and education activities — both replete with opportunities for decentralized actions — were contemplated by the Constitution with guaranteed availability of resources at the federal level. The power to create social contributions, the main source of financing for social

security activities, is exclusive of the Union. Decentralized spending in this area depends strongly on intergovernmental transfers. In the case of education, 18% of federal tax revenue was earmarked for expenditures with maintenance and development of schooling.[2]

In short, the 1988 Constitution amplified the degree of fiscal autonomy of subnational governments and promoted decentralization of revenues. But failed to decentralize expenditures, concentrating fiscal imbalance at the federal level.

2.3 - Expenditure and Revenue Assignments and Intergovernmental Transfers

Brazilian Constitution determines which activities should be performed or regulated exclusively by the Union and by the municipalities. States may carry out all those functions that are not interdicted to them by the Constitution. Several activities are executed concurrently by the three levels of government.

Table 1 shows expenditure distribution among the levels of government for some functions in 2000, as well as their relative importance.[3]

Table 1
Brazil: Distribution of Government Expenditures in Some Functions — 2000
(In %)

Function	Distribution			Function as a % of Total Expenditure [b]			
	Union	States	Municip.[a]	Union	State	Municip [a]	Total
Social Insurance and Social Assistance	78.8	16.2	5.0	53.8	13.3	9.4	31.1
Education, Culture, Sport and Leisure	19.5	49.6	30.9	6.1	18.5	26.4	14.1
Health and Sanitation	44.2	25.4	30.3	11.2	7.8	21.2	11.6
Housing and Urbanism	15.2	16.1	68.7	1.0	1.3	12.3	3.0
Labor	90.8	9.3	—	3.4	0.4	—	1.7
Environmental Management	100.0	—	—	0.6	—	—	0.3
Energy and Mineral Resources	72.2	19.8	8.0	0.3	0.1	0.1	0.2
Transportation	23.8	47.3	28.9	1.8	4.3	6.1	3.5
Sectorial Policies [c]	58.9	33.0	8.1	4.9	3.3	1.9	3.8
Defense	100.0	—	—	5.9	—	—	2.7
Public Security	15.2	82.2	2.5	1.2	7.8	0.6	3.6
Foreign Affairs	100.0	0.0	—	0.4	0.0	—	0.2
Legislative Branch	23.5	41.0	35.5	1.0	2.0	4.0	1.9
Judiciary Branch	42.4	56.3	1.3	3.9	6.3	0.3	4.2
Total Expenditures [b]	45.5	37.9	16.5	100.0	100.0	100.0	100.0

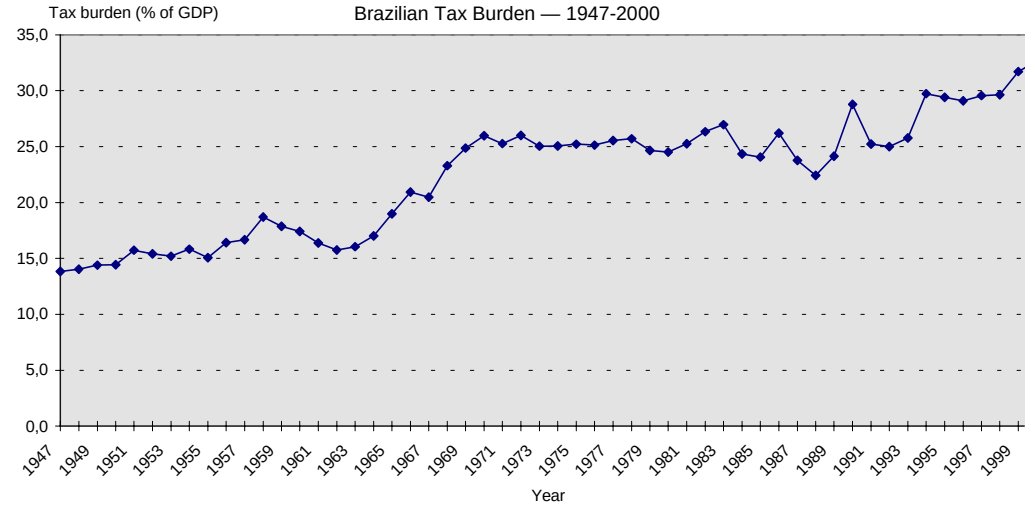
Source: Ministério da Fazenda / Secretaria do Tesouro Nacional (Portaria 239, of the 28th of June of 2001).
[a] Total for 57% of Brazilian municipalities.
[b] Total expenditure excludes Union expenditure on "special responsibilities" (essentially interest payments and debt amortization).
[c] Includes agriculture, agrarian organization, industry, commerce, services, science and technology, and communication.

[2] In the case and municipalities, 25% of fax revenue is eamarked for education expenditures.
[3] About one third of total state expenditure is allocated to the function "Administration and Planning", what may be an indication that there is a classification problem in the data for this level. "Administration and Planning" accounts for 16% of municipal expenditures and for less than 4% of the federal total.

Social Insurance is the most important category of expenditures, followed by Education, and Health and Sanitation.[4] Some functions are exclusive or almost exclusive of the Union (Defense, Foreign Affairs, Environmental Management and Labor). In some other cases — Social Insurance, Energy and Sectorial Policies —, expenditures are concentrated in the federal level. Public Security is clearly a state function, while Housing and Urbanism is a municipal one. The three levels of government share responsibilities for Health and Sanitation, and Education. Expenditures in these two functions account for almost half of municipal spending.

Brazilian tax burden has been growing over time, as shown in Figure 1. In 1947, when systematic production of Brazilian national accounts statistics began, tax burden was 13.8% of gross domestic product (GDP). It increased slowly in the fifties but, after reaching 18.7% of GDP in 1958, it started a downward movement. In 1962, amidst an institution crisis, the tax burden had slid down to 15.8% of GDP.

Figure 1
Brazilian Tax Burden — 1947-2000



Source: Araujo (2001).

The reform of the sixties promoted substantial improvement in the quality of Brazilian taxation. Value added taxation (VAT) was introduced, in place of cascading taxes, at a time European Community was yet preparing its adoption and France was the only country using such tax technique. And VAT was introduced in Brazil at the state level, a unique case until recently, when some Canadian provinces have adopted this form of taxation.

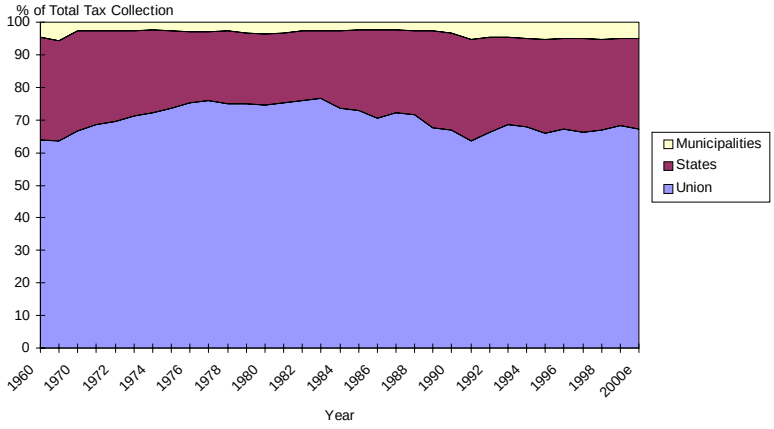
After a transition period, tax burden reached 25% of GDP, a level that had been sustained for the seventies and, despite the recession of the beginning of the

[4] Disposable data does not allow sseparating social insurance from social assistance expenditures for the subnational levels. But, for the federal level, which accounts for almost 79% of these expenditures, sicial insurance corresponds to 95,5% of the federal total.

eighties, up to 1983. A decline is then observed, which continues until the end of the decade. After the exceptional result obtained in 1990 (28.8% of GDP), due to a macroeconomic plan (Plano Collor), the 25% level was reestablished. And after another plan (Plano Real, in 1994), the tax burden grew to a level of around 29%. It has increased again since 1999, reaching 32.7% of GDP in 2000.

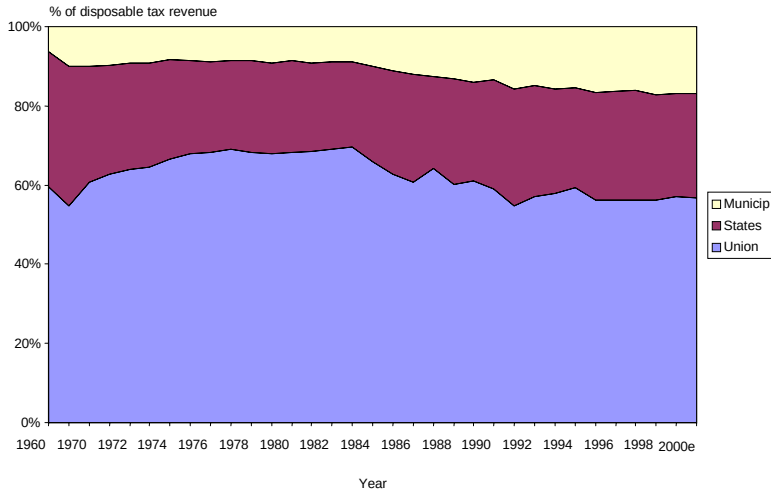
Figures 2 and 3 present, respectively, the distribution of tax collection and of disposable tax revenue among the levels of government. Centralism of the seventies, up to 1983, is clearly displayed by both figures. An increase in intergovernmental transfers and the fragility of federal taxes in a high inflation environment were responsible for decentralization that occurred between 1983 and 1988. From 1989 on, the new Constitution dispositions are the source of decentralization deepening.

Figure 2
Brazil: Distribution of Tax Collection — 1960, 1965, and 1970-2000



Source: SF/BNDES.

Figure 3
Brazil: Distribution of Disposable Tax Revenue — 1960, 1965 and 1970



Source: SF/BNDES.

Brazilian states have always counted on an important source of revenue. In the beginning of the 20th century — a time when most of government revenue was derived from foreign trade —, the export tax (incurred both by international and interstate transactions) was states` main tax. Later, from the thirties on — when domestic taxes gained importance —, the chief state source of revenue was a turnover tax. It was replaced in 1967 by value added taxation. In consequence, aggregate state own revenue has always been an important share of their total resources. In 2000, state governments collected 27.7% of Brazilian tax revenue and their disposable revenue was equal to 26.4% of the total. [5]

Municipalities have traditionally been dependent on transfers from other government levels. Their own revenue has been a low percentage of the country's total. Only after the 1988 Constitution their own revenue has increased, reaching now about 5% of the total taxes. However, their participation on disposable tax revenue has been increasing steadily since 1984, being now equal to 17%.

Table 2 shows tax assignment and tax revenues, as a percentage of GDP and of total tax revenue, in 2000.

Table 2
Tax Assignment and Collection by Level of Government — 2000

Levels of Government / Taxes	% of GDP	% of Total
Union	22.0	67.3
Fiscal Budget	7.7	23.5
Income Tax (IR)	4.4	13.5
Tax on Industrialized Product (IPI)	1.6	4.9
Tax on Financial Operations (IOF)	0.3	0.9
Import Tax (II)	0.8	2.4
Export Tax (IE)	0.0	0.0
Rural Property Tax (ITR)	0.0	0.0
Others	0.6	1.8
Social Security Budget	14.3	43.8
Payroll Social Insurance Contribution	5.0	15.3
Payroll Contribution to the FGTS	1.7	5.2
Turnover Contributions (Pis/Pasep and Cofins)	4.4	13.5
Net Profit Contribution (CSLL)	0.8	2.4
Bank Debit Contribution (CPMF)	1.3	4.0
Others	1.1	3.4
States	9.1	27.7
ICMS	7.6	23.2
Tax on Motor Vehicles (IPVA)	0.5	1.5
Heritage and Endowment Tax (ITCMD)	0.0	0.0
Others	1.0	3.0
Municipalities	1.6	5.0
Tax on Services (ISS)	0.6	1.8
Tax on Urban Property (IPTU)	0.5	1.5
Tax on Property Transfer (ITBI)	0.1	0.3
Others	0.5	1.5
Total Tax Burden	37.2	100.0

Source: SF/BNDES.

[5] Disposable revenue is equal to own revenue plus transfers received from the federal government less transfers made to municipalities.

Most of federal revenue comes from social contributions, which finance exclusively social security activities. These are payroll (social insurance contributions), turnover (PIS and Cofins), net profits (CSLL) and bank debit (CPMF) taxes. All other expenditures — which compose the so-called fiscal budget — are financed by another set of taxes. The IR and the IPI, shared with state and municipal governments, are the most important. In 2000, the federal government was responsible for about two thirds of total tax collected.

ICMS is the chief Brazilian tax, accounting for 23.2% of the total tax burden and for 84% of state governments tax collection. The tax on services and the urban property tax are municipal governments principal revenue sources.

Brazilian Constitution establishes several tax sharing instances. As shown in Table 3, constitutionally created government transfers amount to 5.8% of GDP of which 60% are transfers from the Union to states and municipalities. The FPE, the FPM and the share of the municipalities in the ICMS are the most important transfers. Table 3 considers only mandatory tax sharing. Voluntary transfers also exist and are particularly important in the area of Health.

Table 3
Brazil: Own Revenue, Constitutionally Established Tax Sharing and Disposable Revenue — 2000

Own Revenue, Revenue Shared and Disposable Revenue	Amount (R$ Million)	% of GDP	% of Total
Own Revenue	354,998	32.7	100
Union	238,768	22.0	67
States	98,387	9.1	28
Municipalities	17,844	1.6	5
Total Revenue Shared	62,522	5.8	100
Union to States	20,813	1.9	33
FPE	12,182	1.1	19
FPEX	1,500	0.1	2
IOF Ouro	0	0.0	0
Seguro Receita ICMS [a]	2,436	0.2	4
Fundef	2,875	0.3	5
Salário Educação	1,819	0.2	3
Union to Municipalities	16,640	1.5	27
FPM	12,816	1.2	20
ITR	112	0.0	0
IOF Ouro	1	0.0	0
Seguro Receita ICMS [a]	811	0.1	1
Fundef	2,900	0.3	5
States to Municipalities	25,444	2.3	41
ICMS	17,431	1.6	28
IPVA	2,648	0.2	4
FPEX	375	0.0	1
Fundef	4,990	0.5	8
Disposable Revenue	354,998	32.7	100
Union	201,316	18.5	57
States	93,755	8.6	26
Municipalities	59,927	5.5	17

Source: SF/BNDES.
[a] *Non-constitutional. Created by a complementary law.*

3 - SOME FACTS OF THE 90'S

3.1 - Recentralization and the Quality of the Tax System

After 1988, the federal government took steps to reduce its chronic fiscal imbalance, which was magnified by the deconcentration of resources without concurrent decentralization of responsibilities, promoted by the new Constitution. The discontinuation of several programs and of the provision of some services cut expenditures. The institution of new duties and the increase in rates of social contributions and taxes that were not shared with subnational governments boosted tax proceeds.

The measures to increase revenue had three important effects. First, they counterbalanced decentralization promoted by the Constitution and, as reflected in Figures 2 and 3, even brought about some recentralization. Second, as no compensating tax reduction occurred in states and municipalities, total burden increased to an all-time peak. Third, the quality of the tax system has been considerably worsened.

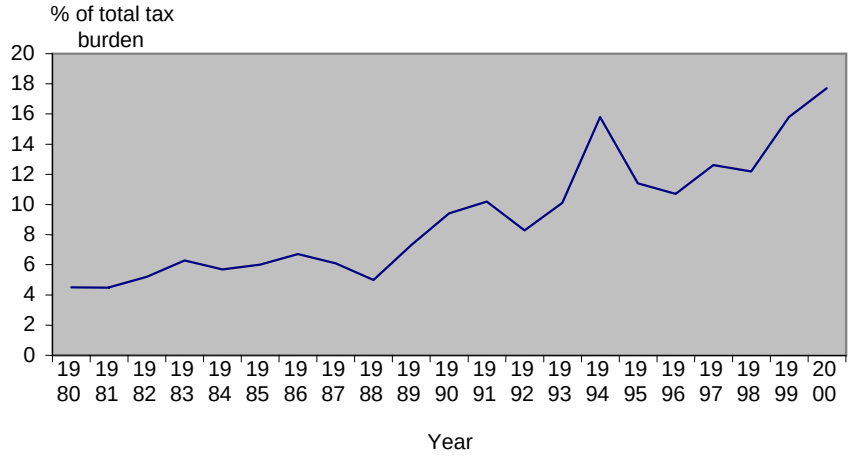
The income tax and the IPI (a partial value added tax on industrialized products) are good quality federal taxes. They are the main sources of financing for all federal expenditures but those related to social security activities. As already mentioned, 44% of their revenue is set apart for the States and Municipalities Participation Funds, the major federal tax sharing devices. Furthermore, another 10% of the IPI proceeds are shared with states.

Social contributions, on the other hand, are revenue sources exclusive of the federal government. Besides the payroll tax, which finances the social insurance, the most important levies in this group are two turnover taxes and a bank debit duty, all of them cascading taxes. As shown in Figure 4, participation of these three social contributions in total revenue increased steeply in the nineties: they were responsible for less than 6% of total tax revenue in the late eighties; in 2000, their share reached almost 18%.

As social contributions are constitutionally earmarked to social security outlays only, funds raised by means of these instruments might not be used to finance any other government activities. To solve this problem, an amendment to the constitution was passed which allowed the temporary use of part of the revenue derived from social contributions for other ends. This short-term authorization has already been renewed three times and is now in force until 2003.[6]

[6] The first authorization had been in effect, for 1994 and 1995, by force of the 1st Revision Amendment to the Constitution, of the 1st of March of 1994. The latest authorization was given by the 27th Amendment to the Constitution, of the 21st of March of 2000.

Figure 4
Participation of Cascading Social Contributions in Total Tax Revenue — 1980-2000



Source: Varsano et al(2001).

Technically, collection of bad taxes instead of satisfactory ones, to bypass revenue sharing rules, is an easy to correct fault. Federal government would not be stimulated to substitute poor quality taxes for good ones if all its revenues — instead of only those derived from the income tax and the IPI — were shared with state and municipal governments through the Participation Funds.[7] But, of course, in order to keep constant the amount of revenue shared, present applicable percentages should be reduced.

An intricate political problem corresponds to this simple arithmetic calculation. If a constitutional amendment proposal with this purpose were sent to the National Congress, it would bring on a discussion on whether present division of public resources among the three levels of government is adequate and, if not, on what should be each level fair share. The probable result would be further decentralization.

Further revenue decentralization implies that a revision of expenditure assignments should also take place, in order to preserve fiscal balance. As federal government fears that Congress would restrict decentralization to the revenue side, it does not support such proposal. Without its support, chances are that the proposal would not succeed.

[7] Another reason for the preference for bad taxes is that they are easier to collect. Tax administration quality must be improved to counteract this bias.

3.2 - ICMS: a Partial Reform

The 1988 Constitution substituted the ICMS for the previous existing value added tax, the ICM.[8] A complementary law should regulate the new tax. The Constitution, to prevent a possible legal vacuum, stipulated that, if such law were not enacted until 60 days after its promulgation, states could provisionally make the tax effective by means of a covenant.

In 1995, when an amendment proposal was presented that, among other objectives, aimed at overhauling the ICMS, the due law had not yet replaced the provisional covenant.

The lack of a law gave rise to judicial actions claiming that, without it, the ICMS could not be charged. It was argued that seven years is too large a lapse to be adherent to the concept of provisional. The main source of state revenue was at risk.

To fill this legal gap, federal deputy Antonio Kandir proposed, in May of 1996, a law that would not only regulate the ICMS but also reform some of its features.[9] Soon after, he became the minister of planning and had the opportunity to conduct himself the discussions with state governments that led to the approval of Complementary Law 87, of the 16th of September of 1996, known as Kandir Law.

Kandir Law is not a mere reproduction of Kandir's original proposal. Its content is based on three different projects of law and results from a couple of months of technical effort, made jointly by federal and state officials, followed by hard political negotiations. These include definition of a scheme for compensation of conceivable revenue losses resulting from the changes in the characteristics of the tax (the "seguro receita", considered in Table 3).

The law introduced three economically meaningful alterations. First, all exports were exonerated from the state tax, marking the end of a dispute that had lasted for over a century. Second, investment goods were also freed from the burden, by allowing buyers to credit the tax paid against their tax liabilities. Third, taxpayers were allowed to compensate with their liabilities taxes previously paid on all their inputs. Before the law, primary product and "semi-elaborated" manufacture exports, as well as capital goods, were taxed; and only taxes on inputs that incorporated to the produced goods might be compensated.

Unfortunately, due to posterior state governments political pressures, subsequent legislation[10] determined that the tax on capital goods should be compensated

[8] As already noticed, the main difference between the ICM and the ICMS was the inclusion in the state tax base of fuel, electric energy, minerals, and transportation and telecommunication services.
[9] The proposal did not contemplate a thorough reform of the ICMS because some of its features may be changed only by means of an amendment to the Constitution.
[10] Complementary Laws 92, of the 23rd of December of 1997; 99, of the 20th of December of 1999; and 102, of the 11th of July of 2000.

along a four-year period instead of immediately; and postponed to 2003 the effects of the disposition on tax credit for inputs. Notwithstanding its interference with state fiscal autonomy, Complementary Law nº 87/96 is, concerning improvement of economic effects of taxation, the most important piece of legislation in the decade.

3.3 - Interjurisdictional Tax Competition

The practice of reducing state value-added taxes to attract new investment has been unlawful since 1975, except in cases in which the intended reduction is unanimously approved by the 26 states and the Federal District. Yet, the law has been disregarded and tax competition among Brazilian states intensified in the nineties. Foremost among many cases is the dispute for the wave of new automotive vehicle industrial plants that had looked for a location in the country since 1995.

Decentralized industrial policies seem to be a reasonable course once regional disparities and the absence of a national policy for regional development are taken into account. They have the legitimate goal of expanding production, employment level, and income in order to make up for the development gap between poor and rich states.[11]

From the standpoint of any particular state, granting fiscal incentives to attract investment seems worthwhile. The amount of tax revenue forgone would not exist anyway, unless the beneficiary would choose to locate his business in the state even in the absence of the incentive. Plus, aside from their direct impact on production and employment, newly attracted firms induce additional economic activity, creating still more jobs and income, and, of course, some tax revenue.

If this were the whole story, state tax incentive would be a valuable development tool. But, when other states replicate the successful experience of one of them, a destructive tax competition — the so-called fiscal war — starts.

One of the features of fiscal war is that it tends to engulf all the states. Firms benefiting from fiscal incentives are conferred an advantage in relation to competitors located in other states. These competitors may threaten to move into the state granting the incentive, unless a similar benefit is offered in the state where they are located. Soon, to avoid the risk, all states engage in tax competition.

As attraction of new investors grows more difficult, state incentive policies become more aggressive. This includes sending government officials to other

[11] Income disparities among Brazilian states are quite large. *Per capita* GDP of the Southeast region is more than threefold that of the Northeast; and *per capita* GDP of the richest state, São Paulo, is sevenfold that of the poorest, Tocantins.

states in order to entice firms into relocation. Conflict in the federation is exacerbated.

As the practice of granting incentives spreads out, its efficacy fades: revenue goes down in all states; and, since taxes have been equally reduced everywhere, the fiscal benefit ultimately loses its power to induce relocation of production. When the process reaches this stage, firms choose their location considering only market and production conditions.

Pressed by larger spending and smaller tax collection, the financially weaker states, which are the less developed, become unable to provide services and public works necessary to attract private investment. At the final stages of the fiscal war, the more developed states win all battles. Disparities — already very large in the case of Brazil — tend to increase.

The fiscal cost for the country of the tax war is very high. A recent dissertation that analyzes three cases of newly installed vehicle factories concludes that, in two of the cases, the present value of the stream of subsidies exceeds the value of the private investment; and the fiscal cost of creating a job is over US$ 350.000 [see Silva (2001)].

Furthermore, this does not seem to be a cost incurred to attract investment to the country. The plants would probably be located in Brazil in the absence of the tax break.[12] The subsidy is the cost of attracting the investment to one particular location that, if the incentive had been truly effective, would not be the one recommended by efficiency considerations.

A change in interstate trade taxation rules might provide the result that the 1975 law has not been able to bring about so far.

Almost all firms attracted to a state by tax incentives have the bulk of their markets elsewhere. Were the ICMS rate on interstate exports equal to zero, state governments would not be able to grant tax incentives. But in Brazil, interstate sales are taxed at a positive rate under the ICMS. Interstate taxation provides the base for the incentive, which consists of a disguised refund of ICMS dues, generally in the form of a zero or low interest long-term loan.

One way of undercutting this practice would be to assign revenue arising from interstate trade to the state of destination of goods rather than the state where goods are made. This would limit the value of tax incentives to attract investments. They would only work to the extent that the goods produced in a given state were sold in that same state.

[12] A possible but improbable alternative location, given that the market to serve is chiefly the Mercosur, would be Argentina. If this alternative had, in fact, been considered and discarded because of the incentives, the fiscal cost cannot be said to be in vain. On the other hand, Brazilian states policy would be unduly inflicting a loss on the partner.

Adoption of the destination principle would also improve revenue prospects of less developed states, where consumption tends to be larger than production. And it would solve some other problems that stem from current interstate tax procedures.

The already mentioned 1995 constitutional amendment proposal, as well as its modified 1999 version, suggests the replacement of the ICMS (the state VAT) and the IPI (the partial federal VAT) by a dual VAT regulated by a single law — instead of the 28 different laws now in existence (one for each state and the Federal District, and one for the Union). According to the proposal, states would be able to set their respective rates of tax but within an interval around a nationally set rate. The destination principle would be adopted for treatment of both foreign and interstate trade, practically putting an end to the state tax war. The proposal has not been dismissed; but Brazilian tax reform discussion reached a deadlock in 2000.

3.4 - Education and Health: Financial Cooperation Arrangements for Decentralized Provision

The 1988 Constitution forbade the earmarking of taxes. Nevertheless, an exception was made in the case of education. As already seen, 18% of the proceeds of federal taxes which finance the fiscal budget, net of intergovernmental transfers, and 25% of state and municipal taxes, transfers received added and those made excluded, have to be spent in the maintenance and development of education. The Constitution also determined that during the first 10 years after its promulgation at least half the earmarked resources should be used to eliminate illiteracy and universalize primary education, which should be mandatory and free.

Furthermore, the Constitution created a social security budget — that includes social insurance, health and social assistance expenditures — apart from the federal fiscal budget, which considers all other expenditures. The social security budget has, akin to earmarking, exclusive sources of revenue, namely, the social contributions. This means that about 75% of total federal disposable revenue is reserved to finance social security activities.

The 1988 Constitution hinted, though did not determine, that near 30% of the resources of the social security budget should be spent in health services. These, according to its text, would be provided by a single system, decentralized and financed not only by federal but also by state and municipal funds. The text did not specify how much states and municipalities should spend in health activities.

As shown in Subsection 2.3, education and health are the most important subnational government functions. During the first half of the nineties, in the case of education, and for the whole decade, in that of health, government performance in these functions had been considered unsatisfactory. In the case of education, the intended municipalization of primary schooling was proceeding too slowly, its quality was poor, and spatial distribution of resource availability was very

unequal. In the case of health, the fiscal crisis, especially that of the social insurance, implied shortage of resources for the function. Temporary measures as the creation of the CPMF, which was earmarked to health expenditures, were taken; but a permanent solution was perceived as necessary.

The responses in both cases had been proposals that, among other provisions, called for earmarking resources of the three levels of government for these purposes. The proposals resulted in two amendments to the Constitution.

The 14th amendment to the Constitution[13] established that, for a period of ten years, states and municipalities must spend at least 60% of the resources earmarked to education in primary schooling. Federal government must spent no less than 30% of its earmarked resources in the eradication of illiteracy and the development of primary education.

The amendment also created the Funds for Maintenance and Development of Primary Education and Valorization of Professorship (Fundef). These are state funds made up with part of the resources earmarked to primary education: 15% of both the state and the municipal shares of the ICMS proceeds (including the compensation — "*seguro receita*" — provided by Kandir Law) and of the FPEX, as well as 15% of the FPE and the FPM received by the state and its municipalities, respectively.

Resources of each of these funds are distributed among the state and its municipalities on the basis of enrollment in their respective primary schools. At least 60% of the resources must be spent in the payment of wages to teachers. If the resources of a state Fundef are not enough to match a minimum annual expenditure per pupil, set by the Union, federal government transfers resources to the fund in order that at least the minimum standard is attained all over the country.

Fundef started in 1998 in all but three states, where it had begun a year earlier. Results obtained so far seem to be very good. Comparing 1996 and 2000 data, enrollment in primary schools has increased 8%. Municipalization of primary education was stimulated because disposable resources became related to enrollment instead of local financial capacity. Enrollment in municipal schools, which had accounted for 33.3% of the total in 1996, reached 47% in 2000. The number of teachers and their qualification increased. Quality of primary education improved and there is evidence that spatial disparities were reduced.[14]

The 29th amendment to the Constitution earmarked resources to health public actions and services.[15] It determined, as a permanent rule, that annual expenditures in health actions and services will be, in the case of the Union, no less than an amount specified in a complementary law; and, in the case of states and

[13] The 14th amendment to the Constitution was put in force in the 12th of September of 1996.
[14] For an evaluation of the results of the Fundef, see Mendes (2001).
[15] The 29th amendment to the Constitution was put in force in the13th of September of 2000.

municipalities, amounts at least equal to percentages, to be set by the same complementary law, of their respective total tax revenue plus constitutional transfers received, net, in the case of states, of transfers made to municipalities. The law will also define the criteria for distribution of federal funds to states and municipalities and of state resources to their municipalities, aiming progressive reduction of spatial disparities in the provision of public health services. The law will be revised at least every five years.

The amendment established, as a transitory rule, that the Union would spend in 2000 in health actions and services no less than 105% of 1999 similar expenditures; and that, from 2001 to 2004, the amount to spend in the function will be equal to that of 2000, adjusted by the variation in nominal GDP. The transitory dispositions stipulated as well, to be in effect until 2004, the percentages mentioned in the permanent rules: 12% in the case of states and 15% for municipalities. These same dispositions shall apply from 2005 on if the complementary law mentioned in the permanent rules is not enacted.

As many states and municipalities spend currently in heath actions and services less than the required minimum, and as instant adjustment is impossible, a transition period has been established by the amendment. Each of these units would have to spend at least 7% of its taxes and transfers in health actions in 2000 and gradually close the gap to the required minimum. The difference must be reduced at a rate of, at least, one fifth per annum until 2004, so that the minimum is attained in 2005.

It is too early for an evaluation of the effects of the 29th amendment. Expectations are that availability of fund for health actions and services will increase in the three levels of government. A comparison between a forecast for 2004 and 1998 data shows an increment of more than 40% in total public resources spent in health. In terms of participation, Union share in health financing would remain approximately constant (around 55%) and municipal one would decline (from 26.2% to 23.6%). States, which share is the smallest (18.4% in 1998), are expected to have the proportionally largest increase in expenditures (65%) and to participate with 21.4% of total resources by 2004 [see Faveret *et alii* (2001)].

3.5 - Civil Servants Social Insurance

Until the 1988 Constitution, two different legal regimes applied to labor relations between government and its employees. Some employees were contracted according to the same rules prevailing for the private sector ("*CLT regime*"),[16] while others were hired under legal rules specific of the public sector ("statutory regime"). For the first group, retirement proceeds and pensions for surviving dependents were equal to those paid to private employees. Their value is subject to a ceiling. For the second group, full wages were paid after retirement or as pension.

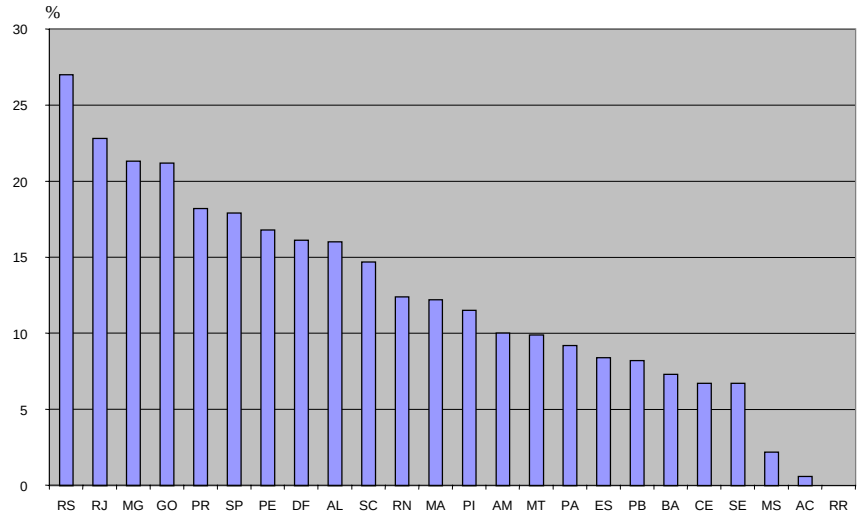
[16] CLT stands for "labor legislation consolidation".

The Constitution unified the public employment regimes. After its regulation, the "single juridical regime" has applied to all public sector labor relations. In this regime, like in the case of the "statutory regime", retired and active servants perceive equal returns. This change brought about a short run positive cash flow to state and municipal finances but a huge long-term imbalance.[17]

Civil servants social insurance policy has been traditionally conceived as an extension of personnel policy. There is not a pension fund based on sound actuarial calculations. Employees pay a contribution, which is not earmarked to a retirement plan and is actuarially insufficient to finance the payment of full wages that civil servants are entitled to receive for the whole life. In the case of states, expenditures concerning retirement and pension payments amounted, on average, in 1997, to 30% of total personnel expenditures or, equivalently, to around 20% of states' net current revenue.

Though it troubles almost all states, the social insurance problem is more severe in those were debt service payments are also large. As shown in Figure 5, Rio Grande do Sul, Rio de Janeiro, Minas Gerais, Goiás, Paraná and São Paulo are the states with larger retirement and pension payments as a percentage of their respective net current income. Among these, only Paraná does not present a large debt to net current revenue ratio.

Figure 5
Brazilian States: Social Insurance Expenditure/ Net Current Revenue — 1997



Source: Pinheiro (1999).

[17] Under the *CLT regime*, employees and employers have to pay a contribution to the National Social Insurance Institute (INSS). Employers have also to make a deposit in an employee account, the FGTS, which funds are administered by the federal government and may be used only in case of retirement or dismissal. Under the "single juridical regime", subnational units do not pay these amounts and receive a contribution from the employees. Besides, INSS had to indemnify states and municipalities to compensate previously paid civil servants retirement contributions. The counterpart is that subnational units assumed future retirement and pension payments for those who were formerly under *CLT regime*.

Civil servant social insurance is in a process of reform in all levels of government. The basic proposal is to create a new retirement plan in which receipts and payments are actuarially balanced. The trend is to depart from the present pay-as-you-go system to a hybrid one in which retirement and pension payments by the government would be limited to a ceiling, and the civil servants, upon additional contribution to a pension fund, would be able to get an income complementation.

One fundamental question is how to finance transition to the new regime, as all civil servants on duty before the change was introduced have the right to receive retirement returns and pensions according to the old rule. To face this problem, some state — e.g., Paraná and Bahia — have already set up pension funds, which are capitalized, in part, with resources derived from privatization of their enterprises. But, in most units, a solution for the transition problem has not yet been found, which means that further fiscal adjustment will be necessary in the future.

3.6 - Subnational Borrowing: a Conditional Bailout

Subnational borrowing in Brazil presents the characteristics of a typical federative relation, in view of the important role played by the federal government in the process [see Afonso (1992)]. First, the Union — and, more specifically, the Federal Senate — is in charge of regulating subnational borrowing. Second, federal government has generally been the most important source of credit for subnational units, acting both as a lender and as the guarantor of state foreign debt. And third, central government has traditionally provided bailout, either through the National Treasure or the Central Bank, whenever a subnational unit was in deep financial distress.

Subnational debt was practically inexistent until the mid-sixties. After 1964, several institutional changes — introduction of indexation, for instance — turned public indebtedness possible. Concurrently, fiscal centralism contributed to make indebtedness attractive as a way of bypassing the shortage of fiscal means. Nevertheless, it was only after 1975, when changes in debt control legislation were introduced, that conditions for significant expansion of subnational debt appear.

In fact, the stock of state debt grew steeply.[18] Paradoxically, the increased power to spend derived from this source of finance corresponded to a larger degree of dependence upon the federal government. Debt of that time took mainly the form of loans, provided by foreign or public financial institutions. Foreign borrowing was typical of state government enterprises linked to federal holdings (as in the case of electric energy). Their main purpose, rather than funding investment opportunities, was to improve the balance of payments of the country, a policy

[18] Municipal borrowing was, and still is, relatively unimportant. Exceptions are the cities of São Paulo and Rio de Janeiro. This subsection considers only state debt.

assigned to the Union. Loans from federal banks were earmarked to types of expenditure that were of interest to the federal government. And as debt accumulated, given state's own revenue capacity, the state became more dependent on federal grants to balance their fiscal accounts.

In the beginning of the eighties, as a result of the international shortage of lending funds, Brazil resorted to the International Monetary Fund (IMF). The IMF agreement required that a fiscal adjustment process took place. For the states, this signified the rupture of their financing standard, since the availability of loans and voluntary grants from the federal government was severely restricted. State official banks became the main source of funds; and they were used so intensively that some had to be rescued by the Central Bank. A few states, the more developed ones, were able to raise part of the needed funds by issuing bonds and finding in the market bearers other than their own official banks.

When the National Constituent Assembly was installed, in 1987, state indebtedness was already perceived as a macroeconomic problem [see Rezende and Afonso (1988)]. Despite demands from subnational governments, the Assembly was not able to insert in the new Constitution a solution for the state debt problem.

Perception that subnational borrowing became a national problem was half the way to a bailout. After some political pressure, the federal government assumed states' and municipalities' foreign debt in 1989 and refinanced it to these units.[19] A second round of negotiation that had started in 1991 resulted, in 1993, in the rescheduling of the debt contracted with federal institutions.[20] In both cases, conditions were very favorable to subnational units. The debt was refinanced in up to 30 years at subsidized interest rates. On the other hand, an attempt to include in the negotiation with the federal government state debt in the form of bonds and that contracted with state official banks did not succeed.

Also in 1993, in an attempt to reduce the rate of growth of the stock of state bonds, an amendment to the Constitution was passed, which limited state bond issues to, at most, the amount necessary for refinancing maturing bonds.[21] Despite the limitation, state debt in bonds continued to grow fast due to the very high interest rates prevailing in the nineties.

Table 4 compares the rate of growth of state bond stock with the level of interest rates on state and federal bonds. Between 1992 and 1996, debt in bonds increased at an average annual rate of 19,6% while debt previously refinanced by the federal government grew at a rate of only 3% per annum. This time, tight monetary policy practiced during the nineties, rather than excessive state expenditures, was the origin of the financial distress.

[19] Law 7.976, of the 27th of December of 1989.
[20] Law 8.727, of the 5th of November of 1993.
[21] 3rd amendment to the Constitution, promulgated on the 17th of March of 1993.

Table 4
Growth Rate of Debt in Bonds and the Level of Interest Rate

(In %)

Items	1992	1993	1994	1995	1996
Growth Rate of Debt in Bonds [a]	35	4	14	33	15
Interest on Federal Treasury Papers (LFT)	30	7	24	33	15
Interest on State Treasury Papers (LFTE)	35	10	28	36	16

Source: Central Bank of Brazil.
[a] *Excludes precatory bonds.*

Debt in bonds was not a widespread problem since only the more developed states were able to use the bond market. Hence, as shown in Table 5, four states — São Paulo, Rio de Janeiro, Minas Gerais and Rio Grande do Sul — were responsible for more than 90% of total bond issues. A significant proportion of their disposable revenue would be tied to principal and interest payments in case they were unable to refinance the maturing issues. In fact, as the size of their debts soared — and, consequently, the risk of bearing their bond issues increased — the market refused the papers. The Central Bank had to intervene, subscribing state bonds, in order to avoid default and a fiscal crisis in the economically more important states.

Table 5
State Debt in Bonds — 1990 and 1996

State	1990		1996	
	As % of GDP	As % of total	As % of GDP	As % of total
Minas Gerais	0.5	21.7	1.3	22.4
Rio de Janeiro	0.4	17.4	0.9	15.5
São Paulo	0.9	39.1	2.1	36.2
Rio Grande do Sul	0.4	17.4	1.0	17.3
All others	0.1	4.4	0.5	8.6
Brazil	2.3	100.0	5.8	100.0

Source: Central Bank of Brazil.

Bonds accounted, in 1996, for about 30% of total debt not yet refinanced by the Union, which had reached an amount over US$ 100 billions. There was no feasible state fiscal adjustment that could overcome such a significant financial imbalance. The solution was again federal bailout.

This time the solution proposed by the federal government, inspired by IMF practices, was a conditional bailout. The major part of the state not yet rescheduled debt was refinanced in the context of an agreement — The Fiscal and Financial Restructuring Program — that presumed a rigorous long term fiscal adjustment, privatization of public enterprises and the sale or liquidation of the state official bank, which abuse had been the source of many troubles.

Debt was rescheduled according to the rules set by Law 9496.[22] Negotiation was made in a case-by-case basis; but, in all cases, refinancing conditions were again very favorable to states. Real interest rate was set between 6% and 7.5%. The principal should be paid in 30 years; but no more then 15% of a state net current revenue has been tied up to debt service, which means that the term will, in most cases, be expanded. On the other hand, a down payment amounting to 20% of the rescheduled debt must be made. This clause practically obliged privatization of state owned enterprises in order to raise the necessary funds. The sale of public enterprises resulted in a cash flow of more than US$ 20 billions.

As a counterpart of refinancing, the agreements bind states to an in depth reform of the public sector and to a severe fiscal adjustment. They have established that missions, composed by National Treasury Secretariat technicians, will monitor state accounts to verify the accomplishment of contracted aims and discuss public finance situation and required adjustments. The objective is to avoid the need for bailouts in the future.

Of course, these agreements point out a reduction of state fiscal autonomy. But, paradoxically, the Fiscal and Financial Restructuring Program was essential for the consolidation of decentralization. First, rationalization of expenditures improved public sector efficiency. Second and most important, if the agreements were not in effect, state liabilities would tie up a significant parcel of state resources to debt service payments.

Table 6 presents the results, for the Brazilian regions and some units of the federation, of a simulation of the state debt paths, under the hypothesis that the conditional bailouts have not occurred. It is assumed — conservatively — that state indebtedness would increase at the pace determined by interest rate on federal bonds. Table 6 concerns only debt refinanced under Law 9496 rules, which amounts to about half the standing total. It shows that, in the most important units of the federation, interest rate payments would exceed, in 2000, 30% of their respective net current revenues (reaching 43% in the case of São Paulo), more then double the amount effectively disbursed under the agreements.[23]

The results imply either an explosive path to the debt — assuming, falsely, that states were still able to borrow from the market — or insufficiency of funds even to pay personnel expenditures only. In other words, the conditional bailouts imposed a loss of fiscal autonomy to states; but preserved the decentralization process that, without it, would become unsustainable.

[22] Law 9.496, of the 11th of September of 1997.

[23] Note that payments to the federal government correspond not only to interest but also to amortization of the principal of the debt.

Table 6
Simulation of State Debt Path in the Absence of Refinancing
(In R$ Thousand of December, 2000)

Region/State	Refinanced Debt — Law 9496 (A)	Debt in the Absence of Refinancing [a] (B)	Interest Rate Payments in 2000 (C)	Net Current Revenue in 2000 (D)	(C)/(D) (E)
North	754,879	999,637	97,868	6,759,212	1%
Northeast	4,234,502	6,207,707	607,756	16,930,135	4%
Southeast	106,226,379	173,772,093	17,012,890	44,852,208	38%
Minas Gerais	15,726,477	25,133,489	2,460,656	7,766,187	32%
Rio de Janeiro	20,300,847	3,952,746	2,345,057	6,956,241	34%
São Paulo	69,627,737	123,772,798	12,117,786	28,068,914	43%
South	15,277,176	23,691,410	2,319,471	12,946,986	18%
Rio Grande do Sul	12,523,043	19,727,777	1,931,418	5,636,596	34%
Center-West	5,303,952	8,050,552	788,177	6,462,640	12%
Mato Grosso do Sul	1,642,950	2,588,169	253,391	1,114,033	23%
Brazilian States	131,796,888	212,721,397	20,826,162	87,951,181	24%

Sources: Senate, Treasury Secretary, Brazilian Statistical Bureau, Central Bank.
[a] *In September, 2001.*

3.7 - Decentralization and Macroeconomic Management: the Fiscal Responsibility Law

The Fiscal and Financial Restructuring Program marked a change in the nature of intergovernmental fiscal relations. The simple limitation imposed on subnational borrowing was replaced by a comprehensive monitoring of fiscal and financial accounts, which intends to prevent excessive borrowing and, thus, financial crisis. This new approach was strengthened by the enactment, in 2000, of the Fiscal Responsibility Law (FRL).[24] This is a very complex law, which encompass many public finance aspects. Only a few of its points are mentioned here.

FRL determines, to ensure fiscal sustainability, that any new permanent expenditure — those that will exist for more than two fiscal years — must be attached to a new permanent source of financing — a new tax or the increase in the rate of a tax, for instance.

The law establishes, in an attempt to improve efficiency of the public sector, limits to personnel expenditures, which shall not exceed 50% of net current revenue, in the case of the Union, and 60%, in that of states and municipalities. In addition, the law established limits to expenses with legislative and judiciary personnel. The legal dispositions are an important instrument for the executive branch, which has no power to limit the expenditures of other branches.

According to the FRL, in electoral years, when governments are prone to spend more than disposable revenue and leave the imbalance to their successor, contracted expenditures may not be settled in the next fiscal year unless present year resources are reserved for this purpose.

[24] Complementary Law 101, of the 4th of May of 2000.

Fiscal sustainability is an integrated vision of debt control. Even so, FRL presupposed specific debt limits. According to its text, in the case of subnational units, limits are set by the Federal Senate, after a proposal of the president of the republic. Requirements for contracting new credit operations are stringent, working as an obstacle to borrowing. Furthermore, credit operations between federation entities, to finance current expenditures or refinance standing debt, are forbidden.[25] This means that new bailouts are ruled out.

The FRL is a landmark in Brazilian public finance. It represents the introduction of the concepts of fiscal transparency and accountability in the practices of the Brazilian public sector. It established a new paradigm — coherent with macroeconomic principles and stressing fiscal sustainability —, which helps consolidation of price stabilization insofar as it sets up the conditions to attain long run fiscal equilibrium. In this sense, it is an instrument of macroeconomic management. It also contributes to the solidification of the decentralization process, insofar as it prevents irresponsible fiscal and financial management. All these benefits have some costs. One of them is the imposition of further reduction in the degree of fiscal autonomy of subnational governments.

4 - FINAL REMARKS

Despite the reconcentration of revenue promoted by increased reliance of the Union on social contributions, which are not shared with subnational units, the episodes considered in Section 3 point to the reinforcement of decentralized public action and cooperation among the levels of government, and, concurrently, to the reduction in the degree of fiscal autonomy of Brazilian states and municipalities. The need for a tax reform that improves the quality of the tax system and prevents fiscal war among states is also suggested.

Decentralized provision of public goods and services, and technical and financial cooperation among different levels of government are essential to increase efficiency of the public sector, especially if priority is assigned to social policies in a country where income disparities among regions, as well as among local units within each region, are wide. Efficient use of public resources is indispensable if government intends to provide a meaningful amount of services, because a large portion of its revenue is tied up to transfers to individuals — interest payments and social insurance expenditures.

Notwithstanding the greater importance of states and municipalities as expenditure units, it is probable that they will suffer further reduction in their fiscal autonomy in the near future, this time related to the revenue side of their accounts. There is growing concern with the impact of taxation on economic efficiency and on competitiveness of private firms; and, due to increased openness of the economy and to regional economic integration, with international tax

[25] States and municipalities may, however, bear federal bonds.

harmonization. This concern will require some reduction in the taxing power that states have now.

Federalization of the main state tax, the ICMS, along with revenue sharing deepening is not a solution compatible with Brazilian federative tradition. All attempts to follow this path were promptly repelled by state governments. A detailed national legislation, which would apply to all states, coupled with states' power to legislate on local specificities and to fix their own tax rates seems to be a reasonable compromise that would make reform feasible insofar as state taxation is concerned.

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