

Subnational constitutionalism in Brazil: Taxing, spending, and borrowing*

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Overview of Brazilian federalism

Brazil has been a federal country for more than a century. It is now under the aegis of the 1988 Constitution, approved as a result of the country's return to democracy after almost 20 years under a military regime. Unlike many polities, Brazilian federalism was never a response to social fissures along ethnic, linguistic, and religious lines but rather a result of regional disputes better accommodated under a federal than a unitary structure. Like many federations created in the 19th century, it was influenced by US federalism. The federation is now made up of 26 states plus the Federal District (Brasília) and 5,561 municipalities.

Unlike many federations, Brazil is a three-tiered federation. This is because the municipalities were never a creation of the states and because the 1988 Constitution incorporated municipalities as part of the federation together with the states, reflecting a tradition of municipal autonomy and little state control in municipal matters.

The 1988 Constitution not only provides principles, rules, and rights, but also a wide range of public policies. This is because (a) the drawing up of the constitution was not a result of a conclusive political process and the inauguration of a new democratic order rather it came into being as part of the political process of transition to democracy. It was because the writing up of the Constitution coincided with the transition to democracy that constitution makers were unsure of its outcome, and therefore opted to deepen the trend of previous democratic constitutions to constitutionalize a wide range of issues; (b) the main goal of the constitution makers was to legitimize the new regime; this meant reconciling interests among new and old actors. Because legitimizing the new regime was the main goal, economic issues such as the public deficit, inflation control,

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fiscal adjustment, and globalization, issues that would later confront the new democracy, were not on the drafters' nor on the country's agenda due to the enthusiasm at the prospect of the restoration of democracy.

The 1988 Constitution (a) provided more resources to subnational units, in particular to local governments; (b) expanded societal and institutional control over the three orders of government by increasing the power of the legislature and of the judiciary and by recognizing the role of social movements and of non-governmental institutions in controlling the government; (c) universalized social services, in particular access to health care; and (d) kept a trend toward uniformity as regards subnational orders of government, tying their hands, in particular those of the states, on the introduction of policies closer to their priorities.

Since the 1988 Constitution, it is difficult to describe the Brazilian federation as either centralized or decentralized. It has been marked by federally centralized policies and by constraints on subnational freedom to introduce legislation, blocked also by juridical interpretation, with few constitutional powers allocated to the states and municipalities. At the same time, subnational governments now enjoy considerable administrative autonomy, responsibility for policy implementation, and a share of public resources they had never enjoyed previously.

Because the 1988 Constitution was designed to legitimize the return to democracy rather than deal with economic issues, its reform was on the agenda of the federal government and of multilateral and business organizations soon after its approval. Many constitutional amendments were designed to introduce tight fiscal adjustment affecting the three orders of government.

Constitutional amendments have revised certain important decisions taken by the 1988 drafters as regards subnational resources. These changes were mainly designed to (a) impose limits on subnational freedom to spend their resources, as a requirement of the federal policy of fiscal control; (b) earmark specific resources to be spent on health care and primary education; and (c) decrease the amount of resources to be freely transferred from the federal to subnational orders. Constitutional amendments have also created new federal taxes or have raised the rates of certain taxes not shared with subnational orders.

State institutions

Constitutionally, each constituent unit has the same powers, i.e., Brazil has adopted symmetrical federalism in a socioeconomically asymmetrical federation. There are two main sources stimulating symmetrical federalism. First, the rules governing subnational jurisdiction, revenue, and many public policies are detailed chapters of the Constitution. Second, the Federal Supreme Court systematically decides that the state constitutions and laws should reflect the federal Constitution, therefore imposing a hierarchical interpretation of constitutional norms. Hence, regional and local interests fit into an external rationale of constitutional and legal homogeneity despite varying regional interests.

The states have their own constitutions promulgated in 1989. The writing up of these constitutions followed the same rules applied to the federal Constitution, as did the rules for their approval and further amendments. Although state constitutions are not bound by federal constraints, except that they should follow the principles in the federal Constitution, most of them replicate federal mandates. State constitutions are, therefore, modeled on the federal constitution.

The constitutions have always listed the jurisdictions of the three orders of government and the 1988 Constitution has furthered this trend. The Union holds the largest number and also the most important exclusive powers. Although residual powers rest with the states, the high level of detail in the Constitution leaves little room for the states to make use of their residual powers. Concurrent powers are listed in the Constitution, covering a wide range of issues, but gaps remain between what the article says and how it is put into practice.

State political institutions are similar to those of the Union, except for bicameralism. Although the states enjoy relatively little constitutional power, they (a) levy and determine the rates of the highest tax in absolute terms, the ICMS, a type of value-added tax which, unlike in many federations, is under the states' jurisdiction;¹ (b) administer more public resources than in the previous regime, although since the early

¹ Constitutional Amendment no. 42, issued in December 2003, provides more resources to subnational levels but it also limits the states' prerogative for determining the rates of their main tax.

1990s the states' participation in the national public resources has decreased vis-à-vis federal and local governments; and (c) enjoy greater administrative freedom.

The role of the states in the federation has always been a matter of tension with the federal Executive. This is because the states were granted great political and financial autonomy when the first republican Constitution was promulgated in 1891. Constant disputes between and among regional oligarchies and between regional interests and those of the federal Executive have characterized Brazilian politics and federalism until the mid-1950s. It is no coincidence that the country's two authoritarian regimes in the 20th century not only centralized political and financial resources but decreased state resources to a larger extent than those at municipal level.

Taxation and spending

The Constitution grants taxation authority to the three orders of government. Some taxes are exclusive to one order, others are collected by the federal government and shared with states and municipalities, and others are collected by the states and shared with their municipalities. The rate and rules of certain taxes, including state and local, are determined by federal legislation.

One important issue regarding the fiscal system in Brazil was that the decision to upgrade the financial role of subnational governments was taken by the 1988 drafters and not by the federal government, making it a highly politicized issue. Subnational governments collect today 32% of all taxes collected in the country. With transfers from federal taxes, they are now responsible for 43% of tax revenue. In terms of spending, subnational governments are responsible for 62% of payroll expenditure and for 78% of public investment.

From a historical perspective, however, the states have lost their financial importance vis-à-vis other levels of government. In 1960, the states had a 34% share of public revenue. The military regime, which ruled the country from 1964 to 1985, made a radical change, when the states' share dropped to 22%. In the initial years of the transition to democracy, the states were able to recover their financial position, becoming accountable for 27% of public revenue and reaching 29% in 1991. After that year, however, the states' share fell steadily, reaching 25% of public resources in 2003. The states did not lose resources in absolute terms; however their share of the total amount of

public resources levied by the three orders of government has decreased. There are several reasons for this relative decrease. One is the successful reaction of the federal government to make up for its financial losses brought by the 1988 Constitution. A second reason is a result of what became known as a fiscal war among the states, in which the states granted subsidies and tax breaks to attract private businesses. And a third reason can be found in the historical tensions between the federal Executive and the state governments mentioned above.

The 1988 Constitution set up complex mechanisms of intergovernmental tax transfers. Federal revenues from the income tax and the tax on industrial products are shared through participation funds established for this purpose. There also are schemes of federal transfers to subnational governments to carry out national policies such as health care and primary education approved by constitutional amendments in 1996 and in 2002. Intergovernmental transfers are high, representing 8% of GDP in 2002.

Borrowing

To be able to borrow, federal, state, and local governments have to (1) obtain the approval of their legislature; (2) submit their request to the Central Bank which issues a report sent to the Senate recommending approval or rejection of the request; and (3) have Senate approval. However, in 1996, a major scandal was disclosed involving certain states and municipalities that were making improper use of a 1988 Constitution mandate which allowed subnational governments to issue bonds to pay for debts contracted before 1988. The bonds could only be issued when the courts recognized the debt as pertinent. Because of the high rates of inflation before 1994, governors and mayors had over-estimated the amount to be paid and apparently used the resources for other purposes. As a result of this scandal, the Senate set up a Parliamentary Inquiry Commission. Although the commission failed to start procedures to punish officials responsible for the misuse of resources, there were important consequences. Several new rules and laws were passed restricting subnational debts, and the Senate issued a self-binding resolution that delegated some of its powers to the Central Bank and opened the way for the promulgation of the Fiscal Responsibility Law in 2000. This law imposes charges if public sector managers do not meet their requirements. It was enacted in 2000 and it limits public sector debt and expenditure, including on payroll (60% of current revenues

of the three orders of government) and prohibits the bailing out of the federal government of new debts contracted by subnational governments. It also limits transfers to the judiciary and the legislature, coupled with the issue of public bonds for ten years.

Subnational governments can borrow both from the market and from federal financial institutions, although borrowing rules and restrictions are tougher now. As in the US, the states are not equal in their ability to borrow and in the cost of their borrowing. Five states have been responsible for 65% of the states' total debt, led by São Paulo, Brazil's economically better-off state.

States' debt

Public debt has always been a serious constraint, and subnational debt was of major importance until the end of the 1990s. The states were the largest debtors, reaching 42% of the public sector debt in 1997. The indebtedness of the states is rooted in the 1966 fiscal reform imposed by the military regime and in the federal policy of using new loans to finance old ones in order to maintain a high rate of investment. The states not only had their own resources reduced, as shown above, but they were stimulated by the federal government to borrow. With the promulgation of the 1988 Constitution, the low level of states' revenue was partially sorted out, but a web of unpaid debts remained, leading to chronic problems in states finance, also affecting national public accounts. Later, the states' debts were further troubled by the 1994 federal government's stabilization plan, under which interest rates have been raised to unprecedented levels. In raising interest rates, the plan increased the states' financial disarray. Most of them did not contract new debts after the plan's adoption, but because of the increase in interest rates their financial solvency was undermined by inherited debt.

Several attempts have been made by the federal government to sort out the indebtedness of the states. Between 1988 and 1998, seven agreements between the federal government and the states were signed to renegotiate their debts. However, these agreements were systematically evaded by the states, one of the reasons being that they knew the federal government would bail them out because of the impact of the states' debt on public finance as a whole. Finally, between 1997 and 1999, the federal government managed to change the terms of the agreements, introducing mechanisms authorizing the federal government to retain a share of the states' revenue whenever the

state did not fulfill its obligation. Another important change was a program launched by the federal government to prepare the state commercial banks for privatization. All these agreements and programs imply the federalization of part of the states' debt, meaning that they now owe around 10.3% of GDP to the federal government. The debt is to be paid in 30 years time and with interest rates lower than that of the market. Payments are subject to an indexation formula which later proved to be highly unfavorable to the states because it is affected by the fluctuations of the Brazilian currency. As a result, the states' capacity to fulfill their obligations with the federal government continues to be a matter of concern and subject to constant pressure from the governors to change the rules of the agreements.

After signing agreements, the states embarked on a policy of tight fiscal control, stimulated by the programs described above. Another incentive for fiscal control by the states derives from the fact that most financial resources for investment and poverty alleviation programs now come from multilateral organizations such as the World Bank and the International Development Bank, and to have access to these resources, the states have to keep their accounts in order.

As a result of all of this, the states have decreased their spending by 2.1% in real terms. Although they have managed to decrease payroll expenditure, the main reduction has been in capital spending, which fell from 19.5% of the states' total spending in 1999 to 13.2% in 2001. This means that the states' investment capacity has been seriously affected by their financial restructuring.

Concluding remarks

There is a consensus that redemocratization and the 1988 Constitution have strengthened the federation, despite later changes in the fiscal system destined to overcome the country's economic problems. Macroeconomic demands brought by changes in the international environment have arisen, requiring tight fiscal control and budget surpluses. This has posed more constraints on the states than on the municipalities. It has also heightened tensions between fiscal controls versus a broader role of the states in the federation's division of labor.

The Brazilian experience displays a trend toward uniformity as regards subnational orders of government. Although the 1988 Constitution provides more

freedom to subnational levels of government, other political, economic, and juridical forces restrict this freedom. Furthermore, a crucial issue in the states' decision-making freedom is how to reconcile the need for fiscal adjustment with the need for more autonomy of the constituent units and more state investment in social programs and in infrastructure. The states' investment capacity is also bound by their debt payment. Another problem affecting states is the opening up of Brazil's economy. This tends to make intergovernmental relations more complex as it increases the differences between developed and less developed states.

The Brazilian experience can be used to test the often-quoted assumption in fiscal federalism literature that federalism constrains fiscal policy making. The Brazilian case demonstrates that although federal institutions do indeed pose certain obstacles to addressing solutions to fiscal problems vis-à-vis unitary systems, other variables play a role in opening the way for bargaining and negotiations toward changing fiscal policies. These variables include (a) the way federal institutions are designed, in particular intergovernmental relations; (b) the interdependence of the different levels of government in policy making and in public finance; (c) the position of federal and state financial bureaucracies within the government and vis-à-vis other bureaucracies; and (d) the degree of consensus toward the introduction of a new economic agenda. In certain federal countries such as Brazil bargaining and negotiation among the actors of the three levels of government toward changing the making of fiscal policy have been possible, showing that the design of federal institutions is an important variable when it comes to changing the status quo.

In Brazil the adoption of fiscal policies does not require changes in the state constitutions. This is because the federation has been designed to allow adjustments to new agendas without the formal approval of subnational institutions. Furthermore, the functioning of institutions and decisions regarding public policies affecting the states depend more on the federal rather than the state constitutions or policies. Nevertheless, the states' role in the federation has been constrained by several factors, including new fiscal policies. Addressing the lack of investment capacity and the relative loss of revenue currently experienced by the states will depend more on what will be agreed at the national level rather than at the level of the states.