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Macroeconomic Management and the Division of Powers in Brazil

Perspectives for the Nineties

Antulio N. Bomfim
and
Anwar Shah

Brazil's new federalism has limited, but not imperiled, the scope of fiscal policy as a stabilization tool. But the federal control over monetary policy has improved.

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The federal authority for macroeconomic management in Brazil changed profoundly with the institutional changes that culminated in a new federal constitution in October 1988.

Bomfim and Shah analyzed the implications of the new fiscal arrangements for the federal exercise of macroeconomic policies.

The literature on fiscal federalism stresses that stabilization policies are best carried out by the federal government. So it is interesting to find out to what extent the federal control over macroeconomic management gets diluted in a highly decentralized federation such as the one that now exists in Brazil.

The authors found evidence that the new federalism has limited, but not imperiled, the scope of fiscal policy as a stabilization tool. On the other hand, federal control over monetary policy has improved.

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MACROECONOMIC MANAGEMENT AND THE DIVISION OF POWERS IN BRAZIL:* PERSPECTIVES FOR THE NINETIES

Antúlio N. Bomfim and Anwar Shah**

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** The views expressed in this paper are those of the authors alone and should not be attributed to the World Bank. The authors are grateful to Bela Balassa, Johannes Linn, Javad Shirazi, Helena Cordeiro, and Martha de Melo for helpful discussions and comments.

MACROECONOMIC MANAGEMENT AND THE DIVISION OF POWERS IN BRAZIL: PERSPECTIVES FOR THE NINETIES

Antúlio N. Bomfim and Anwar Shah

Executive Summary

The federal authority for macroeconomic management in Brazil has experienced a profound change as a result of the institutional changes that culminated with the promulgation of a new Federal Constitution in October of 1988. This paper examines the implications of the new fiscal arrangements for the exercise of macroeconomic policies by the federal government.

The two pillars of macroeconomic management are fiscal and monetary policies. The fiscal federalism literature reserves for the federal government the fundamental role in the performance of macroeconomic stabilization. The ability of this government to control key fiscal and monetary variables is crucial for the success of macroeconomic policies. In any federation, this ability can be potentially undermined by the existence of other layers of government with which the federal government must share powers and responsibilities. Thus a careful study of the mechanisms of intergovernmental relations is needed to address this issue.

The profound changes undergone in the mechanisms for intergovernmental relations in Brazil have had a differentiated impact on the federal government's ability to conduct stabilization policies. On the one hand, it seems that the conditions for macroeconomic management via fiscal policy have deteriorated; on the other hand, the federal control over monetary policy appears to have improved. These points seem to be confirmed by the stabilization plan being currently undertaken by the federal government.

Decentralization is the dominant characteristic of the newly implemented Brazilian system of tax and expenditure assignments and intergovernmental transfers. As a consequence, this paper finds three basic inter-related

problems concerning the conduct of fiscal policy: (i) the federal government has lost considerable control over some fiscal policy instruments; (ii) the effectiveness of the instruments that have remained under federal jurisdiction can be potentially undermined by the fiscal behavior of the lower levels of government, and (iii) the federal government has come under a fiscal squeeze because transfers of tax assignments and revenues have not been accompanied in practice by a transfer of expenditure responsibilities.

As noted, the implications of the developments of the late 80s for monetary policy seem to have been more favorable than the ones mentioned for fiscal policy. Two important events discussed in the paper that helped enhance the federal government's ability to conduct a sound monetary policy are (i) the end of the "Monetary Budget", i.e., the consolidation of the federal budget into one single budget and the end of mechanisms that effectively allowed authorities to use the printing press of the Central Bank to finance transfers and other public expenditures, and (ii) the reduced importance of the National Monetary Council, i.e., the new Constitution vested a more clear assignment of monetary policy responsibility with the Central Bank. Despite these two favorable developments, however, this paper points out to another potential obstacle in the route to macroeconomic equilibrium via monetary stabilization; this can be found in the nature of the relations among the Central Bank and the state banking institutions. The recurrent bail-outs of troubled state banks by the federal monetary authorities are a contributing factor to monetary instability in Brazil. In 1987, for instance, nearly one half of the monetary base was constituted by debt of the state banks with the Central Bank.

In view of the above problems, the following policy recommendations may be warranted:

- Fiscal Policy: macroeconomic stabilization objectives require that the federal government be freed from its current financial strains. Current difficulties are a result of an accumulation of expenditure responsibilities at the center which is incompatible with the new disposition of revenues across levels of government and of the federal authorities lacking a dynamic source of finance. Thus it is recommended that:

(i) The ongoing transfer of expenditure responsibilities to states and municipalities should be accelerated.

(ii) The Value Added Tax (VAT) which is currently being administered at the state level could be better administered by the federal government and its proceeds shared with other levels of government. Tax evasion is less pervasive with a VAT than with the federal income tax.

(iv) There is a growing concern that municipalities might be "free riding" on the generosity of federal and state transfers instead of undertaking unpopular measures concerning the collection and institution of local taxes and fees to finance their own expenditures. Therefore the disbandment of federal transfers to municipalities and their substitution by state transfers is recommended.

Under the new system of intergovernmental fiscal relations in Brazil, the success of fiscal policy depends critically upon the fiscal behavior of the lower levels of government. The importance of policy cooperation among national and sub-national governments can therefore be hardly overemphasized.

- Monetary Policy: The frequent need for the Central Bank to bail-out troubled state commercial banks is an important source of monetary instability. The financial problems of state banks are largely attributable to their excessive allocation of loans to their state treasuries. Thus it is recommended that the federal monetary authorities adopt stricter regulations and monitoring of the portfolio allocations of commercial state banks. Clear guidelines should be instituted for these banks' loans to their respective state treasuries.

1. Introduction

An inherent feature of contemporaneous economies is the high degree of variability in their aggregate output levels. Identifying the sources of this variability, as well as suggesting effective remedies for its cure, is at the heart of modern macroeconomic theory. Within this framework, a very common, though by no means general, belief is that the government should play an active role in trying to minimize the extent of such fluctuations. Accordingly, it should make use of the fiscal and monetary policy instruments at its disposal to try to stimulate more production when output performance is poor, and exert its powers to discourage production when the economy is over-heated.

An effective implementation of stabilization policies requires control by the government over taxes, public expenditures, and the money supply so that the necessary adjustments in these variables could be made in ways consistent with stabilization objectives. Whether or not policy makers actually control these variables is a non-trivial question that becomes particularly relevant in a federation. This is so because, in federal systems, policy makers' control over instruments of policy risk becoming too diluted among the different levels of government --It might well be the case that no single level of government retains a degree of control necessary for the implementation of the stabilization policies alluded to above.

This paper examines how recent changes in the division of powers among federal, state, and local governments in Brazil have affected the conditions for macroeconomic management in that country. This examination gains an added significance given that the erratic character of macroeconomic performance in Brazil has often been blamed on macroeconomic mismanagement. The focus in this paper is on how federal control of the policy variables mentioned here has been affected by the latest developments in Brazilian institutions.

Section 2 presents a brief discussion of the Brazilian institutions relevant for the analysis. A framework for analysis is specified in section 3. This framework is used to evaluate the current system in section 4. A summary of the paper and some policy recommendations are presented in section 5.

2. Institutional Setting

Within the Federal Republic of Brazil there are three relatively autonomous layers of government. The federal government is located in the Federal District where Brasília, the nation's capital, was built in 1960. The second layer is represented by the state governments; there are 26 of them in the federation. Finally, more than 4000 municipalities constitute the third and lowest level of government. This section will attempt to offer some insights of the way these three levels of government interact on issues of macroeconomic management.

The description of intergovernmental relations in Brazil undertaken here will cover two different perspectives: a fiscal and a monetary one. Most works in this area deal only with fiscal issues; it will be shown, however, that, at least for the purposes of this paper, there are many important aspects of such relations that are deeply related to the Brazilian monetary system. These aspects, it will be argued later on, have very important implications for monetary policy issues.

2.1 Fiscal Considerations

Three main questions concerning the Brazilian federation are of interest here. The first two are related to the distribution of taxing power and public expenditure responsibility among the different layers of government. The third issue relates to the structure of intergovernmental transfers in Brazil. [1]

2.1.1 Tax Assignment

The arrangements set forth by the 1988 Constitution imposed a profound change in the allocation of taxing power across the three levels of government. Under the new regime, there has been a remarkable transfer of tax assignments from the federal to state and local governments.

The trend towards decentralization of taxing responsibilities is best illustrated by the changes that took place in the domain of the general value added tax (VAT). Pre-1988 arrangements empowered the federal government with the ability to levy special taxes on communications, fuels, electric power, minerals, and transports. According to the new settings, however, all of these five separate taxes have been abolished, their bases being transferred to the state level VAT (the so-called ICMS).

Other changes characterizing the new division of taxing powers in the Brazilian federation are (i) the authorization to states to levy a supplemental rate of up to 5% on the federal income tax base; and (ii) the implementation of new municipal taxes on the retail sale of fuels and on transfers of real estate and property between living persons.

Table 1 shows the historical evolution of tax collections by level of government. In 1988, tax collections by the federal government fell below 50% of total tax revenues for the first time in twenty years.

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[1] Shah (1990) has examined the implications of the 1988 fiscal arrangements for efficiency and equity of public service provision in Brazil. The analysis here will be limited to the implications for macroeconomic management.

Table 1

BRAZIL: TAX REVENUE COLLECTION BY LEVEL OF GOVERNMENT

Year	Shares (%)			
	Union	States	Municipalities	All
1957	48.1	43.3	8.0	100.0
1958	53.3	41.2	7.5	100.0
1959	49.0	44.0	6.4	100.0
1960	49.5	44.5	6.0	100.0
1961	49.5	44.6	5.9	100.0
1962	49.2	44.5	6.3	100.0
1963	51.0	42.5	6.5	100.0
1964	48.8	44.8	6.5	100.0
1965	50.7	42.5	6.8	100.0
1966	51.3	41.4	7.3	100.0
1967	15.8	49.4	4.8	100.0
1968	51.5	44.7	3.8	100.0
1969	53.7	42.7	3.7	100.0
1970	54.4	41.9	3.7	100.0
1971	56.4	40.0	3.6	100.0
1972	58.3	37.8	3.8	100.0
1973	58.5	37.7	3.8	100.0
1974	59.8	36.9	3.8	100.0
1975	59.0	37.0	4.1	100.0
1976	62.3	33.1	4.6	100.0
1977	60.9	34.0	5.2	100.0
1978	58.2	36.1	5.7	100.0
1979	58.3	35.9	5.9	100.0
1980	58.7	36.2	5.1	100.0
1981	58.2	36.7	5.1	100.0
1982	57.2	37.6	5.2	100.0
1983	57.8	37.0	5.2	100.0
1984	56.9	38.6	4.5	100.0
1985	57.6	38.3	4.1	100.0
1986	53.5	42.2	4.3	100.0
1987*	54.2	41.6	4.2	100.0
1988*	47.1	49.4	3.6	100.0

* Preliminary data

Source: Shah (1990)

2.1.2 Expenditure Responsibility

A noteworthy feature of the pre-1988 system of public spending responsibilities was the centralization of authority in the hands of the federal government. Even functions of a purely local nature such as urban infrastructure and elementary education were being financed and carried out by Brasília. In this matter, the main contribution of the new Constitution comes in the form of a clear assignment of expenditure responsibility across levels of government in a way that is broadly consistent with the decentralization trend noted above. This division of responsibilities, however, has left a large array of functions under the common jurisdiction of federal and state governments and has not addressed the issue of how to effectively carry out the proposed transfers of spending assignments to sub-national governments.[2] In fact, the general perception is that the decentralization of tax assignments has not yet been followed by the corresponding shift of public spending responsibilities to the lower levels of government.[3] This has exacerbated the current crisis of the federal budget and led Brasília to attempt to start transferring spending responsibilities to states and municipalities --this attempt has been called *Operação Desmonte*. As part of this operation, in 1989, the federal government proposed to transfer spending responsibilities by reducing federal intergovernmental allowances for social programs. This initiative, however, faced strong opposition of state governors and mayors and was not approved by Congress. Thus, in that same year, *Operação*

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2 One might argue that such lack of details might be appropriate for a Constitution, specially those in the Anglo-American tradition, but the general treatment given to intergovernmental spending responsibilities stands out as a clear exception in the Brazilian Constitution which covers a diverse number of topics, such as tax assignment and intergovernmental transfers, in great length.

3 See Tribunal de Contas da União (1988; p. 20), Afonso and Rezende (1990; p.10), Afonso and Serra (1989; p.38-39), Afonso (1989, May; p.40), and Longo (1987; p.24-25).

Desmon was basically implemented through the reduction, or even the outright elimination, of some federal intergovernmental transfers not explicitly specified by the Constitution, especially the negotiated transfers. Much more can be done in this area however given that such transfers took .96% of GDP in 1987. [4]

2.1.3 Fiscal Transfers

Given that the revenues from the assigned and shared taxes and the financial outlays associated with the expenditures responsibilities are not likely to be compatible for the different levels of government, intergovernmental transfers will have to play an important role in any federation. This is indeed the case in Brazil. Table 2 shows the evolution of the disposition of revenues by level of government in that country after the revenue sharing and intergovernmental tax transfer schemes are taken into account. As the table shows, the last ten years are marked by an increasing decentralization of public revenues.[5]

The trend towards decentralization is more evident for fiscal transfers than for any other aspect of Brazilian intergovernmental relations. This is illustrated by the revenue sharing mechanisms for the Income Tax (IR). Even though this is basically a federal tax, the new Constitution specifies that, when the new system is fully implemented in 1993, the federal government will have to transfer nearly half (47%) of its IR proceeds to state and municipal governments. Decentralization of revenues becomes even more evident with the federal tax on industrial products (IPI) tax; only 43% of the proceeds from

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4 Afonso (1989) pp. 37-38 Afonso and Rezende (1990) pp. 10-11.

5 This is a result of both the decentralization of tax assignments, discussed in sub-section 2.1.1., and the changes that culminated with the implementation of the new system of revenue sharing and intergovernmental transfers.

Table 2

BRAZIL: FINAL DISPOSITION OF REVENUES BY LEVEL OF GOVERNMENT

Year	Revenue Shares			
	Union	States	Municipalities	All
1957	42.7	46.0	11.3	100.0
1958	45.7	44.7	9.5	100.0
1959	43.3	47.9	8.9	100.0
1960	43.2	48.2	8.5	100.0
1961	41.8	49.7	8.6	100.0
1962	39.6	48.9	11.5	100.0
1963	41.9	46.0	12.0	100.0
1964	39.6	48.5	11.9	100.0
1965	39.0	48.1	12.9	100.0
1966	40.6	46.3	13.1	100.0
1967	36.9	45.2	17.9	100.0
1968	40.6	42.6	16.9	100.0
1969	45.8	39.8	14.4	100.0
1970	45.7	39.6	14.7	100.0
1971	47.7	38.4	13.9	100.0
1972	49.7	36.5	13.8	100.0
1973	49.1	37.1	13.7	100.0
1974	50.2	36.2	13.6	100.0
1975	50.3	36.0	13.7	100.0
1976	51.4	34.4	14.3	100.0
1977	50.2	34.8	15.0	100.0
1978	47.3	36.7	16.0	100.0
1979	47.5	36.3	16.2	100.0
1980	49.3	35.5	15.2	100.0
1981	49.2	34.8	15.9	100.0
1982	48.0	35.7	16.3	100.0
1983	48.4	35.2	16.4	100.0
1984	46.8	36.5	16.7	100.0
1985	44.7	37.5	17.8	100.0
1986	39.5	40.7	19.9	100.0
1987	42.5	38.6	18.8	100.0
1988*	33.4	50.7	15.9	100.0
1993**	36.5	40.7	22.8	100.0

* Preliminary data
** Estimate

Source: Shah (1990)

this tax actually stay in the hands of the central authorities.[6] For the taxes associated with royalties for mineral extraction and hydroelectricity, only 5% stays with the federal government. Other shared taxes are the ones on financial operations and insurance and on rural property. At this point, it is important to note that the federal government has no participation in the proceeds of the general state value added tax.

Tax transfers are just one mechanism of the system of intergovernmental transfers in Brazil. Another important characteristic of this system is the significant role played by the so-called non-Constitutional transfers. These are, as the name suggests, transfers not explicitly specified in the Constitution and usually not directly related to any specific tax. A large proportion of these transfers, 40% in 1987, can be classified as "negotiated."[7] These are obtained through direct bargaining between federal and state/local governments and the results of such negotiations are often determined by non-economic considerations. [8]

The paper now proceeds to describe some aspects of the intergovernmental relations in Brazil that go beyond the standard fiscal considerations listed above and are not always fully discussed in this literature.

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6 The real magnitude of such transfers is further stressed by Act 104-A of 1989 that imposed on the federal government strict deadlines for the delivery of IR and IPI funds committed to states and municipalities (see Camara dos Deputados (1989)). This Act came to address the long standing complains of governors and mayors that Brasilia was benefiting by delaying the release of their entitlements from the revenue sharing schemes and not paying any monetary correction on the original amount (see Castro (1989)). Under the current set up, not only the lower levels of government are receiving a larger share of the pie, but also the erosion of their receipts by inflation, the Oliveira-Tanzi effect (Oliveira (1967) and Tanzi (1978)), has been considerably reduced by Congressional directive. On the other side of the coin, the federal government is faced with two additional burdens: increased transfers to states and municipalities and limited opportunities to extract inflation tax receipts on these transfers.

7 Afonso (1988; p.34).

8 See Shah (1990; p. 53).

2.2 Monetary Policy Considerations

Because of the many ways by which the different levels of government interact in the Brazilian money and banking system, any study of the macroeconomic implications of the new system of intergovernmental relations in Brazil must include at least a description of this country's monetary arrangements.

The New Brazilian Constitution establishes that among the items upon which the federal government has the exclusive power to legislate are:[9]

a. authorization for the operation of financial institutions, insurance, and capitalizations companies;

b. organization, operation and duties of the Central Bank, as well as the requirements for the appointment of members of its board of directors;

c. operation of credit cooperatives;

The above assignment implies that monetary policy is the exclusive domain of the federal government. In pursuit of this objective, the federal government retains a monopoly on coinage and currency and on the overall regulation of the banking and financial system.[10] There are however many aspects of the Brazilian money and banking system on which lower levels of government have played an important role. These aspects are discussed in the following sections.

2.2.1 Quasi-budgetary role of the Central Bank

Under the previous constitutional arrangements, the Central Bank was a

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9 Article 22.

10 Articles 21 and 164 of the Federal Constitution.

potential direct source of funds for the financing of intergovernmental transfers. This was so mainly due to two factors: the "Monetary Budget", and the predominance of the National Monetary Council views on the conduct of monetary policy.[11]

The Monetary Budget: Pre-1987 public budgeting practices in Brazil segmented the federal budget into three different parts: the Fiscal Budget, the Public Enterprises Budget, and the Monetary Budget. The focus of the present section is on the peculiar nature of the latter.

The Monetary Budget was administered by the executive branch of the federal government through the Central Bank and the Bank of Brazil. Expenditures determined in this budget were mainly carried out by the Bank of Brazil and mostly financed through new issues of paper money by the Central Bank. Financial assistance to local and state governments were among the main categories of expenditures included in these mechanisms. [12] The Monetary Budget was not restricted by the same legislative limitations imposed on the Fiscal budget. It could easily be used to finance expenditures not programmed in the latter. The budgeting decisions were under the jurisdiction of the National Monetary Council to which the discussion now turns.

The National Monetary Council (CMN): Another way by which intergovernmental relations could potentially influence the money and banking system in Brazil was through the deliberations of the National Monetary Council. This institution was created in 1964 by Law No. 4959/64.[13] It had general responsibilities for money and banking policies. In the pre-1988 set

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11 A third indirect factor will be discussed later. This is the nature of the relations between the official banks from different levels of government.

12 See The World Bank (1989, June) page 16.

13 See The World Bank (1984, July; p. 133).

up, its members were the Ministers of Finance, Planning, Agriculture, Housing and Urban Development, Industry and Commerce, Interior, Labor, the president of the Central Bank, the chairmen of several other banks, and other private sector representatives. The Council was chaired by the Minister of Finance. The CMN played such a predominant role in the conduct of monetary policy that it took many of the responsibilities commonly attributed to a Central Bank such as the monitoring of the aggregate money supply and the implementation of interest rate policies. Moreover, the Council also assumed an increasingly quasi-fiscal role by making extensive use of its prerogatives to meet short term priorities on the determination of federal expenditures in general, including intergovernmental transfers and subsidies.[14] This, of course, was made possible by the existence of the monetary budget.

The promulgation of the new Constitution in 1988 has introduced some important changes in the ties between intergovernmental relations and the monetary system in Brazil. In 1987, while the Constitution was still being drafted, the above mentioned Monetary Budget was replaced by the Credit Budget which is now issued as an annex to the Annual Budget that has to be submitted to Congress and whose expenditures have to obey the standard budgetary and legislative practices.[15] Given that the new constitutional order prevents the Central Bank from issuing new money to directly finance public expenditures,[16] the Credit Budget is basically an account of the credit operations of the federal government.

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14 "By 1982, 58% of the domestic financial assets of the monetary authorities originated from quasi-fiscal activities.... Transfers of funds mobilized by the monetary authorities played a role similar to that of tax transfers in the allocation of resources in the Brazilian economy." (The World Bank, 1984, February; pp 42-43.)

15 See Secretaria do Tesouro Nacional (1988) Vol. 1 p. 117-118.

16 Federal Constitution article 164, paragraph 1.

Another very important implication of the new Constitution to the intergovernmental relations/monetary system link is the limited scope that the new order left to the National Monetary Council. Nowadays, the Ministry of the Economy and the Chairman of the Central Bank are formally responsible for the conduct of monetary policy and have been limited in their ability to act as direct quasi-fiscal agents.

2.2.2 Intergovernmental Relations in the Official Banking System

Many important aspects of the intergovernmental relations in Brazil are hidden in the official banking system, i.e., the interactions among federally owned banks and state banks.

The relative size of the state banking system in Brazil gives enough reasons to guarantee the inclusion of such topic in this discussion of intergovernmental relations and macroeconomic management. One cannot underestimate the importance of the official banking system in Brazil: in 1988, out of this country's 103 commercial banks, 24 were owned by state governments. In the same year, these banks held 23% of all demand deposits and made 28% of all commercial bank loans. [17]

One remarkable characteristic of state banks that clearly differentiates them from commercial private banks is the large degree of dependence of the former on federal sources of funds. The predominant role played by the Central Bank and other federal credit institutions in the financing of these funds can be seen in table 3. As this table shows, "about three-fourths of state commercial banks funds are provided by loans from the Central Bank and other federal agencies." Moreover, in 1987, state commercial banks' debt with the

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[17] See The World Bank (1989, November, p. 2)

Table 3

STATE COMMERCIAL BANKS AND FEDERAL GOVERNMENT

	Borrowings from Federal Government/ Total Domestic Funding	Debt with Central Bank/ Monetary Base
	(Percent)	
JUN/83	69	2
DEC/83	70	8
JUN/84	71	9
DEC/84	72	30
JUN/85	71	46
DEC/85	65	21
JUN/86	55	10
DEC/86	52	8
JUN/87	71	49
DEC/87	73	49

Source: The World Bank (1989, November)

Central Bank totaled half of the monetary base.[18]

The nature of these intergovernmental relations in the banking system becomes even more important when one analyzes the financial health of many state banks in the last decade. Since the early eighties, these banks have been experiencing recurrent crises with potential destabilizing factors for the entire banking system. That has led the Central Bank to take actions that range from direct intervention to waivers of required reserves. One of the effects of these periodic bail-outs is an increase on the already large degree of dependence of state banking institutions on their federal counterparts making this an even more important channel for intergovernmental relations in Brazil.

3. Framework of Analysis

This section describes the concepts that will be used as the basis for evaluations and for developing recommendations concerning the institutions described in section 2.

The starting point of the current analysis is that the government has an important role to play in the stabilization of both output and prices. Thus, assuming that macroeconomic stabilization by the government is feasible and desirable, which level of government should have the primary responsibility of fulfilling such function? In the division of powers and allocations among the three levels of government of a federation, which one should be ultimately in charge of carrying out macroeconomic management?

3.1 Stabilization as a Public Good

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[18] Idem pp 5-7.

It is within the framework of public finance theory that the most relevant discussion of the topics introduced above can be found.[19] The treatment given by this theory to issues of macroeconomic management is best understood if one is reminded of the public good nature of output and price stabilization. If such stabilization is provided, it will be available to all, regardless of who bears the costs of implementing it; therefore, no single individual might have the incentive, or maybe even the ability, to exert any effort towards macroeconomic stabilization. Thus, this is a role that must be played by the government. The question is: which government? Should the public good of macroeconomic stabilization be provided by the federal, the state, or the local government?

As regards the allocation of public good provision responsibility in a federation, Wallace Oates (1972, p.55) has argued that:

> "Each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalize benefits and costs of such provision"

Even by their own name --*macro* is Greek for large-- macroeconomic policies have a scope which can be potentially larger than that of any sub-national government. Given the increasing integration of today's markets, inflationary pressures in any individual state, will most likely be transmitted to the rest of the nation --inflation by itself is generally treated as a national phenomenon. Accordingly, even though unemployment rates may vary from state to state, more severe unemployment and deeper recessions tend to be events of a national scope. These spatial spillovers are also reflected in the implementation of policies aimed at economic stabilization. Suppose that a state is contemplating the possibility of unilaterally

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19 See especially Musgrave and Musgrave (1973), Oates (1972), and Courchene (1986).

increasing tax rates in order to curb inflationary pressures. Even if such measure were to succeed in bringing down inflation, it would be very unlikely that any individual state would actually do it on its own. For an individual state, the benefits from achieving lower rates of inflation would very likely be more than offset by the losses due to a possible outflow of productive factors to other states with a more favorable tax system. In other words, this state would have to bear alone all the costs of bringing down inflation, but would enjoy only a share of the corresponding benefits since these will spill out to the rest of the federation.

The situation just described fits well within the discussion of spatial externalities. Spatial externalities arise when benefits and/or costs of public services are realized by non-residents. In the case of benefit-spillout, the jurisdiction providing the service does not consider the proportion of benefits of a public service accruing to non-residents and therefore would under-provide such service. As a corollary, this service would be best provided by the government at the highest level i.e. by the federal government.[20]

If macroeconomic stabilization is interpreted as a service being provided by the government, the preceding discussion provides a strong argument for federal provision of this service. Macroeconomic management should be primarily carried out by the center because it is this layer of government that controls "the minimum geographic area that internalize the benefits and costs" associated with its provision. This "minimum geographic area" is nothing short of the entire nation. Given the presence of the spatial externalities, local pursuit of such a policy would lead to much of the gains

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20 See Shah (1990, p.6).

being lost to outside jurisdictions.[21]

3.2 Federal Control over Policy Instruments

Given that theoretical considerations warrant that macroeconomic stabilization be carried out by the federal government, the conditions for an effective implementation of such function crucially depend on the central authorities' ability to exert control over key policy instruments. These are the variables related to fiscal and monetary policy --taxes and public spending for the former, and the aggregate money supply for the latter.

If taxes, public spending, and the money supply are perceived as important determinants of economic activity, then there should exist enough flexibility in the hands of the federal government so it can alter any of these variables as the state of the economy requires. By flexibility, however, it is meant not just the power to change these variables, as defined by the legal environment, but also the practical feasibility of undertaking such changes. As an example, consider the case of fiscal policy; it is true that its success greatly depends on how much of the taxes and public spending are commanded by the federal government, but it is also true that these instruments cannot be used if other important factors are out of line. A factor that deserves special attention is the size of the federal debt and deficit.[22] If it is the case that the deficit is already intolerably high, the fact that the federal authorities exert full control over taxes and public spending will be of little help in times of recession. The use of either

21 Ibid p. 7.

22 Other factors that may also impair the effective use of fiscal policy instruments are indexation of wages and public debt. This is so because both wages and debt service represent a large share of federal expenditures and their indexation imposes additional constraints upon the federal budget. Currently, however the federal government is engaged in putting an end to the official indexation of wages as well as in reducing the size of its deficit.

policy tool would imply in an even larger deficit and that might not be feasible or desirable.[23] In other words, the size of the deficit can put a check on the flexibility necessary for the implementation of macroeconomic management. This is a point that will be particularly relevant for a discussion concerning Brazilian institutions.

3.3 Conclusions

Three main conclusions can be derived from earlier discussion.

(i) In the division of powers among the different layers of government, macroeconomic management should be primarily performed by the federal government;

(ii) An effective implementation of macroeconomic management requires some federal control over the national tax system, over the allocation of public spending, and over monetary variables;

(iii) The size of the federal deficit should be kept within certain limits if macroeconomic management is to become feasible.

These three results will constitute the general guideline for this paper's evaluation of the conditions for macroeconomic management in the Brazilian federation.

4. Evaluation

The theoretical notions just discussed imply that macroeconomic stabilization is primarily a responsibility of the federal government. In the following, an examination of how the new system of intergovernmental relations

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23 Clearly, this dilemma would not exist if the problem were to alleviate inflationary pressures. Then, an increase in taxes and/or a decrease in federal spending would help achieve both lower deficits and greater macroeconomic stability.

in Brazil has affected the ability of the federal government to carry out its basic functions in macroeconomic management is undertaken. This is indeed the central concern of this paper.

4.1 Fiscal Policy

4.1.1 Control over expenditures

The overall redistribution of fiscal revenues from the federal to state and local governments imposed by the new Constitution has reinforced the trend towards the decentralization of expenditure responsibilities. The best example of this phenomenon is provided by *Operação Desmonte*.[24] Its objective is clearly one of making expenditure responsibilities compatible with the revenue sharing mechanisms made explicit by the new Constitution. Although certainly desirable from a public finance point of view, this shift of expenditure responsibilities has potentially detrimental implications for the federal government's menu of fiscal policy instruments. It is estimated that, in 1988, only 43% of public expenditures were under federal government control.[25]

Though certainly relevant, the share of total public spending directly under the control of the federal government[26] is just one factor to be considered when assessing the effectiveness of changes in government spending as an instrument for macroeconomic stabilization. Another relevant issue to be examined is the question of to what extent and in which direction the lower levels of government would be willing and able to react to changes in the

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24 See page 5 in this paper.

25 Shah (1990; p. 21)

26 Within this share, it is important to distinguish between discretionary and non-discretionary federal spending. In the latter, it is included the constitutionally mandated spending programs such as the ones on education. Clearly, the former is the one with more importance for fiscally based macroeconomic stabilization.

level of federal government's expenditures. Suppose, for instance, that the federal government decides to engage on an expansionary increase in its expenditures. Would that lead lower levels of government to engage in some sort of free-riding behavior and in turn decrease their own expenditures? To what extent would that be a plausible situation and under which conditions would that offset the effects of the discretionary change in federal expenditures?

Regardless of the answers to the hypothetical questions above, one major result stands out concerning the effectiveness of government expenditures as a policy instrument: the new constitutional framework has not made it easier to implement fiscal stabilization policies based on changes in government expenditures. The new system requires a substantial degree of coordination between Brasília and at least the major state governments. There is no guarantee that such coordination could be feasible or enforceable.[27]

4.1.2 Control of tax rates and tax bases

Even if the new Constitution has limited the effectiveness of government expenditures as a policy instrument for macroeconomic management, that does not mean that fiscal policy per se has been rendered ineffective. Elementary notions of macroeconomics would tell us that changes in the level of government expenditures are just one fiscal policy instrument that the federal government has at its disposal. Another very important tool to be used in this

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27 Anecdotal evidence from the most current stabilization effort (The Collor Plan, implemented in March 1990 and still under way) suggests that, in many cases, states may not be willing to go along with federal measures. Consider the case of the proposed lay-off of more than 200 thousand public servants. This is perceived as a way to address the current crisis of governmental finances in Brazil. Even though this crisis is certainly generalized to all layers of government, there was little that Brasilia could do in terms of inducing state governors to adopt similar measures. The burden of the unpopular policy was felt entirely by the federal government. Presumably, the federal adjustment would not have to be so big, had state governments also taken their share of the effort.

area are taxes.

The new Constitution did move towards a more decentralized system of tax assignments as section 2 above showed; however, substantial discretionary power still remains in the hands of the federal government. This paper argues that the new tax system has mixed implications for the effectiveness of changes in tax rates and tax bases as policy instruments.

On one hand, the new Constitution has eliminated many federal taxes and incorporated their bases into the state administered ICMS. By the same token, it has given states the option of levying supplemental rates of up to 5% on the federal income tax. Reinforcing this tendency towards decentralization, there are the new constitutional revenue sharing schemes that greatly favor states and municipalities at the expense of the federal government.

On the other hand, it could be seen that one of the most important fiscal instruments still basically remains under federal jurisdiction. This is the determination of the income tax base and rates. It is true that the federal government barely keeps 50% of the proceeds from this revenue source, but one should be aware that it has the sole responsibility of determining rates and the taxable base. This gives the federal government the possibility of not only affecting aggregate disposable income, and therefore aggregate demand, but also of exerting direct influence over the revenues and fiscal behavior of the lower levels of government who end up receiving the other half of the proceeds of this tax.

What might actually be a more interesting consideration is the extent of interactions between revenue collections in the different levels of government. Here, as in the analysis of government expenditures, consider the following possibility: suppose the federal government decides to implement a discretionary income tax cut. This federal tax cut will have a potentially significant effect on the revenues of state and local governments given their large share in the proceedings of this tax. It might be the case that to offset this substantial loss in revenues from federal sources, lower levels of government might choose either to increase the rates and/or bases on the taxes under their jurisdiction, or increase their tax effort.[28] The sorts of state and local government reactions suggested here would potentially undermine the effectiveness of taxes as a fiscal policy instrument; however there remains to be seen the extent to which such undermining would be significant.

Despite the qualifications discussed above, it seems plausible to say that the new Constitution leaves substantial room for an effective use of changes in income tax rates and bases as a means of implementing macroeconomic management. Although there is the possibility of partial undermining of federal policies by state and local governments, cooperation, or even inaction, by lower levels of government can still be considered as possible outcomes.

4.1.3 The Federal Debt

The theoretical framework discussed in section 3 introduced the size of the federal debt as an important factor when considering the conditions for macroeconomic management. Therefore, the implications of the new Brazilian system of intergovernmental relations to the size of the federal debt have to be well understood before drawing any final evaluation of the current situation. Here there are important consequences both on the expenditure and the revenue side of the federal accounts.

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28 Mahar and Dillinger (1983) have pointed out that the low yield of municipal taxes is partially explained by low tax effort. More recently, there is an increasing concern that tax effort by municipalities might have gone down even further due to the generosity of the current revenue sharing schemes. (See Shah (1990) and Andrade (1989)). The present paper claims that this could leave local governments with ample maneuver to increase tax effort in times of federal tax cuts if they so desire.

Implications for federal expenditures: As shown above, the new Constitution has reinforced the trend towards a transfer of fiscal resources from the federal to the lower levels of government. This measure would not be so problematic for the federal budget if it were followed by the corresponding transfer of spending responsibilities to states and municipalities. Even though the new Constitution has specified in detail the mechanisms of intergovernmental fiscal transfers, it has not explicitly defined rules for the transfer of expenditure responsibilities. The implications of that for the federal budget are then obvious. Brasília has lost important revenue sources, but still faces obligations that correspond to the pre-1988 system. Even though federal officials have been prompt to try to implement initiatives that would transfer expenditure assignments back to state and local governments--the so-called *Operação Desmonte*-- opposition of governors and mayors has put the federal budget under substantial pressure and with increasingly less room to engage in macroeconomic management.

Implications for federal revenues: Another important factor that helps increase the size of the federal debt with a potentially large contribution for the reduced flexibility of federal policy makers in matters of macroeconomic stabilization is the limited federal access to more productive tax bases. The primary source of federal revenues is the income tax. It is generally understood, however, that such a tax is easier to avoid and evade. On the other hand, the value added tax is considered as a more productive revenue source. . The latter tax is a state responsibility. Thus, under the new constitutional setup, the federal authorities lack a more productive tax that would help both counteract the debt problem and render more flexibility to the implementation of fiscally-based macroeconomic stabilization.[29]

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29 Shah (1990) has advocated the transfers of the VAT assignment to the federal jurisdiction on tax administration grounds as section 5 of the current

4.2 Monetary Policy

Two basic monetary policy variables are interest rates and the monetary base. The discussion of monetary policy will differ from that of fiscal policy in the sense that, instead of discussing different policy tools, it will only be considered how the monetary authority's ability to effectively control the supply of base money has been affected by the new system of intergovernmental relations. This section will also provide a brief discussion of the division of powers in the implementation of incomes policies.

4.2.1 Control over Money Supply

As suggested by the previous sections, the end of the Monetary Budget and of the dominant role played by the National Monetary Council have contributed significantly to more transparency in the intergovernmental relations in Brazil. The scope for the financing of negotiated transfers was further diminished by the constitutional prohibition on the Central Bank's issuing of new money to finance government expenditures.[30] All of these changes in the links between intergovernmental relations and the monetary system have direct implications for the conduct of stabilization policies by the federal monetary authority.

Clearly the fact that no intergovernmental transfer, or any other type of expenditure, can any longer be financed through increases in the monetary base adds substantial maneuvering power in the hands of the Central Bank for the purposes of macroeconomic management. It is no longer the case that short run

analysis will briefly discuss. This point is further strengthened in this paper based on macroeconomic policy considerations.

30 See article 168 of the Federal Constitution.

considerations of the National Monetary Council should necessarily override long run stabilization objectives. Even if such considerations were still present, the new legal environment would not allow for these and other forms of pressures from interest groups and lower levels of government to exert as much influence as what they could potentially do in the previous regime.

Monetary stability becomes particularly crucial in a country like Brazil where a return to two-digit annual inflation rates would be considered almost a blessing. In this sense, the new Constitution seems to have changed things for the better. Governors, mayors, and other rent-seeker groups will have to resort to other sources for the financing of their demands with the federal government.

4.2.2 Has the quasi-budgetary character of the Central Bank really ended? (Intergovernmental relations in the official banking system--State Banks)

The above discussion suggested a significant improvement in the federal government's ability to conduct a sound monetary policy. However, despite what has been suggested elsewhere (The World Bank, June 1989), the end of the Monetary Budget and the increased importance of Central Bank over Monetary Council authority in the conduct of monetary policy might not have "effectively terminated the Central Bank's role as a quasi-fiscal agent" (p. iv). Much more remains to be changed if the goal is to really improve the perspectives for an efficient role of the Central Bank in macroeconomic management.

What the account of the state banking system suggests is that there are many implicit transfers from the federal to state governments that take place through the interactions between their respective official banking institutions.[31] The conspicuous nature of such transfers is certainly not desirable from a public finance perspective. Moreover, heavy state bank borrowing from the Central Bank allows states to effectively participate in the proceedings of the inflation tax with clearly adverse implications for macroeconomic stability.[32]

Most of the problems involving the financial position of state banks, it has been suggested,[33] have their roots on their relation with their respective state governments. In the period 1983/87, between 70% and 80% of state banks' loans were made to their state governments. The relative proportion has actually tended to increase over the period. These loans were mostly directed to state treasuries leaving state banks as virtual financial branches of state government expenditures.

The more troubling implications of the above is the fact that this concentration of commercial state bank loans to their state governments might have been motivated by considerations other than the technical analysis of proposed projects on the basis of their profitability and timing of expected returns. State governments have the potential of exerting substantial power on the portfolio allocations of their banks and that the financial distress of many state governments might have had a substantial contribution to the similar problems faced by their banks.

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31 The World Bank estimates that in the period between August/88 and May/89, 65% of all transfers to Credireal, a bank owned by the state of Minas Gerais, came from the federal government and that an equal amount was passed on to the state government. These transfers consisted of non-interest bearing deposits, subsidized loans by federal agencies, temporary holdings of tax proceeds, and participations in "repasses" (funds on-lent by the federal government). (The World Bank, 1989, November; p. 22-25)

32 See the World Bank (1989, November).

33 Idem.

When the Central Bank is led to bail-out a failing commercial state bank, either to direct intervention, or through special loans and injections of more funds, what actually happens is an implicit transfer from the federal to the state government. As the previous discussion showed, most of the funds passed from the Central to a state bank will eventually end up financing state expenditures --recall that more than three fourths of state commercial banks' portfolio is credit to the public sector. It is suggested by the current analysis that such a system not only significantly impairs the transparency of the intergovernmental relations in Brazil, but could potentially be used to avoid constitutional prohibition on the direct financing of government expenditures through the printing press of the Central Bank with obvious effects for monetary stability.

Periodic increases in the monetary base caused by Central Bank's bail-outs of failing state banks have been an important source of monetary instability and a significant obstacle to macroeconomic management. What makes this issue even more troubling is the realization that there has been an increasing deterioration in the state banks' position vis-à-vis the Central Bank. According to World Bank estimates,[34] state banks' debt to Central Bank amounted to 1% of their liabilities in 1983; this proportion became 21% in the beginning of 1988. Furthermore, this debt to the Central Bank accounted for half of the monetary base in 1987. The potential contribution of this debt to the inflation rate of the period could be large, especially when one is reminded that the funds provided by the Central Bank are turned into base money and therefore have a multiplier effect on the aggregate money supply.

4.2.3 Incomes Policies

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[34] ibid.

An alternative way to enhance monetary stabilization is by resorting to incomes policies. These policies are defined as government measures whose aim is to directly control nominal variables --such as prices, wages, and nominally denominated assets-- as part of an effort to lower the inflation rate and restore macroeconomic equilibrium. These measures can come either in the form of a generalized wage and price freeze or as a more subtle monitoring through well defined ceilings for increases in these variables. The inclusion of incomes policies in this discussion of intergovernmental relations and macroeconomic stabilization in Brazil is warranted by the frequent use that policy makers of that country have made of such policies. Since 1986, nearly all attempts to curb the country's accelerating rate of inflation have included some type of price and wage control, if not direct freeze.

The current stabilization plan --implemented by the federal government on March 16, 1990-- can appropriately illustrate both the popularity of incomes policies among Brazilian policy makers and the little degree of power that states and municipalities enjoy in this important policy instrument. The federal government is empowered with the exclusive ability to impose and enforce price and wage control throughout the nation leaving the lower layers of government with no option other than abide by the orders coming from Brasília.[35] The impact of the current stabilization effort --which not only froze prices and wages, but also a large share of the country financial assets-- on the Brazilian economy[36] clearly demonstrates that despite the

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35 The new Constitution has empowered the federal branch of the federal government with to the ability to decree provisional measures with the effect of law in cases of urgent need. These measures must be approved by Congress and converted into ordinary law within 30 days or they cease to be valid. (Article 62) It was through such provisional measures that the bulk of the current stabilization plan was implemented. States, municipalities, or any other entity can be barred from appealing against any such measures as it was the case with the Plan.

36 "The Greater São Paulo unemployment rate for the month of June has reached

decentralization of tax and expenditure assignments, much remains in the hands of the federal government for sound macroeconomic management, specially when incomes policies are concerned. This fact, by itself, should help explain at least partially the increasing choice of incomes policies in the menu of federal policy instruments: given that the new situation might not have improved the conditions for the use of certain policy instruments, such as taxes and government expenditures, it might be rational to emphasize the use of those tools that have remained under federal discretion, such as the implementation of incomes policies and monetary control.[37]

5. Summary and Policy Recommendations

5.1 Introduction and Basic Framework

The erratic behavior of the Brazilian economy in the last ten years has been increasingly attributed to macroeconomic mismanagement. Fiscal federalism theory reserves to the federal government the fundamental role in the performance of macroeconomic stabilization. This paper has analyzed how the conditions for sound economic management have been affected by the new division of powers implied by the changes that culminated with the new 1988 Brazilian Constitution.

5.2 Basic Findings

Mechanisms for intergovernmental relations in Brazil have undergone profound changes in the last decade. These changes have had a differential

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12.1%, the highest rate since 1985... real wages have hit their lowest levels in five years as well... For May, real wages fell 3% among wage-earners." (Gazeta Mercantil, July 23, 1990)

[37] See Bank of Boston (1990).

impact on the federal government's ability to conduct stabilization policies. On one hand, it seems that the conditions for macroeconomic management via fiscal policy might have deteriorated; on the other hand, the present account suggests that monetary policy may have regained more importance as a tool for macroeconomic stabilization. A summary of the implications for each set of policies follows.

5.2.1 Fiscal Policy Implications

Given that decentralization is the dominant characteristic of the newly implemented Brazilian system of tax assignment and fiscal transfers, federal policy-makers have lost some control over basic fiscal policy instruments. Moreover, even the effectiveness of those instruments that have basically remained under federal control --such as the income tax system-- can be potentially impaired by strategic behavior on the part of state and local governments. The lower levels of government now have much more maneuvering power to change their own fiscal behavior in response to new federal policies; these responses might end up offsetting some of the intended effects of these policies.

What also becomes an equally important issue to consider when discussing the implications for fiscal policy is the increasing degree of rigidity that the new system has imposed on the federal authorities. The transfers of both tax assignments and tax revenues to the lower levels of government have not yet been followed in practice by the corresponding shift of expenditure responsibilities from the center.[38] Therefore, the federal government finds itself overburdened with obligations that far exceed its current fiscal

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[38] Some reduction in the negotiated intergovernmental transfers has been observed, but this paper has pointed out that the relative impact of these reductions is small. (See page 6 of this paper.)

resources and that leave it with little or no room for fiscal maneuvering aimed at stabilization purposes. In other words, the fiscal authorities lack the flexibility needed for the achievement of macroeconomic management via fiscal policy.

There are thus three basic inter-related problems concerning the conduct of fiscal policy: (i) the federal government has lost considerable control over basic fiscal policy instruments; (ii) the effectiveness of the instruments that have remained under federal jurisdiction can be potentially undermined by the fiscal behavior of the lower levels of government, and (iii) the federal government has come under a fiscal squeeze because the transfer of tax assignments and revenues have not been accompanied in practice by a transfer of expenditure responsibilities.

5.2.2 Monetary Policy Implications

The implications of the developments of the late 80s for monetary policy seem to have been more favorable than the ones mentioned in the fiscal considerations above. Two important events helped enhance the federal government's ability to conduct a sound monetary policy. The first significant change took place in 1987 while the new Constitution was still being drafted; this was the end of the Monetary Budget and, consequently, of the direct financing of federal government expenditures and transfers through the printing press of the Central Bank. The second change came in the following year when the new Constitution was finally ready: dominance over the conduct of monetary policy was shifted from the National Monetary Council to the Central Bank where regional and local concerns were less likely to exert a decisive influence.

Though certainly beneficial, the two changes mentioned above are still far from being sufficient as a means of guaranteeing an effective conduct of monetary policy by the federal government. The new system has not yet ruled out another important channel for intergovernmental interaction in this area. This can be found in the nature of the relations between the Central Bank and the state banking institutions. The recurrent bail-outs of troubled state banks by the federal monetary authorities are a contributing factor to both monetary instability and the lack of transparency in government finances. In 1987, for instance, nearly one half of the monetary base was constituted by debt of the state banks with the Central Bank.

There is then one major problem concerning monetary policy implementation under the current system of intergovernmental relations in Brazil, this is the nature of the state bank crisis.

5.3 Policy Recommendations

In view of the above discussions, the following policy recommendations, concerning the conduct of fiscal and monetary policies, may be warranted.

5.3.1 Fiscal Policy

5.3.1.1 The Need to Accelerate *Operação Desmonte*

The decentralization of fiscal resources imposed by the new Constitution has not yet been accompanied by the corresponding shifting of expenditure responsibilities to lower levels of government. This has overburdened the federal government with obligations well beyond its current means which has, as a consequence, substantially limited its flexibility over the spending of the funds that remain under federal jurisdiction. That puts a clear check on the stabilization function of the central authority. Since it can barely meet its current expenditure responsibilities, how, for instance, could it possibly engage in expansionary measures to reverse signs of macroeconomic distress? It is recommended, therefore, that "Operação Desmonte" should be accelerated so that the federal authorities can regain some control over key policy variables. An effective shift of responsibilities to the lower levels of government would free federal finances from their current strain so that macroeconomic stabilization could regain its place in the projects of fiscal policy makers.[39]

5.3.1.2 Discretionary Transfers

Another related measure that deserves immediate attention is a reassessment of the current system of non-Constitutional transfers. The adverse implications of the so-called negotiated transfers for efficiency and equity considerations have been pointed out elsewhere and will not be detailed here. [40] The standard objection to these transfers is that the ad hoc nature of their allocation process puts too much discretion in the hands of federal authorities opening opportunities for political and populist motives to supplant economic ones.[41] From a macroeconomic perspective, however, it must be understood that it is still important for the federal government to retain some discretionary power over the allocation of its transfers. This discretionary power, however, instead of being a device to buy political support from governors and mayors, should be used to achieve the goal of macroeconomic stabilization. It is recommended that the funds that would

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39 The frustrated attempt to transfer public spending responsibilities in social programs was discussed in page 5.

40 See Shah (1990) and Afonso (1989). These authors have suggested the replacement of this type of transfers by one that takes into account objective clear-cut criteria with well defined rules. In addition, Shah has suggested the end of direct federal transfers to municipalities; state governments would be in a better position to play this role with their respective municipalities. These suggestions, as will be shown, are consistent with the present analysis.

41 In fact, the intensification of "Operacão Desmonte" advocated above would certainly be a factor contributing to putting an end in these kinds of transfers.

otherwise go to the financing of negotiated transfers, and also those no longer going to finance functions abandoned through *Operação Desmonte*, should help constitute a strategic reserve to which the federal government should resort for the implementation of macroeconomic management --in periods of poor economic performance, specific purpose grants could be used to stimulate state and local expenditures in areas with the largest multiplier impact on aggregate demand. [42]

5.3.1.3 A More Reliable Federal Tax Base

As earlier noted, one of the problems that the new Brazilian fiscal federalism has posed to the issue of macroeconomic management is the relatively limited participation that the federal government has on tax assignment and revenue collections. With limited revenues, it is unlikely that the conditions for fiscally based stabilization policies can significantly improve. Under the current system, the center derives most of its revenues from personal and corporate income taxes --that is in spite of the fact that it transfers 47% of the proceeds of these taxes to states and municipalities. It has been pointed out elsewhere, however, that the most reliable revenue source in developing countries is actually the value-added tax. [43] This is because tax evasion is less pervasive with a VAT. As discussed, however, the Brazilian VAT (ICMS) is entirelv under state jurisdiction and the federal government has no participation what so ever in its proceeds. The suggestions

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[42] In any case, even if such fund is not formally instituted, the end of negotiated transfers by itself would be sufficient to help enhance federal government's flexibility over the use of its fiscal policy instruments. As with "Operacão Desmonte", the funds saved through this measure could be used to reduce the federal deficit so as to put the central government in better conditions to engage in stabilization policies whenever necessary.

[43] See Khalilzadeh-Shirazi and Shah (forthcoming).

here are that this tax should be shifted to federal jurisdiction and that participation in its proceeds should be extended to all three levels of government.[44] States might be less reluctant to accept such measure if the new federal VAT were to be implemented as a merger of taxes from all levels of government: the state ICMS, the federal IPI, and the municipal ISS. This measure will also reduce administration and compliance cost of a VAT.[45]

It is therefore argued that the transfer of VAT taxing power from state to federal jurisdiction would not only provide the latter with a valuable source of revenues that could enhance flexibility in the implementation of macroeconomic management via fiscal policy, but also make the national tax system more efficient. With a more dependable revenue source the perspectives for fiscally based stabilization policies would certainly be brighter.

5.3.1.4 Strategic Interactions among Governments

Given the new division of powers in fiscal matters in Brazil, there are two additional considerations that must be taken into account for a complete appreciation of the effectiveness of fiscal policy. These are the two related problems that will be called "adverse incentives" and "strategic behavior". Accordingly, the following recommendations are made:

The first policy suggestion concerns the adverse incentives that the new revenue sharing and transfer mechanisms have provided to the lower levels of government. Given the generosity of these mechanisms towards states and municipalities, especially the latter, there is a growing concern that municipalities might be "free riding" on federal and state transfers instead

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44 These suggestions should become less important the larger the extent of the actual shifts of expenditures to lower levels of government.

45 "Tax bases for IPI, ICMS, and ISS somewhat overlap but are administered separately by three levels of government... (They) should be combined into one tax to be administered by the federal government on behalf of state and local governments. Thus the proceeds from the tax be shared by the three levels in proportion to their current intake from this source." (Shah, 1990, pp. 34-35)

of undertaking unpopular measures concerning the collection and institution of local taxes and fees to finance their own expenditures.[46] This implies that the federal government is overburdened with responsibilities that could suitably be financed through local charges. Such a situation presumably adds to the degree of inflexibility in the allocation of federal fiscal policy variables. A measure that would help correct both the federal budget problem and the "disincentives for municipalities to exploit own revenue sources" would be a disbandment of federal transfers to municipalities and their substitution by state transfers.[47] "States transfers to municipal levels could be based on a formula... which incorporates per capita municipal fiscal capacity as an important factor..." (Shah, 1990, p.92) Thus the same level of federal, state, and local services could be provided with much less pressure on the federal budget who would then be able to devote more resources to macroeconomic management whenever needed.

The second recommendation relates to the possibilities for policy coordination and cooperation among different levels of government concerning the conduct of fiscal policy. Given the current division of powers, all parties, especially the federal and the state governments, must take into account the possible reactions of their counterparts at other layers of government when making their fiscal policy decisions.[48] Fiscal considerations at one level of government will very likely have non-negligible repercussions at the other levels. The relevant question here would be in which direction

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46 This could be especially true for the case of negotiated transfers. Often they are used to finance functions under local responsibility. (See Shah (1990), Andrade (1989), and Afonso (1988) for a discussion).

47 Accordingly, federal transfers to states would be increased. That would not put the federal government under any additional pressure given that this is just a counterpart to the disbandment of direct transfers to municipalities.

48 As mentioned before, a federal tax cut might be at least partially offset by states attempt to increase own tax effort or rates to counterbalance the loss in shared revenues from the federal government.

states would behave when facing discretionary changes in federal fiscal policy. Would they be willing to go along with the federal initiative and promote tax cuts in times of recession and cut expenditures in times of inflation? Or would their individual interests dictate measures in the opposite direction of the federal authorities? In any likelihood, the recommendation is simply a warning that the new system will require a great deal of cooperation, and therefore compromises, between federal and state authorities. Under the new system of intergovernmental relations in Brazil, even though the ultimate burden of macroeconomic stabilization still lies in the hands of the federal government, the success of fiscal policy depends largely on some cooperation and negotiation with at least the richest states of the federation. [49]

5.3.1.5 Summary of Recommendations for Fiscal Policy

(i) The federal government should no longer be involved in direct transfers to local governments. Instead it should increase its transfers to states and let states replace it as a grantor of fiscal transfers to their own municipalities. States would be in a better position to monitor the fiscal behavior of their municipalities, especially their fiscal effort.

(ii) In areas of common responsibility of federal and state governments, the former should limit itself to setting standards for public services provision while leaving the financing and administrative responsibilities to the lower levels of government. Even though this might imply weaker federal control over public spending, this helps achieve the much needed balance

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[49] It should come then as no surprise that when the Collor Plan was being implemented, the Governor to São Paulo, by far the richest and most industrialized state of the federation, was one of the first to step down and assure the federal government that it would go along with it in the measures to avoid massive unemployment while the recessive effects of the anti-inflation plan were having their impact on the economy.

between federal revenues and expenditure responsibilities that would enhance flexibility for the conduct of macroeconomic management.

(iii) The IPI, ICMS, and ISS should all be merged into one single VAT to be under federal jurisdiction. Participation in this new tax should be extended to all levels of government.

(iv) Policy coordination should gain a new meaning under the new system of intergovernmental fiscal relations.

5.3.2 Monetary Policy

5.3.2.1 State Bank Reform

Given that the financial problems of state banks are largely attributed to their role as quasi-fiscal agents of their governments, it is recommended that clear guidelines by the Central Bank on loans by state banks to their treasuries be instituted. Stricter preventive regulation and monitoring over the portfolio allocations of state commercial banks would certainly be desirable.

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