Wrestling with states and municipalities

Brazilian Federalism

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Brazil is at war with itself in the battle to strengthen its public finances. Its federal system is weakened by ceaseless pressures on its resources by state and municipal governments that tax too little and spend too much in order to advance the careers of local politicians. This essay examines the causes of chronic fiscal deficits of Brazilian states and municipalities, focusing on the perverse incentives bred by the political system, and suggests ways to overcome this problem.

Among the political actors, the federal government has the biggest stake in fiscal reform, since it is responsible for Brazil’s macroeconomic performance. Federal authorities – particularly the President and his economic advisors – are the country’s main defenders against economic crisis. But governors, mayors and members of Congress are judged by the amount of benefits channeled to their local supporters. As a result, at the expense of macroeconomic stability, these politicians tend to try to secure the maximum amount of resources possible, leaving the bill to be paid by their successors or by the federal government.

Brazil is not alone in the struggle against the power of local interests. All federations grapple with disputed sovereignty within their territory. As James Bryce observed in his classic The American Commonwealth (1893), the legislator’s “first and main duty is to get the most he can for his constituency out of the treasury, or by means of legislation. No appeal to the general interest would have weight with him against the interests of that spot.”

What makes this problem more acute in Brazil are key provisions of its 1988 Constitution and its political-electoral system:

- Poorer and smaller states and municipalities are disproportionately represented in Congress, using their veto power over key bills proposed by the Executive to block reform efforts and to bargain for more financial aid. Also, richer states in financial trouble are seen as too big to fail, calling for bailouts that endanger stability.
- The 1988 Constitution channeled additional shares of federal revenues to states and municipalities, which use their legislative and bureaucratic influence to pressure for even more.
- Institutions for auditing and Supervision of public spending (audit tribunals, prosecutors, etc.) are disorganized and controlled by the politicians that appoint them, facilitating fraud, mismanagement and corruption.
- Federal financial institutions (Central Bank, commercial and investment banks owned by the federal government, pension funds for public employees) lack institutional independence and thus cannot resist political pressure to bail out states and municipalities.

Perverse Incentives

Perverse incentives are the devices of law and custom rewarding behavior that undermines the stated purpose of institutions. Perverse incentives distort the use of public money, especially at the local...
level, driving states and municipalities to extract more and more money from the federal government for special projects and financial rescue operations. Let’s look at a few statistics: In 1997, 27% of federal revenues were transferred to states and municipalities. In 1996, 10% of all municipalities did not bother to collect taxes, since all their spending was funded by federal transfers, stimulating a proliferation of new municipalities over the past decade. Of Brazil’s 5,507 municipalities, 89% get 95% or more of their revenues from Federal or state transfers. In no other country is the federal government driven politically into such huge and recurrent bailouts of state and municipal governments.

Over the last two decades the Union refinanced state debts equaling roughly $200 billion (26% of GDP). Of all state and municipal debt, 91% is owed to the federal government, which is the main financier of fiscal irresponsibility. In an editorial July 16, 1999), O Estado de S. Paulo summed up Brazil’s fiscal federalism; “When it comes to distributing tax revenues, Brazil is a federation. But when the time comes for fiscal tightening and paying public debts accumulated in years of irresponsible spending, Brazil becomes a centralized state. In other words, the states spend and the Union pays the bill.” There are few firm and clear rules. Bailout agreements to recapitalize failed state banks and refinance state and municipal debts on easy terms are subject to perennial political pressure to renegotiate. Little is sealed except the dare of the next elections. The victors then seek to undo the financial commitments of their predecessors.

As if the disorder of local financial customs were not enough, state and municipal governments also adopt some fiscal vices of the Federal authorities. The best example of this is the social security system. In Brazil citizens can begin collecting pensions at an early age. The average retirement age is 49 years, with many pensioners receiving payments for more years than they worked. The biggest distortion in the social security system lies in pensions for public employees, at all levels of government, most of whom enjoy more generous retirement and contribution schemes than in the private sector. In 1999 state governments were expected to spend $15.5 billion on pensions, nearly four times what they receive in contributions. The Supreme Court has just virtually bankrupted state governments by ruling that payroll taxes for public employees and pensioners are unconstitutional.

The currency crisis of January 1999 dramatized the weight of local public finances in Brazil’s economy. The state of Minas Gerais declared a moratorium on its debts, launching Brazil into a net round of political and financial instability. The moratorium showed the world that, without a sound fiscal regime, the battle to end inflation and to create a stable currency would be lost. The Minas moratorium also showed how the fluidic of Brazil’s federal system could destroy its international credit. Within days of the moratorium announcement, a financial panic forced the Central Bank to abandon its efforts to defend the value of its four year-old currency, the real.

**Electoral Incentives**

What is the linkage between democratic elections and fiscal imbalances? The Nobel laureate James P. Buchanan and other economists developed the hypothesis of “fiscal illusion”; taxation is diffuse, paid by all. It is embedded in the price of goods, payroll deductions, inflation and growth of the public debt. The benefits of public spending, however, are visible and concentrated in well-defined groups that pressure for spending increases, whom politicians accommodate in order to maximize their electoral chances. Those paying for increased spending are disperse and cannot resist pressure to increase spending. So the tax burden and the public deficit grow.
Other economists reject the theory of fiscal illusion, arguing that people cannot be fooled forever. In the long term, voters hurt by the ratio of taxes paid to benefits received will vote against politicians exploiting the fiscal illusion. But even when there is no fiscal illusion in the long run, this illusion can operate in the short run, in view of voters’ difficulties in obtaining and processing information needed to decide their vote.

Another electoral incentive operates when a government tries to influence the actions of its successor. Elected officials, expecting to leave office after the next election, may expand deficit spending to capture short-term benefits and reward their supporters. The new government, facing an increased debt burden, cannot finance its own programs and, in Brazil, will try to repudiate the debts it inherited. Still another electoral incentive arises when politicians compete for central government funding of local projects to strengthen their election campaigns. Since most public spending is financed by national taxes, legislators compete to include projects benefiting their local election districts in the federal budget.

The impact of electoral incentives on the fiscal balance of states and municipalities depends on three factors: (1) the efficacy of public institutions that audit and control government spending; (2) on the rules of the political-electoral system, and (3) on the structure of fiscal relations among different levels of government. These factors decide the strength of budget constraints on states and municipalities. We now will examine why budget constraints are so weak at the local level in Brazil.

**Soft Budget Constraints**

A budget constraint limits public spending. The Hungarian economist Janos Kornai created the concept of “soft budget constraints” while studying over-investment in the centrally-planned economies of Eastern Europe. However, as Kornai emphasized, the term can also help to understand the problems of public financing in Latin American economies in periods of high inflation.

“The softening of the budget constraint appears when the strict relationship between expenditure and revenues has been relaxed, because excess expenditure over earnings will be paid by some other institution,” Kornai wrote. Local governments in Brazil operate under soft budget constraints, knowing that they can get Federal aid to cover deficits.

Soft budget constraints depend on law and custom. The transfer of federal funds under soft constraints comes from bargaining and political pressure. In Brazil, local governments extract more federal money in several ways. Instead of spending their own resources, they get pledges of federal Funds to finance a given program. They also seek new appropriations to complete projects paralyzed by a lack of funds, or they can transfer their debts to the central government. In addition, local governments can obtain loans from the public or private financial sector with implicit federal guarantees. While there may be no clause in the loan contract binding the central government as guarantor, both the borrower and the lending institution know that federal authorities will pay if the debtor defaults.

A good measure of soft budget constraint for local governments in Brazil is the amount of debt passed on to the central government. In July 1998, 34% of the whole federal debt burden were state debts assumed by the Union in a 1997 renegotiation, the third major bailout of state debts over the past decade. Recurrent refinancing of state debts accounts for 53% of the assets of the Federal Treasury. Mayors, governors and members of Congress haunt the federal bureaucracy in search of more money or debt relief.

Soft budget constraints relax cost controls, especially in public employment. “Since the return of democracy and the enactment of the 1988 Constitution, payroll spending increased,” writes the political scientist Fernando Abrúcio. Public investments are made without considering project viability or cost. In 1995, the Senate Temporary Committee for Unfinished Works itemized 2,029 paralyzed public works that ran out of money, estimating that $9 billion was needed to finish half of them.

According to political scientist Scott Mainwaring, no other Western democracy gives politicians as much freedom from party discipline as Brazil. So politicians are free to put state and municipal interests ahead of party policy. Local politicians join parties so they can have a place on the ballot. Freedom of politicians from party discipline rests on these pillars:

- Election of state and federal legislatures by proportional representation. Voters choose one candidate. Once the number of seats won by each party has been settled, the candidates with the most votes occupy these seats. Only Brazil and Finland have this open list system. All other democracies
empower parties to choose which candidates have priority in occupying seats won by the party, under a closed list system.

- Incumbent legislators have priority to run for reelection. Even those who regularly vote against party policy are guaranteed a place on the party ticket in the next election.

- Once elected, legislators face no restrictions against switching parties. In the Congress elected in 1994, 40% of members switched parties. In many other countries, a legislator must resign his mandate if he switches parties. Brazilian politicians use parties as vehicles to get elected, multiplying the number of “rental parties” that rent places on their tickets to free-floating candidates.

- There are no rules to force legislators to adhere to party leadership. In many other countries, anyone who votes against the leadership on important matters must resign.

- There is no minimum voting percentage for a party to be entitled to a seat in Congress. This encourages proliferation of small parties, complicating political negotiations in Congress.

The weakness of parties makes election campaigns individualistic. Candidates for proportional election compete against other candidates of their own party. In poorly structured parties with too many candidates conducting individualistic campaigns, each candidate must finance himself. Thus local public spending becomes critical to political campaigns. One way to lower private campaign costs is to mark off an area of influence, an electoral stronghold, and channel public spending into that area. In Brazil, this reinforces parasitic activity by politicians seeking federal and state grants.

The power vacuum created by the weakness of political parties is filled by governors who control state and federal legislators. A politician who disobeys the governor is not invited to inaugurate public works. Nor does he get a place on the speakers’ platform at election campaign rallies. Nor can he get the state government to repair a school or pave a street in his municipality. If he is the governor’s ally, a candidate has easier access to campaign funds. In short, Brazilian legislators hunt for federal and state funds for their municipal strong-holds and their states under command of the governor, of whom they are essentially political vassals.

Free of party discipline, members of Congress use their votes as a bargaining tool. The federal executive branch, instead of negotiating policies with the party leadership, must engage in petty negotiations with each member of Congress as they respond to municipal and state demands.

To impose hard budget constraints on states and municipalities, three basic improvements are needed. First, legislators must be subject to party discipline. Second, limits must be imposed on the creation of new parties. Third, the costs of campaigning must be reduced. Political reform proposals currently being debated in Congress include innovations that could help to achieve these goals, such as: party fidelity, proportional electoral systems with pre-defined lists determined by the parties, and minimal voting limits in all or a majority of states in order to obtain seats in Congress.

The 1988 Constitution

Resumption of direct elections for state governors in 1982 was a crucial phase in the military regime’s strategy for a “slow, gradual and secure” return to civilian rule that finally took place in 1985. Local power regained strength after a period of political and administrative centralism. The new governors wasted little time in demanding fiscal decentralization. Making use of their Congressional majority created during military rule, the poorer states won decentralization based on increasing federal transfers to states and municipalities, the main revenue source for most poor local governments, under the 1988 Constitution. Of the Brazilian federation’s 27 states, 12 of them, all in the Amazon and Northeast regions, get most of their revenue from federal transfers. Meanwhile, the richer states called for decentralized taxation, which would enable them to exploit their tax bases more intensively.

Thus soft budget constraints were weakened further. Federal transfers to states and municipalities are calculated as a fixed share of Federal tax receipts, which fluctuate with the level of economic activity. Thus debt burdens that were sustainable before a recession can become unbearable after an economic shock. State governments dependent on transfers are unable to generate enough additional resources to avoid deeper deficits. The central government then either will bail the State out or let it go bankrupt. But because the political and economic fallout from public bankruptcy is so severe, bailouts become the rule.

Local governments are aware of this scenario. Knowing that they can rely on the federal government to bail them out, local governments tend to relax spending controls and borrow more,
exposing themselves more and more to an economic shock. During periods of prosperity, when transfer revenues increase, there is little concern for setting up a reserve as insurance for darker days. Instead, increases in transfers tend to be converted immediately into fixed budget obligations.

Brazil is not the only country where tax revenues oscillate with economic growth rates. However, in Brazil, as in other major economies of Latin America, these oscillations are more intense than in richer countries. In 1994, the Real Plan brought a fast fall in inflation. Increases in real incomes bred more private consumption and higher state tax revenues. Stare and municipal spending was geared to this new revenue plateau. However, the federal government had to curb consumption to avoid a revival of inflation. Interest rates were raised, slowing economic activity and reducing tax revenues and transfers to states and municipalities. Higher interest rates, used to defend the currency and curb demand, raised local government debt bills while payroll expenses were frozen under constitutional provisions for job security. State governments pressured the federal government to absorb these costs. In December 1995, the National Monetary Council authorized the federal government to bail out the states by renegotiating their debts.

Cooperation between poor states with political power and rich states with economic power also weakens budget constraints. In the 1994-98 Congress, the poorer states held half the seats in the Chamber of Deputies and nearly three-fourths of the Senate, while representing only 41% of Brazil’s population and 26% of GDP. The political power of these states enables them to threaten to veto government bills in Congress in order to obtain more money. Likewise, the rich states, with their big debts, are too big to fail. The federal government bails them out in times of crisis to avoid panic in financial markets.

A curious “joining of forces” thus develops between rich and poor states. When their debts grow too big, the rich states seek bailouts, which must be approved by the Congress, controlled by the poor states. Congress refuses to authorize a bailout unless the poor states get money as well.

The 1994 failure of Banespa (State Bank of São Paulo) shows how this cooperation works. When São Paulo State convinced the Federal government to adopt a refinancing package totaling $50 billion, with aid to Banespa alone totaling $15 billion, representatives of the poorer states resisted for months. The Senate Economic Affairs Committee withheld approval for nearly a year, until the Finance Ministry finally agreed to refinance all state banks.

**The Budget Process**

Politicians present budget amendments to fund local projects (sports facilities, libraries, public sanitation, health care centers) to help them win elections. Of the 503 deputies in the 1998-2001 term of Congress, roughly 30% are expected to be mayoral candidates in municipal elections in 2000.

Under the 1988 Constitution, members of Congress can submit budget amendments for new spending only if they are offset by spending cuts instead of increases in revenue estimates, or by correction of errors or omissions in the proposed budget law. However, several tricks evade limits on budget amendments. “Corrections” of errors and omissions are used to inflate expected revenues, beyond those estimated in the Executive’s budget proposal, in order to increase spending on local projects. Another common practice is to cut cost estimates. Legislators also create a “budgetary window” for small grants for local projects or activities, with the aim of obtaining more funds later under political pressure to finance uncompleted projects. These local projects drain funds from strategic programs promoting Brazil’s economic and social development.

There never is enough money to pay for all these amendments. So the government rations its spending. Since the budget law authorizes but does not mandate spending, many of these projects are never carried out. Legislators often must engage in a second round of lobbying and political negotiation, haunting government ministries to obtain release of funds budgeted under their amendments in exchange for support of the President in critical votes in Congress. A good example of this is the so-called “lower-clergy” in Congress, rank-and-file deputies with little political influence individually but with a mass of votes. They get federal funds for their municipalities in exchange for voting with the government on key measures. O Estado de S. Paulo (December 12, 1999) observed: “The federal government could release close to R$ 500 million [US$ 280 million] this week to endorse individual amendments attached by legislators to this year’s General Budget....Virgílio [Arthur Virgílio, the government’s leader in Congress] argued that disbursing funds for individual amendments is needed to improve the government’s political support in Congress.”
In 1997 Congress approved $4.1 billion worth of amendments. This was more than half of the $7.6 billion targeted for fiscal adjustments by the federal government in October 1998 during the international financial crisis that followed Russia’s default. It is also more than double the $1.9 billion a year that the federal government intends to save by freezing its employees’ salaries and raising their pension contributions in order to finance the social security system.

The government’s program of constitutional reforms added importance to budget amendments in negotiations between Congress and the Executive. Complicating these political negotiations was pressure by the Executive for a constitutional amendment authorizing reelection of the President. Each reform requires approval by three-fifths of all members in two separate votes in each chamber of Congress. Votes in favor of constitutional reforms are traded for release of funds for local projects under budget amendments. The slowness of this process, involving many concessions and compromises, explains the reform fatigue gripping Brasilia, leaving the reforms far from complete.

Several public institutions are supposed to oversee and regulate the use of public funds: legislative branches (municipal councils and state assemblies), audit tribunals (federal, state and municipal), the Stare Attorney’s Office, the Senate, the Central Bank, and the National Monetary Council. These agencies have been unable to correct the misuse of public funds. Nor have they built a reputation that could intimidate careless or corrupt officials.

The Constitution empowers the Senate to establish and monitor the limits and conditions of borrowing by the Union, states and municipalities. But Brazilian legislators want to transfer federal funds to their own election districts. As such, senators are less concerned with containing public debt than with making it easier for their own state to borrow. Rarely does the Senate fail to authorize public borrowing. Should requests for authority to borrow violate limits set by the Senate itself, exceptions are easily obtained. One example is the precatório scandal of 1997-98, involving fraudulent public borrowing ostensibly to pay for court judgements against state and municipal governments. A Senate investigation found that the Senate’s own laxity allowed states and municipalities to issue bonds based on false documents.

Investigation and supervision by State accounting tribunals and prosecutors are limited by rules of appointment. Heads of state accounting tribunals are chosen partly by the legislature and partly by the governor. Since governors usually control legislatures, they also control appointments to the accounting tribunals that supervise state finances. The rule for choosing state attorneys-general also is defined by the Constitution; the governor selects a name from a list of three career officers. Thus the governor also appoints the law officer empowered to prosecute him for any misconduct.

According to São Paulo Treasury Undersecretary Fernando Dall’acqua, a professor of public administration at the Getúlio Vargas Foundation, “political independence is nonexistent within institutions responsible for the control and auditing of public spending.” Dall’acqua explains how the governor’s control over the Audit Tribunal and the São Paulo State Attorney enabled him to avoid detection of the financial mismanagement that led to the failure of Banespa and the bankruptcy of the state of São Paulo in 1994-95: “It is common to have political connections between the Executive Branch, the Audit Tribunal and the State Attorney’s Office....Long-serving public prosecutors at the State Attorney’s Office are appointed to posts in the Executive....A prosecutor may hold a high Executive post and then be appointed to the Audit Tribunal, where he oversees the accounts over which he had responsibility in the Executive Branch.”

The Federal General Accounting Office (TCU) follows a similar pattern. The Constitution states that heads of the TCU be selected by the President (one-third) and by Congress (two-thirds) and that nominees must have “notable financial, economic, accounting and juridical or public administration knowledge.” But Congress gives these jobs to politicians in the twilight of their careers. The
A professional history of the present TCU members shows that just one of the eight TCU councilors has auditing experience. Five of the eight had long political careers. Four held federal or state government executive positions.

**What Is To Be Done?**

Decisive measures, aimed at preserving Brazil’s federal system on a realistic fiscal foundation, are needed to guarantee stability and growth and to prevent a revival of chronic inflation. Here are some ideas about what must be done:

**Party discipline** could be strengthened by ending the promiscuous switching of parties. Legislators wishing to change parties, or vote against the party leadership on major issues, should resign their seats. Under proportional representation, parties should be empowered to select a pecking order of its candidates to win seats according to the party’s share of the total vote. This means doing away with the “open list” method in which a party’s candidates compete with each other. Limits should be placed on the number of candidates each party can hold to end the proliferation of contestants by which parties lose control of their members, who often become bogged down in internal rivalries.

**Limit the creation of new parties** by establishing an entry barrier for occupying seats in the legislature, such as obtaining a minimum number or share of votes nationwide or in each state. Perverse incentives for creation of new parties can be reduced by limiting benefits such as free electoral time on television and legislative office space and staff for small parties.

**Reducing campaign costs** can be achieved by public funding of campaigns. Spending in excess of public funding provisions should be publicly accounted for and revealed before taking place. Campaign costs and vote-buying could also be reduced by ending compulsory voting.

**More power of parties over individual politicians** would reinforce their focus on issues of national interest. Governors would lose the vassalage of legislators who, in turn, would become more strongly bound to their parries. Thus local politicians would be driven less to seek federal revenues and financial aid. The federal government is proposing a reform package along these lines. However, this type of reform will not be easy. Politicians will resist change, as they build their careers on an electoral strategy rooted in diverting federal funds into local districts.

**Local autonomy.** At the fringes of Brazil’s federal system, some states highly dependent on Federal transfers, with excessive payroll costs as a share of revenues (Acre, Rondônia, Espírito Santo, Alagoas and Piauí), have become channels for international traffic in drugs and firearms. In the absence of institutional controls at the federal and state levels, criminal gangs penetrate state governments and police forces, feeding criminal activity elsewhere in the federation. The Folha de S. Paulo (November 28, 1999) reported:

_Fraud schemes using taxpayers’ money get more and more sophisticated, involving many of the 5,507 mayors of the country, breeding an industry of phony receipts. According to the chief-prosecutor in Alagoas, Delson Lyra da Fonseca, municipalization multiplied this kind of fraud, involving “phantom schools, phantom medicines for phantom clinics, phony receipts for buildings never constructed and work never performed. Production of phony receipts became a national industry after the decentralization of spending.” Criminal organizations involved in robbery and murders also use this kind of corruption. In Piauí, for example, 90% (201) of the 223 municipalities are suspected of being involved in a criminal gang organized by Colonel José Viriato Correia Lima of the Military Police... The politics of “plunder”, as defined by the chief-prosecutor in Espírito Santo, Ronaldo Albo, also serves to pay electoral debts.... In his state, he says, the criminal organization known as Scuderie Detective Le Coq (supposedly involving police officials) invests money in municipal elections.... Those elected are expected to return the amount lent in one way or another. The murders of mayors in Piauí are almost all related to threats from loan sharks._

Local autonomy should be protected if it is politically responsible and economically viable. A
minimum should be fixed for the share of local taxes in total revenue. For states and municipalities, states unable to meet this minimum after a transition period of, say, 10 years would become federal territories, losing their political autonomy. Insolvent municipalities would become districts of solvent municipalities and thus be freed of the overhead costs of local administration. These criteria would reduce the number of states and municipalities created in the recent past merely to harvest federal transfers. With a minimum ratio of only 5% of local tax revenues to total spending, more than 2,000 municipalities would lose their political autonomy if they could not raise more taxes.

Reducing transfer payments. Brazil’s federal system relies much more on fiscal transfers than other Latin American countries. Local fiscal autonomy could be increased by reducing Federal transfers to states and municipalities while expanding their own tax base. The Union could reduce income tax rates, enabling states and municipalities to add a local fraction to the federal tax.

People who pay taxes usually want to know how their money is spent. More local fiscal autonomy and less dependence on transfers would increase supervision and responsiveness among voters. Reducing transfers gradually would give local governments time to improve tax collection with federal technical support. Phased reduction of transfers could soften political resistance to change in the system, since current governors and mayors would be less affected than their successors.

Smaller transfers aimed at moderating inequality in the Fiscal capacities of rich and poor states could survive. Transfers could be fixed in nominal terms and not as a share of federal tax revenue, reducing oscillation of transfers to states and municipalities and discouraging spending surges from sudden transfer increases. There would also be less clamor for bailouts when a fall in federal revenues reduces transfers.

Brazilian states and municipalities experience sharp revenue fluctuations due to the instability of GDP. Since a steadier growth path for GDP in the future is not likely, fixed nominal transfers could work as a sort of hedge. As GDP and tax collection falls, transfers would remain fixed, preventing loss of revenues. In times of economic boom, more robust local tax collection would support revenue growth. Increased local taxing power would discredit the claim that the federal government is responsible for the fluctuation of local revenues because it is also responsible for the variations in economic growth, an argument often used to pressure for federal aid. This plan could only work, however, if the amount of federal transfers was reduced. If not, federal finances would be undermined in times of recession, as the Union would have to sustain a fixed burden of transfers when tax collection falls.

The Union now resists sharing taxes with states and municipalities, since revenue increases go to local governments. Instead, the federal government prefers to create new taxes not subject to sharing. Since traditional tax bases (income, consumption and property) are already being exploited, new taxes are applied on company turnover, payroll and financial transactions which, in turn, burden production, investments and exports. If fixed transfers to local governments, not proportional to revenue, became policy, the Union’s interest in perverse tax increases would be diminished.

Nominal values of federal transfers to local governments for state and municipal public services, such as education, transportation and public security, should be fixed previously. The Union would allocate enough money to ensure minimum nationwide quality standards. From that base, states would decide how much they would add of their own money for that activity. If the Union finds it important to prod local governments to spend for a given purpose, it should limit itself to providing a basic financial grant for this program, leaving it up to states and municipalities to decide if they want to invest additional funds to raise the standard above the minimum financed by the Union. These transfers would be restricted to exclusive state and municipal functions. The Union would provide financial support, though not services. Where the Union also provides services (public health, for example), more complex systems of joint financing and decentralization should be adopted. The scope for special spending agreements negotiated between different levels of government should be reduced. The federal government must set priorities and base transfers on a fixed total, closing the special windows that serve local interests.

A new budget process. Instead of sending a complete and detailed budget to be voted on in Congress, the Executive should initially limit itself to sending just the overall budget numbers (total revenues and total spending) and the basic fiscal goals (total balance, amount of revenues for paying interest, growth of public debt in relation to GDP during the year). These overall numbers would
then be voted on by Congress. Upon voting on the aggregate figures, Congress would be more exposed to public opinion. Because special interests would not be in play, party leaders would possess more power over rank-and-file legislators.

Once the overall figures are voted on, the Executive would then proceed to detailed budgeting within previously approved parameters. The detailed budget would then be resubmitted to Congress for examination. At this point, Congress would not be permitted to change the general parameters already voted and agreed upon, thereby impeding the raising of the revenue estimate and/or an increase in the deficit to accommodate local amendments.

When Congress examines the detailed budget, its first responsibility should be to establish the total amount of funds to be reallocated, indicating where corresponding cuts should be made. This proposal, made by the Budget Committee, would be voted on by Congress as a whole. This new procedure would make the process of amending the budget more transparent, providing for more detailed debate on proposed cuts. All this would be done before voting on the amendments for new spending and thus before special interests come into play. Only then would Congress vote on proposed amendments.

**State Banks.** Beginning in the mid-1960s, state banks gradually became effective tools for states to extract federal funds. Nearly all Brazilian states owned banks that would lend money to the state treasury, which then routinely would default on these loans. Thus state banks frequently faced liquidity crises, forcing them to seek Central Bank loans. State governors then would use political pressure to win pardoning or reduction of the state bank’s debt. After 1980, the Central Bank struggled repeatedly to clean up and revive state banks.

In 1994 the federal government once more tried to save state banks. The federal program now poses three solutions: privatization, liquidation or transformation of a state bank into a “development agency” that cannot take deposits or grant loans with its own funds, but instead channels financing from outside agencies. If a state government wants financial aid to keep control over its bank, it must provide half of the funds for the cleanup and refloating process.

By October 1998 the program had already cost $42 billion. Of that total, $22 billion went to Banespa, now operated by the Central Bank under federal ownership and scheduled to be privatized. Nossa Caixa Nosso Banco, a large São Paulo state government savings bank, got $5.5 billion in the process of being reorganized. Another $4.2 billion went to four state banks of Minas Gerais, two of which were privatized, another closed and the fourth is currently being transformed into a development agency. The state banking sector is now greatly reduced. However, eight state banks, roughly one-third of the original total, still survive, five of which were reorganized and three remaining outside the program. Surviving heavyweights, such as the Rio Grande do Sul and Santa Catarina banks, could cause problems in the future. Also, São Paulo’s Nossa...
Caixa, after Banespa’s privatization, could become vulnerable to political manipulation. Thus more rigid criteria for operating state banks are needed.

**Federal Banks.** The federal government banks (Banco do Brasil, Caixa Econômica Federal, Banco do Nordeste Brasileiro, Banco da Amazônia, Banco Nacional de Desenvolvimento Econômico e Social [BNDES]), which generate most of the banking system’s credit, are big lenders to state and municipal governments. Many loans by federal banks become defaults, generating political debt negotiations.

The Bank of Brazil, one of the country’s oldest and most pervasive official institutions, declared the biggest one-year loss ($4.3 billion) in the annals of world banking for 1995, and lost another $7.8 billion in the first half of 1996. To rescue the Bank of Brazil from insolvency, the federal government had to float some $8 billion in new public debt. In 1999, the Bank of Brazil faced another capital loss of $3 billion in fraudulently-issued bonds of the São Paulo municipal government, soon to expire and with no apparent possibility of being honored. São Paulo said it could not pay the debt, shifting the problem to the federal government, which agreed to a generous renegotiation, stretching its payment term to 30 years at subsidized interest rates.

There are two ways that the channels used to finance bailouts can be closed. The first would be to impose more restrictions on the federal government’s ability to borrow. Unable to incur debt at will, the federal government would find it harder to recapitalize public banks that sunk into deficit after lending to states and municipalities. The second way would be the privatization, extinction, or division of the controlling shares of these institutions with the private sector.

**The Central Bank.** The Central Bank needs the institutional power to resist political pressure to lend to all levels of government. Brazil’s Central Bank can set interest rates freely, yet it is unable to resist political pressure to finance public deficits. This is an explosive combination. Financing a permanent public deficit demands continuing increases in interest rates, which increases deficits in a vicious cycle.

The Central Bank needs more stability. A measure of its continuing institutional weakness is the rapid turnover of leadership: 17 Central Bank presidents in the past 14 years. An important step would be to establish fixed terms for its president and directors, not concurrent with that of the President of the Republic, to be interrupted by Congress only for previously defined serious causes. In addition, increased transparency and accountability of Central Bank operations must be established to justify political independence.

**Future Prospects**

These proposals would expand the tax base of states and municipalities and endow them with sufficient autonomy and flexibility to adjust to economic fluctuations. Lobbying by politicians for federal financial aid would be reduced. If channels for financial aid were closed, there would be fewer bailouts. Fewer bailouts would encourage local governments to adopt more responsible and efficient fiscal practices, while discouraging them from misusing public funds for electoral purposes. Reducing the total amount of transfers, changing the transfer distribution system, and budget reform would minimize financial ambiguities and entanglements among different levels of government.

Under hard budget constraints, states and municipalities would have to minimize public service costs. They also would have to concentrate on high priority investments. They would spend less time and energy seeking financial help from the federal government and more time and energy running their own affairs. Insolvent states and municipalities, under the threat of being turned into federal territories or districts of bigger municipalities, could not rely on fiscal parasitism of local politicians and federal legislators.

Closer linkage between local public services and local taxes would bring more efficiency, since local voters would see the connection between taxes paid and services rendered and would become more demanding of their leaders. These measures would encourage Brazilian states and municipalities to quit being rent-seekers, wasting time and money in endless struggles to shift costs elsewhere and extract resources from the rest of the federation. Instead, they would have to become welfare-seekers, focusing their efforts on maximizing both quality and quantity of public goods and reducing their cost. The great evil of fiscal parasitism is that it drains away the wealth of society instead of helping to produce more. Brazilian federalism needs to escape from this trap.
2. What is Federalism?

Marcos J. Mendes and Norman Gall

Federalism is a fragile and dynamic form of political cooperation for sharing power and responsibility among diverse territorial units. In a federalist system, each sphere of government (i.e., the union, states, provinces, counties, municipalities) possesses its own agencies. At the same time, the central government exercises jurisdiction over the citizens of a given state independently of local authorities within the limits of a federal constitution.

In several fields of official activity, the central government tends to play a lesser role than state and local governments. A government performs well in strengthening public services when it knows the preferences of the local population. Services such as safety, education and health (including water supply and basic sanitation), fundamental in social and economic development, tend to be the responsibility of state and municipal governments, demonstrating the importance of good local administration.

The degree of centralization or decentralization of power tends to create a balance between the different levels of government. State and local governments are closer to the citizens, facilitating not only popular control of public acts but also cooperation between different public agencies. Federalism does not allow a far away central government to have total control.

In his classic Democracy in America (1840), Alexis de Tocqueville outlined the dilemma involving division of power in a federation:

The most prominent evil of all federal systems is the complicated nature of the means they employ. Two sovereignties are necessarily in presence of each other. The legislator may simplify and equalize as far as possible the action of these neo sovereignties, by limiting each of them to a sphere of authority accurately defined; but he cannot combine them into one or prevent them from coming into collision at certain points. The federal system, therefore...

demands the daily exercise of a considerable share of discretion on the part of those it governs. A divided sovereignty must always be weaker than a unitary one.

The operation of two sovereignties within one territory is crucial to federalism. Both the national and the local power each have attributes under the federal constitution that frees each of them from interference by the other in specified areas. This is what makes federalism a complex political model. It is not always possible to find clear limits to federal and state power in the federal constitution. There are always gray areas which both spheres believe they have the right to act and legislate. The potential for conflict is great. Some simple examples illustrate this. The federal government is empowered to run foreign trade policy. However, in doing so, it may create customs barriers which harm the economies of some states and benefit others. State and municipal governments are responsible for public education at the primary and secondary levels. Yet the federal government could set policy targets, supported by federal financing, for a basic curriculum, minimum salary for teachers and basic school equipment as national priorities. Is the federal government thus infringing upon state jurisdictions?

The potential for conflict stemming from dual sovereignty in federalism means that such a system can only work well if there is a pact between the different parts of the federation. The federal pact has two main components. First, the governments forming the federation (state, municipal and federal) should agree on minimum rules for working together: a division of taxation powers, forms of political representation, a hierarchy of national and local laws, division of responsibilities for public services, of ownership of natural resources, and of legislative powers, forms of distribution of resources from developed
regions to those less developed. All these provisions should be in the federal constitution. Second, a judicial authority is needed for resolving conflicts with power to interpret the constitution, usually a supreme court.

In the United States, the cradle of modern federalism, the Supreme Court often is called upon to settle federal conflicts. Its constitution is two centuries old, yet the division of federal and state powers is still not clearly delineated. To this effect, The Wall Street Journal recently reported:

Over the past decade, the Supreme Court has issued a string of decisions whose effect is to return power to the local communities in which they arise. The best known case is Lopez, in which it ruled in 1995 that Congress couldn’t ban guns within 1,000 feet of public schools; it had overstepped its authority to regulate interstate commerce. But it has also let states place limits on abortion, ruled that Congress couldn’t order sheriffs to do background checks on would-be gun buyers, and said that Congress couldn’t pass a law saying states could be sued in federal courts. There is a clear pattern here of restoring authority to the community.

The fragility of federalism has been recently manifested in the dismemberment of the former Yugoslavia and the Soviet Union. In Brazil the conflict over distribution of tax revenues and payment of state debts jeopardizes economic stability. In Germany the wealthiest states are increasingly less willing to subsidize the poorer states; instead of transferring revenues to residents of other states, the tendency is to lower taxes and raise available income to their citizens. In both Russia and China states are supposed to collect taxes to be passed on to the central government, an issue of bitter contention in both countries.

The dynamic character of federalism can be seen in the reunification of Germany after 1989 and in the recent decentralization of political power in such different nations as the United States, France, Britain, Italy, Spain, India, Brazil, South Africa, China, Chile, Peru and Venezuela, as well as in debates over federalism in the development of the European Union. The World Bank’s World Development Report 1999/2000 observes: “countries everywhere are decentralizing political, fiscal and administrative powers to lower levels of government – countries large and small, rich and poor, largely driven by demands for greater local autonomy.”

The constitutional distribution of power in a federation can strengthen the central government by making the states financially dependent on the union, with little political autonomy and without their own judicial systems. At worst, the states stop being autonomous, becoming mere administrative departments of the central government. This is no longer a federal system but a unitary government, since dual sovereignty was suppressed in favor of sovereignty of solely the central government.

If power is concentrated in the states, the federal government will have little influence in local affairs. A federal system thus becomes a confederation. There are many historical examples of autonomous entities (countries, states or, historically, city-states or kingdoms) uniting to create a confederation to which they delegate tasks of common interest such as defense, trade regulation between members, emission of a single currency and resolving conflicts between members. Each member of the confederation keeps its independent character and sovereignty. The central government is an agency looking after the common interests of the participants, without autonomy to act directly in the interests of state citizens. States in the confederation exercise power through representative delegates.

Classic examples of confederations are the ancient Greek city-states, Italian Renaissance cities, the 17th Century Dutch Republic and the Articles of Confederation (1781-88), under which the United States was ruled briefly after the American Revolution. All these confederations were unstable and short-lived.

Federations in which the constitution unsettles the balance of power in favor of the federal sphere tend to create great federal bureaucracies with little vision or capacity for dealing with everyday, local-level problems. A typical example of this situation in Brazil was Getúlio Vargas’ Estado Novo, which ceremoniously burned state flags and appointed all state governors. The fall of Vargas and restoration of democracy produced a wave of decentralization, with a new constitution returning power to state governments.

When a federation is too decentralized, acquiring traits of a confederation, it breeds other
risks. Disunity, predatory disputes and secession are bred by economic rivalry between states, attempts by some members to dominate the confederation, disobedience of those dissatisfied with majority decisions of the confederate states or by the fragile federal government.

In the celebrated Federalist Papers, essays written in favor of ratification by the confederate states of the United States Constitution in 1787, Alexander Hamilton, James Madison and John Jay analyzed the ancient Greek confederations (446-146 BC), which were too decentralized to operate successfully:

Among the confederacies of antiquity the most considerable was that of the Grecian republics.... The members retained the character of independent and sovereign states and had equal votes in the federal council.... This council had a general authority to propose and resolve whatever it judged necessary for the welfare of Greece; to declare and carry on war; to decide in the last resort all controversies between the members; to fine the aggressing party; to employ the whole force of the Confederacy against the disobedient; to admit new members.... They had a declared authority to use coercion against refractory cities, and inhere bound by oath to exert this authority on the necessary occasions.... Very different, nevertheless, was the experiment from the theory.... The more powerful members, instead of being kept in awe and subordination, tyrannized successively over all the rest.... The deputies of the strongest cities avowed and corrupted those of the weaker; and the judgment went in favor of the most powerful party. Even in the midst of defensive and dangerous wars with Persia and Macedon, the members never acted in concert, and were, more or fewer of them, eternally the dupes or the hirelings of the common enemy.

The reflections in The Federalist Papers on separatism in excessively decentralized federations seem a foreboding of the U.S. Civil War (1861-65). The southern states, opposing federal policies argued that since the Union had been created by the states, states should have the power to annul federal laws that violate their interests. In 1832 South Carolina declared federal export tariffs unconstitutional. Federal customs agents were banned from the state. Another kind of nullification was tried recently in Brazil. State treasury secretaries collectively proposed a constitutional amendment giving veto power over federal legislation to a council of state governors.

Federal systems are threatened by two extremes. On one hand, they risk excessive growth of the central government, suffocating local participation in decisions and distancing itself from local interests. At the other extreme, excessive decentralization tends to generate predatory competition between regions while stimulating fiscal laxity and separatist initiatives. Thus a federal pact must provide for a balanced distribution of power as well as an efficient process for dealing with conflicts between different jurisdictions.

The main article of this edition of Braudel Papers analyzes the principal traits of Brazilian federalism since the revival of civilian rule in 1985. In Brazil, as in the Holy Roman Empire of medieval Germany, the king is in the hands of his barons. The Brazilian president depends on state governors for passage of critical legislation in Congress, without which the federation would be bankrupt. The Brazilian federation is delicately tied together by an elaborate system of financial transfers from the federal government to local authorities. The 1988 Constitution shaped a fiscal system in which states and municipalities receive large flows of federal funds while remaining free to manage their finances and to contract debts. Local governments have no responsibility for sustaining the financial or political viability of the Union.

We live in an unbalanced federal system where states and municipalities have won, in the 1988 Constitution, powers and prerogatives that allow them to dominate the Union politically and to compete amongst themselves in a disorganized and predatory fashion. Many municipalities live entirely off federal transfers without bothering to tax their own citizens. A slogan of the American Revolution against British colonialism (1775-81)
was: “Taxation without representation is tyranny.” Brazilian federalism could offer another slogan; “Representation without taxation is a farce.” The 1988 Constitution and the organization of political forces since re-democratization together confer a confederate character to the Brazilian federation, subjecting it to those centrifugal and separatist forces typically present in confederations.

The Union struggles to resist pressures from the states and municipalities to absorb their debts to save them from bankruptcy. Meanwhile, municipalities and states fight among themselves for growing chunks of federal revenues (participation funds, agreements, amendments to the budget, etc.). There seems to be no sense of restraint and no urgency for fiscal reform to enable Brazil’s economy to produce more wealth and social justice.

Instead, Brazil must deal rationally with constitutional rights that cannot be enforced and that weaken its political and economic viability. Some of these prerogatives compose the perverse incentives that undermine social justice and the federal system. Professor J.H. Elliott of Oxford University, a historian of Spain’s imperial decline, once observed: “There are few contests of wider import and greater significance than that between the demand for change and the insistence on the sanctity of tradition.” This contest is being fought out in Brazil today. Its federal system faces a challenge of adaptation that will shape its viability for many years to come.

Translation: Todd Benson

Our Thanks

The Fernand Braudel Institute’s program of research and public debate on perverse incentives in public institutions is supported by the Tinker Foundation. Marcos Mendes’s work on Brazilian federalism is pounded by Votorantim, Brasmotor, Semens, Souza Cruz and White Martins.