

## EDITORS

Constantino Cronemberger Mendes  
Diana Chebenova  
Ana Carolina Lorena



## Years of the Brazilian Federal Constitution perspectives for Brazilian federalism



Forum of Federations

The Global Network on Federalism and Devolved Governance

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# CONTENTS

<b>PRESENTATION</b> .....	7
---------------------------	---

<b>FOREWORD</b> .....	9
-----------------------	---

<b>INTRODUCTION</b> .....	11
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## **CHAPTER 1**

THE POLITICAL ENGINEERING OF FEDERALISM IN BRAZIL .....	13
Celina Souza	

## **CHAPTER 2**

PREFERENCES REGARDING THE VERTICAL DISTRIBUTION OF AUTHORITY IN BRAZIL: ON MEASUREMENT AND DETERMINANTS.....	33
Marta Arretche	
Diogo Ferrari	
Rogerio Schlegel	

## **CHAPTER 3**

EXPECTATIONS AND FRUSTRATIONS: THE RECENTRALIZATION OF POWER AND THE EXPANSION OF FEDERATIVE CONFLICTS AND IMBALANCES .....	59
Fernando Rezende	

## **CHAPTER 4**

FISCAL COMPETITION: DECENTRALIZATION .....	75
José Roberto Afonso	
Sérgio Guimarães Ferreira	
Ricardo Varsano	

## **CHAPTER 5**

FISCAL FEDERALISM AND FISCAL EFFORT IN BRAZIL: THE DILEMMA OF THE TAX ON URBAN TERRITORIAL OWNERSHIP (IPTU)....	95
Marcelo Piancastelli	





## **PRESENTATION**

This book is the product of a joint initiative organized by Ipea and the Forum of Federations. This initiative is based on the Technical Cooperation Agreement number 5, signed on July 16th, 2015, between Ipea and the Forum, facilitated by the Secretariat for Federative Affairs (SAF) of the Government Secretariat of the Presidency of the Republic of Brazil. Brazil has been a member country of the Forum of Federations since 2008. The Forum's lead liaison partner within the Federal Republic of Brazil is the Secretariat of Federative Affairs.

Not only did the Technical Cooperation Agreement number 5 propose publishing studies such as this book, but it also proposes other cooperation efforts, a number of which have materialized in the last three years. One of the biggest achievements among these efforts is the establishment of the Forum of Federations office inside Ipea, which made possible the exchange of technical missions, the organization of joint events, among other activities.

The initial idea of this book was to gather some of the most important Brazilian experts on Federalism. Many of these experts have been long-term collaborators of the Forum and have contributed with studies and expertise to the Forum's work. It was also the objective of this book to mark and celebrate the thirty-year anniversary of the Brazilian Constitution, enacted in 1988.

There is a strong, unforeseen thematic convergence between the articles in this book. A number of them discuss the role of municipalities in Brazilian federalism. Details of our country's federative model are studied and the book demonstrates possible benefits of decentralization, but also takes challenges and potential improvement of the system into consideration. Federative conflict and imbalance, competition between government tiers, the dilemma of municipal tax collection, the signifiers of authority distribution and the political engineering of Brazilian federalism are the main topics of the articles in the book.

In conclusion, the book consolidates the interinstitutional agreement between SAF, Ipea and the Forum of Federations. It also shows the path for future studies on Brazilian federalism, discussing its potential development and improvement. At the same time, international experience brought by the Forum of Federations enriches the book's discussion of the Brazilian federative model.

Ernesto Lozardo

**President of the Brazilian Institute for Applied Economic Research**

Carlos Henrique Menezes Sobral

**Former Vice Minister for the Secretary of Government of the Presidency**



## FOREWORD

It gives me great pleasure to have collaborated with Ipea in the production and publication of this volume on Brazilian federalism. This volume is essential reading for anyone interested in understanding how the three spheres of government function, interact and are financed in Brazil. The volume pulls together contributions by the leading scholars of federalism in Brazil.

For practitioners of federalism, Brazil is an important case for several reasons. First, identity and ethnic issues were not the primary motivation for federalizing the country. Rather, it was the need for balanced regional representation and regional development that primarily drove federalism in the country. The implication here for others considering federal options, is that federalism is an important tool with which to manage inter-regional conflict even in countries where race, ethnicity or language do not represent major social cleavages. Second, unlike in many other countries federalism has been a constant in the evolution of the Brazilian polity since 1889, through multiple constitutions. Third, Brazil is an interesting case study for new and emerging federations because of the manner in which it has constitutionalized local government. Fourth, Brazil presents an interesting case study of detailed constitutional guidelines for the distribution of functions and government revenues.

For an outsider looking in, the Brazilian federation has been largely successful in resolving regional conflicts and spreading development around the country. Clearly, the papers point to the challenges that confront the federation both in terms of the competition for power between the various orders of government, but also around issue of adding to tax efforts and managing fiscal imbalances. For the student of comparative politics, these are challenges common to most federations and should remind us that federalism is always work in progress. So too are concerns about the legitimacy of any federal project and the tension between achieving the right balance between decentralization and centralization in public policy. That Brazil has been a pioneer in the constitutional recognition of local government and a leading developmental federation recognized around the world.

It has been a privilege for the Forum of Federations to work with the Secretariat for Federative Affairs (SAF), Ipea, and with all the authors of this volume over many years to enrich the global discourse on comparative federalism.

Rupak Chattopadhyay  
**President and CEO**  
Forum of Federations



## INTRODUCTION

The book *30 Years of the Brazilian Federal Constitution: perspectives for Brazilian federalism* has the objective of gathering studies written by the leading Brazilian experts on the topic of federalism. The book authors are also researchers who have significantly contributed to projects conducted and sponsored by the Forum of Federations. Even though the articles in this book use different analyses and approaches, the themes discussed converge on the debate about the role of municipalities in Brazilian federalism.

The two first articles *The political engineering of federalism in Brazil*, by Celina Souza, and *Preferences regarding the vertical distribution of authority in Brazil: on measurement and determinants*, by Marta Arretche, discuss intrinsic issues of the political sphere. The first article describes the necessity of a constitutional design that can be adapted to political and macroeconomic circumstance in order to promote the stability of the federative system. The second article defends the role played by territory identity, social and demographic factors, and the geography of income in the determination of individual preferences regarding the distribution of authority between government tiers.

The remaining articles use a more economic approach to examine the role of municipalities in Brazilian federalism. The article *Expectations and frustrations: the recentralization of power and the expansion of federative conflicts and imbalances*, by Fernando Rezende, discusses the importance of a reform of fiscal federalism in order to strengthen the federation, which would allow the government to promote sustainable development. The study *Fiscal competition: decentralization*, by José Roberto Afonso, discusses the advantages of fiscal capacity in the provision of public services, taking into consideration welfare increase and decrease among different kinds of inter-federative competitions. It also discusses mechanisms to reduce the negative effects of fiscal competition in the context of globalization, in which productive factors are increasingly flexible and assets increasingly mobile. Finally, the article *Fiscal federalism and fiscal effort in Brazil: the dilemma of the Tax on Urban Territorial Ownership (IPTU)*, by Marcelo Piancastelli, studies the limits of fiscal federalism, describing institutional and economic obstacles to federative cooperation, and unsatisfactory results regarding the increase of welfare.

The papers in this book allow the reader to not only understand the challenges Brazil faces in improving its federative model, especially as it regards the role of municipalities, but also to visualize necessary advancements in Brazilian federalism. The book seeks to provide Brazilian society with important elements to understand its federative model and strengthen itself in this process. We wish the reader an enjoyable, informative experience.

The editors



## THE POLITICAL ENGINEERING OF FEDERALISM IN BRAZIL<sup>1,2</sup>

Celina Souza<sup>3</sup>

### 1 INTRODUCTION

Brazil has been a federal country, a republic and has adopted a presidential system for almost two centuries. Federalism was introduced in 1889 and laid out in the 1891 Constitution. Brazil 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. The study of Brazilian federalism is closely connected to the study of the country's seven constitutions and its amendments because although the country has preserved its federal status, constitutions have always altered the way the federation works.

Unlike many polities, Brazilian federalism was never a response to social fissures along ethnic, linguistic, and religious lines but rather of regional disputes when the country became a republic in 1889. Political elites understood that regional disputes at that time would be better accommodated under a federal rather than a unitary structure. During colonial times, Brazil's unity was threatened by Spanish, Dutch, and French invaders, but they were all defeated. Separatist movements were relatively common only during Portugal's domination, but at the beginning of the nineteenth century, the unity of the country was not an issue, in contrast to the former Spanish colonies in Latin America. Since the promulgation of the 1988 Constitution, pressures, but not threats, for territorial subdivision has come from municipalities, not from states.

As many federations created in the 19th century, it was influenced by US federalism. Later there has been an influence of the Weimar and of the Mexican constitutions as regards social provisions. Since mid-1960s, however, constitution-makers have learned from previous experiences and the influence of other constitutions was no longer necessary.

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1. Published in Spanish in the book edited by W. Hofmeister e J. T. Aranda, *Sistemas Federales: Una comparación internacional*. 2017. Madrid: Fundación Konrad Adenauer e Fundación Manuel G. Abad.

2. This research paper has been commissioned by the Konrad-Adenauer-Stiftung (KAS). It draws partially from several other publications by the author (Souza, 1997; 2002; 2005a; 2005b; 2013; 2015).

3. Visiting scholar of the Graduate Program in Political Science of the Federal University of the State of Rio de Janeiro (UNIRIO).

Despite the absence of threats to territorial integrity, Brazil is marked by high levels of territorial inequality. The most striking inequality is among Brazil's five geographical regions, in particular between the Southeast and the Northeast. Although in the last decade this socioeconomic divide has decreased, in 2012 the Southeast contained 42.06% of the country's population but generated 55.2% of its GDP while the Northeast, with 27.79% of the population, was responsible for 13.6% of the country's GDP. In 2014, however, the Northeast's GDP grew by 3.7% and the Southeast's declined by 4.6% while Brazil as a whole grew by only 0.1%. Social indicators nevertheless amplify this economic inequality.

If theories of federalism do not incorporate regional disparities as a threat to the unity of federal countries, they imply that the capabilities of subnational governments to respond to the demands of their constituencies and to provide public goods are highly uneven. This is why since the 1930s political elites have always pursued the decrease of regional imbalance with more or less success.

Unlike in many federations, Brazil is a three-tiered federation. This is because the municipalities are not 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 federation is now made up of 26 states plus the Federal District (Brasília) and 5,570 municipalities.

Over the last century, Brazil had a history of economic boom and bust and its development was hampered by high inflation, excessive indebtedness, political turmoil and two long periods of authoritarian rule. After a decade of economic growth and social achievements, in 2015 the country began to face another turmoil when the economy started to slow down, unemployment raised, corruption scandals reached private companies and politicians and in an impeachment procedure of the President re-elected in 2014 is now under way. The macroeconomic crisis of the last two years has affected the finances of the three levels of government with consequences for the provision of policies under their jurisdiction.

During periods of authoritarian rule subnational units, the states in particular, were affected by political and financial centralization led by the federal level. Federalism, however, did not play a role in the two breaking downs of democracy. The federal system experienced periods of centralization followed by decentralization. Since the 1930s, the federal government has always led social and economic changes.

This paper presents an overview of Brazilian federalism to those not familiar with its details and trajectory. This might be important because as students of federalism know, federations are different and political, cultural, historical and economic features of each country bound their design. The paper argues that the stabilization of federalism as one of the country's longest institutional device is

a product of constitutional designs that make the centralization-decentralization continuum adaptable to changing political and macroeconomic circumstances. This has been particularly so since the enactment of the 1988 Constitution.

The paper is organized as follows. The first session presents an overview of federalism in Brazilian constitutions. The following sections analyze the main aspects of the way federalism works, i.e. how power is allocated between levels of government and how resources are distributed between them. The final session discusses the pros and cons of the current design of the Brazilian federation.

## 2 FEDERALISM IN BRAZIL'S CONSTITUTIONS

Brazil first promulgated a written constitution in 1824 following its achievement of independence from the Portuguese Empire. This Constitution devolved administrative authority to the existing 16 provinces although they had no formal or informal political autonomy. The decentralization of administrative authority was seen as paving the way for federalism.

The 1891 Constitution, promulgated after the republic had been set up, accomplished the decentralization promised by the republican slogan “centralization, secession; decentralization, unity”. Economic resources, however, were channelled to a few states, which shows that the federation was born under a concentration of resources in a few states.

Brazil's experience of isolated, or dual, federalism ended in 1930 with a coup led by a civilian, Getulio Vargas, as a result of regional disputes over the presidency. One of Vargas's first measures was to write off the states' debts to the federal government, including São Paulo's enormous debt incurred from subsidizing coffee growers. In 1932 Vargas sponsored an electoral reform that, among other things, increased the political representation of smaller states in the Chamber of Deputies. Initially conceived to counteract the power of a few states, this principle of representation remains one of the bases of Brazilian federalism.

The 1934 Constitution, promulgated as a result of the 1930 coup, expanded intergovernmental relations by introducing several measures allowing the federal government to grant resources and technical assistance to subnational units. Municipalities were allowed to collect their own taxes and received half of their revenues from one of the state taxes. Nevertheless, the 1934 Constitution was unable to survive conflicts between measures increasing economic intervention and social spending, on the one hand, and the strengthening of regional elites and Congress, on the other.

Vargas sponsored a new constitution in 1937. One of his objectives was to decrease the importance of regional interests in Congress, and to build political

and administrative unity in order to advance socioeconomic modernization. Vargas closed down Congress and the state legislatures and replaced all elected governors with his allies with no ties to state oligarchies. Subnational governments lost revenue to the federal government, which was granted the right to regulate Brazilian exports and interstate exchange. By denying regional oligarchies the right to prescribe their trade rules, Vargas paved the way for industrialization. Nevertheless, horizontal imbalances remained: by 1945 three states possessed more than 70% of all state revenues (Mahar, 1976).

In 1945 Vargas was overthrown by his war minister after pressures from the military and after calls for a liberal democracy arose as a result of the worldwide wave of democratization that followed the end of the Second World War. The 1945 election was won by General Dutra. Vargas won the following presidential election in 1950 and governed Brazil under democratic rule until 1954, when he committed suicide as he was about to be overthrown by the military.

To inaugurate the return to democracy, a new constitution was approved in 1946. It was influenced by liberal ideals. However, they did not last long given the need for rapid economic growth under the aegis of the federal government. As democracy and decentralization have always gone hand in hand in Brazil, the revenues of municipal governments increased. The Constitution introduced a scheme requiring higher territorial units of government to share revenues with lower units in an attempt to address the issue of vertical imbalance. Horizontal imbalance was partially addressed by defining federal revenues to be spent on Brazil's poorer regions. These measures, however, were of limited effect due to the disproportionate growth in federal activities, an increase in the number of new municipalities, inflation, and the non-payment of federal quotas to states and municipalities. Consistent with its liberal approach, the 1946 Constitution was the first and only one, with the exception of the 1891 Constitution, in which only principles, rules and rights were set up in the constitution. All other constitutions, including the current one, regulate public policies and define government functions along with the definition of principles, rules and rights.

The 1946 Constitution lasted until the military coup of 1964. Democracy did not survive a major economic and political crisis, placing Brazil among the wave of dictatorships that ruled Latin American countries during that time. The military did not immediately issue a new constitution. Only in 1967 was a new constitution approved, and in 1969 it was again changed through a long constitutional amendment. The 1967-69 Constitution, together with a 1966 fiscal-reform law, boosted the centralization of public finance. Competitive elections were forbidden for federal and state executive positions and for mayors of state capitals and municipalities considered "national security areas" or "mineral sites".

By the end of the 1970s, the fragility of the military regime became apparent and the country's economy began to slow. The military allowed direct elections for the state governors in 1982 and tried to pacify local elites by gradually increasing federal transfers to municipal governments. Financially weak, the military started to lose support.

Redemocratization started in 1985, and a new constitution was designed to end authoritarian rule. The creation of the 1988 Constitution was coupled with enthusiasm and optimism about the country's future. For 20 months, Congress and Brasília were the centre of Brazilian life, engaging in a visible exercise in democracy and political participation.

The rules determining how the constituent assembly would function were the first signal that drawing up the constitution was going to be a bottom-up process: there were 24 thematic subcommittees, which later merged into eight committees and finally into a systematization committee of 97 members, followed by plenary sessions with two rounds of voting.<sup>4</sup>

The 1988 Constitution was the outcome of a political milieu that aimed to make credible and to legitimate the new democratic regime given that the constitutional assembly was called into being while the political transition to democracy was still incomplete. Because of this, the framers left three options open which later affected the wave of constitutional amendments, many of them with influence on federal arrangements. The first was to make the rule of constitutional amendment relatively easy to fulfil: three-thirds in two rounds of roll call voting in which the House and the Senate vote separately. The second was to increase the number of issues on which the Union (federal executive and legislature) has the exclusive capacity to legislate, thus delegating to future legislators and presidents decisions on policy preferences as well as on whether or not and when to put constitutional clauses into force. There has also been an expansion of issues subjected to concurrent authority vis-à-vis previous constitutions. The third was the increase in the number of issues that are embraced by the constitution i.e. a great deal of public policies and of governmental functions became constitutionalized. These decisions, coupled with changes in the macroeconomic and political contexts of the 1990s made the 1988 Constitution the most amended Brazilian constitution to this day and one that has a high rate of amendments compared to other constitutions in the world.<sup>5</sup>

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4. This bottom-up process and the openness of the constituent assembly contrasted with the process of constitution making in Spain. For the secrecy and close participation in writing up the Spanish Constitution of 1978, see Bonime-Blanc (1987).  
5. Unlike in Australia, India, Mexico, Switzerland, and the United States, where amendments to federal constitutions have to be ratified by state legislatures or by the electorate, there is no such requirement in Brazil. Rather, it is assumed that the states' representation in the Senate guards their interests.

One can say that the 1988 Constitution was the result of political momentum, marked by a need to legitimize democracy, including leveraging the political and financial status of subnational units. This meant reconciling conflicting interests among old and new actors given that the transition to democracy was still in progress. This is also why the Constitution has several mandates requiring further regulation either by amendments or by ordinary or complementary law, despite being very detailed. Consensus was the way forward given the lack of a clear political or ideological majority.

Soon after the promulgation of the constitution, some scholars argued that the constitution would make Brazil ungovernable because of the combination of a federation controlled by state governors, a presidential system and an electoral system of open list proportional representation, hence blocking the approval of reforms and of the federal government's agenda either because of the veto power of several actors or of the high costs for approval (Ames, 1996, 2003; Mainwaring, 1999; Samuels and Abrucio, 200; Samuels and Mainwaring, 2004)). Some scholars went further to argue that this combination was a threat to democratic consolidation (Ames, 2003; Stepan, 2000). These claims reflected, of course, the importance of institutions for the capacity of the government to govern. Nevertheless, scholars did not pay attention to another constitutional rule: the relatively low barriers to constitutional amendments. Furthermore, several issues that had been embedded in the constitution required constitutional amendments to be put into force and they also required fiscal and political stability, which was achieved only six years after the enactment of the constitution.

Scholars did not also pay attention to the evolution of the decisions about the distribution of resources between levels of government during the constituent assembly. Constitution makers were committed to decentralize the distribution of resources after the centralization of the military regime. The states were granted proportionally more resources than the municipalities in the first stages of the assembly. As shown elsewhere (Souza, 1997) the municipalities, however, started to expand their participation in the division of resources and ended up as the winning player of the game. This has weakened the power of state governors in the federation, challenging the analyses above.

Amendments to put into force constitutional mandates became possible after inflation control and the stability of democracy. This was because several issues that had been embedded in the constitution required amendments to be put into force. When the political and the macroeconomic contexts became stable, amendments were approved. The most important amendments affecting the operation of the federal system was the earmarking of resources from the three levels of government for the provision of fundamental education and health care. These amendments also clarified the role of each level of government in the provision of these universal



policies. This decision challenges part of the literature on welfare policies in federal countries which often concludes that federal systems are less redistributive than unitary ones and that federalism decreases the redistributive capacity of the state (Obinger et al., 2005). Part of this literature claims that in “federal countries social policy initiatives are highly interdependent but often only modestly coordinated” (Pierson, 1995, p. 451). This is not the case for Brazil since the late 1990s. The Brazilian experience on social policies supports Congleton et al.’s (2003) conclusions, which deny much of the modern analysis of federalism that emphasizes the importance of competition among local governments as a device for promoting the efficient supply of government services.

The constitutionalization of several issues, making Brazilian constitutions more like a code rather than a document of principles and rules, is not a Brazilian peculiarity. As several authors have shown, there is an increasing trend for issues that would be a matter of ordinary legislation to become constitutionalized. In Ferejohn’s words, “few of the world’s constitutions actually seem to be systems of higher order or regulative rules that stand apart from ordinary legislation” (Ferejohn, 1997, p. 505). Detailed constitutions are also likely to be adopted in consensus democracies and they tend to be a feature of several federal countries, as Lijphart (1999) points out. Furthermore, either by constitution interpretation or by design, policy-making authority (and policy preferences) within a nation emerges gradually over time by a process of constitutional or quasi-constitutional negotiation between regional and central governments, as pointed out by Congleton et al. (2003, p. 169). However, policy-making authority has gradually been incorporated into Brazil’s several constitutions as a matter of federal jurisdiction and not as a process of negotiation between regional and federal governments. National politicians themselves have taken decisions about policy preferences, their financing and the division of labour between the tiers of government. Amendments to the 1988 Constitution have affected intergovernmental relations and the distribution of revenue among the three tiers of government.

What may be to a certain extent a Brazilian peculiarity is the degree of detail that the 1988 Constitution dedicates to policy provisions and its financing and to the distribution of governmental functions among the three levels of government. These details, however, have not prevented the approval of amendments. Furthermore, after 1994 amendments regulating the implementation of social rights, in particular health care and fundamental education, further earmarked revenue from the three tiers of government for their provision, hence expanding a trend of previous constitutions to earmarking. An OECD report estimated that around 80% of federal taxes are now earmarked, in contrast to less than 60% in 1988, when the constitution was approved and around 45% before 1988 (OCDE, 2005).<sup>6</sup>

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6. Earmarking of federal revenue is not only to finance universal policies but several other policies.

The same occurred with taxes collected by subnational governments or transferred to them. As it also happened with federal taxes, subnational taxes became earmarked by constitutional amendments to the federal constitution.

### 3 MAIN FEATURES OF BRAZILIAN FEDERALISM<sup>7</sup>

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, Brazil adopted a judicial review mechanism and 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.

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 political institutions are similar to those of the federal sphere, except for bicameralism. Although the states enjoy relatively little constitutional authority, they levy and determine the rates of the highest tax in absolute terms, the ICMS, a type of value added tax that, unlike many federations, is under the states' jurisdiction. State constitutions were modelled, therefore, 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 federal executive holds the largest number and the most important exclusive powers. Although residual authority rest with the states, the high level of detail in the Constitution about concurrent authority leaves little room for the states to make use of their residual powers. Concurrent authorities are listed in the Constitution, covering a wide range of issues, as shown in Table 1.

Except during authoritarian periods, the separation of executive, legislative, and judicial powers has been a prominent constitutional principle, which provides detailed rules concerning the jurisdiction and functioning of these powers. Federalism is seen as another mechanism for check-and-balance. As in many other presidential countries, the executive branch has become the main proposer of legislation and

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7. For descriptions and analyses of the constitutional characteristics of federal countries, see Kincaid and Tarr (2005).

the Federal Supreme Court has become an active player in decisions regarding the interpretation of the constitution. Power conflicts between the three orders of government and their legislatures are resolved by the Federal Supreme Court through judicial reviews provided for in the Constitution.

Governors may initiate judicial reviews, as may the president, the Senate board, the Chamber of Deputies board, state assembly boards, the general public prosecutor, the bar association, political parties with representation in Congress, and union and business confederations. Governors have been active initiators of judicial reviews.

The 1988 Constitution and subsequent decisions by the Federal Supreme Court have given uniformity to state laws that comply with federal objectives; thus state and municipal interests are consistent with a federal rationale, and there is constitutional and legal homogeneity despite varying state and municipal interests and socioeconomic characteristics.

The federal, state and municipal governments have their own legislative and executive institutions, and the federal and state governments have their own courts. The states are represented in the Senate but are not formally represented in the federal government. However, informally there has always been a tradition of having the states' interests represented in the federal executive through political appointments that often reflect a combination of party memberships and the state interests of those who support the president's governing coalition.

Elections for president, governors and for Congress and state representatives take place simultaneously every four years. Two years later, mayors and municipal councillors are elected simultaneously to four-year terms. Re-election of those occupying executive positions was introduced in 1997, with only one re-election permitted. For federal and state executives and in municipalities with more than 200,000 voters, a second round must be held if no candidate receives a majority of the popular vote. All legislatures are elected through a system of open-list proportional representation, except for the Senate, which relies on a variant of the first-past-the-post rule. The electoral system strengthened the interdependence between national–state–municipal elections, displaying an important feature of theories of federalism, i.e. the importance of the nationalization of political parties to make federal democracies stable (Riker, 1964).

#### **4 ALLOCATION OF AUTHORITIES**

Brazil's constitutions have always defined the jurisdictions of the three orders of government, and the 1988 Constitution furthered this trend. The federal Executive holds the largest number of exclusive authority, including those that are most important. Residual authorities reside with the states, as in the United States,

Australia, and Mexico. However, the high degree of detail in the Constitution and the earmarking of revenues leave little room for subnational units to make use of their residual authorities.

Unlike in many federations, Brazil’s federal executive retains most of the legislative authority regarding concurrent powers. The long list of powers shared by the three orders of government, most of which cover public policies, might suggest that the drafters of the Constitution intended to broaden the scope of cooperative federalism in Brazil.<sup>8</sup> However, this has not happened. One of the reasons is that the capabilities of subnational governments to carry out public policies are highly uneven. Table 1 displays the allocation of jurisdiction between the three levels of government.

TABLE 1  
Exclusive and concurrent authorities in Brazil

Level of government	Spending category
Union only	Defense
	Foreign affairs
	International trade
	Currency, banking
	Use of water resources
	National highways
	Planning: national and regional
	Guidelines: urban development, housing, sanitation, urban transport
	Postal service
	Police: federal and frontier areas
	Regulation of: labour, energy, interstate commerce, telecommunications, insurance, interstate transport, mining, employment, immigration, citizenship, and native rights
	Social security
	National statistical system
Union-state-local (shared)	Guidelines and basis for national education
	Health and social welfare
	Services for disabled persons
	Historic, artistic, and cultural preservation
	Protection of the environment and natural resources
	Culture, education, and science
	Historic and cultural preservation
	Forest, fauna, and flora protection
	Agriculture and food distribution
	Housing and sanitation
	Combating poverty and social marginalization
	Exploitation of minerals and hydroelectricity
	Traffic safety
	Small-business improvement policies
	Tourism and leisure

(Continues)

8. According to the Regional Authority Index, a measure of the authority of regional governments in 81 democracies or quasi-democracies on an annual basis over the period 1950–2010, Brazil’s current score is close to the type of co-operative federations. See <[www.arjanschakel.nl/regauth\\_dat.html](http://www.arjanschakel.nl/regauth_dat.html)>. For an excellent discussion of the distribution of authority between levels of government in Latin America covering the period of 1950–2010, see Osterkatz et al. (2012).

(Continued)

Level of government	Spending category
State only	Residual powers: any matter not assigned to federal or local orders by the Constitution
Mainly local	Preschool and fundamental education Preventive health care
Local only	Public transport (inner-city) Land use

Elaborated by the author.

The logic governing the distribution of authorities in the Constitution is paradoxical: on the one hand and between 1988 and 1994 a decision was made to decrease the federal government’s revenues vis-à-vis the other orders of government; on the other hand, the federal government’s legislative role and jurisdiction have been increased. Constitution makers of 1988 were committed to strengthen the federation by providing a more equitable distribution of governmental powers, given Brazil’s two long periods of authoritarianism and centralization at the federal executive.

Despite the large number of concurrent authorities, neither mechanisms nor institutions to regulate intergovernmental relations are provided for in the Constitution. This is not to say that intergovernmental relations are nonexistent. Subnational governments share federal taxes, the municipalities share state taxes, and there are some social policies, particularly health care and fundamental education, for which the federal government provides guidelines and resources according to rules determined by federal legislation. With the exception of these policy areas, intergovernmental relations are highly competitive, both vertically and horizontally, and marked by conflict. Cooperative mechanisms only come into being with federal support. Although there are several constitutional mechanisms for stimulating cooperative federalism, such as concurrent policy areas, Brazilian federalism tends to be federal-dominated. Furthermore, and unlike in many federations, such as Australia, Belgium, Germany, Mexico, and South Africa, the Brazilian federal government has no formal or informal intergovernmental council, and relations between the states have been marked by competition, particularly in attracting investment. There is only one inter-state council, which is made up of the states’ secretaries of finance, but its rules require approval by unanimity, which is seldom reached because of the states’ different interests given the country’s regional disparity. In contrast, intermunicipal relations have developed rapidly in recent years. The municipalities have created hundreds of consortia through which they share the costs, equipment and personnel required to deal with issues such as health care, environmental protection and economic development.

## 5 TAXATION AND FISCAL FEDERALISM

The current design of the Brazilian tax system is a result of the legacies of three different political and economic momentums. The first legacy comes from the military regime, which ruled the country from 1964 to 1985, when financial centralization was the main characteristic of the tax system and when the trend to raise taxes started. The military regime, however, deepened a previous system of intergovernmental transfers aiming at addressing Brazil's long-lasting and enduring regional inequality. As a result, regional economic disparity decreased slightly. This decrease, however, can be attributed neither to centralization of public resources nor to authoritarianism but rather to good economic performance during decades of accelerated economic growth. Economic growth rates of almost 10% a year for more than a decade allowed decision makers to adopt policies aimed at decreasing regional inequality. However, economic and regional inequality between regions has marked the Brazilian federation since its early years and despite attempts by the military regime and, later, by the 1988 Constitution, it remains as one of Brazil's main constraints. Improvements in the economic performance of poorer regions in the last decade shown above can also be credited to Brazil's economic growth between 2003 and 2014.

The second legacy comes from the 1988 Constitution. The constitution made profound changes on the tax system, mainly by increasing resources to subnational governments vis-à-vis the federal government. This Constitution, as much as previous ones, 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 rates and rules for certain taxes, including state and municipal taxes, are determined either by the Constitution or by federal legislation.

The 1988 Constitution expanded the complex mechanism for intergovernmental tax transfers introduced by the military by earmarking federal revenues. Federal revenues from income tax and from the tax on industrial products collected by the federal government are shared through participation funds established for this purpose. The states receive 21.5% of these tax revenues, 85% going to the North, Northeast, and Centre-West regions and the remaining 15% to the South and Southeast regions, Brazil's two economically better-off regions. The formula for determining state shares is based on population size and an inverse of per capita income. The municipalities receive 22.5%, 10% going to the state capitals and the remaining 90% being calculated using a formula based on the same criteria mentioned above, hence favouring small and poorer municipalities. All these rates and formulas are stipulated in the Constitution. These formulas, however, do not compare to the extensive systems of equalization payments provided for in Canada



and in Germany and the new mechanisms introduced by the 1988 Constitution have not significantly decreased horizontal imbalance. Horizontal imbalance has been partially reduced only during periods of economic growth.

The third legacy began with the launching of a stabilization plan, in 1994, which has succeeded in controlling Brazil's hitherto unstoppable inflation. Following the plan, a fiscal adjustment program became a priority and constitutional amendments were passed to address new issues in an attempt to take the country in a new economic direction. The new macroeconomic agenda has led to a re-centralization of resources at the federal level and to an unprecedented increase on federal taxes as compared to GDP. As it also happened during the military regime, the states' finance were and still are the most affected vis-à-vis other levels of government. Table 2 displays the trajectory of the distribution of financial resources between the three levels of government.

TABLE 2

**Financial revenue by level of government, including intergovernmental transfers (1960-2015)**

(In %)

Year	Federal		State		Local	
	As a % of GDP	As a % of total revenue	As a % of GDP	As a % of total revenue	As a % of GDP	As a % of total revenue
1960	10.4	59.4	5.94	34.7	1.11	5.81
1980	16.7	68.2	5.70	23.3	2.10	8.57
1988	13.5	60.1	5.97	26.6	2.98	13.3
2006	20.4	57.2	8.66	25.4	6.22	17.4
2010	18.7	56.5	8.34	25.1	6.13	18.1
2013	19.2	56.9	8.22	24.4	6.30	18.7
2014	18.6	55.7	8.35	25.0	6.47	19.3
2015 (estimated)	18.4	55.1	8.38	25.1	6.63	19.8

Source: Adapted from several databases compiled by José Roberto Afonso and Kleber Castro, available at: <<https://www.google.com.br/webhp?sourceid=chrome-instant&ion=1&espv=2&ie=UTF-8#q=blog%20jose%20roberto%20afonso>>

The table shows that in 1960 the states had a share of 34% of public revenue. The military regime made a radical change, when the states' share dropped to around 23%. In the initial years of the transition to democracy, the states increased partially their resources. After that year, however, the states' participation has fallen steadily, reaching  $\frac{1}{4}$  of public resources in 2015. 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, varying from a reaction of the federal government against its financial losses brought by the 1988 Constitution to tax

breaks by state governments to attract private businesses and to the decision to grant municipalities the provision of social policies with the financial backing of the other levels of government.

In contrast to the states, revenue administered by local governments has increased dramatically throughout the decades. This is particularly so after the approval of constitutional amendments earmarking federal, state, and local resources to the provision of fundamental education and health care. Since the mid-1990s, municipal governments have become the main providers of health care and fundamental education, following rules and using earmarked resources determined by constitutional amendments. The reason for this federal and state financial support to local governments for the provision of health care and fundamental education is to guarantee local citizens access to these public services based on national programs and minimum standards. Being a federal country, local governments had the choice of adhering or not to the implementation of these programs. The transfer of responsibilities to municipal governments has been, however, a success. This success can be credited to a policy favouring a complex system of intergovernmental relations and transfers that combines incentives and sanctions. The health care program injects additional resources into the municipal purse, and the education program penalizes municipalities that fail to improve school attendance rates at the fundamental level (Arretche, 2000). This transfer of policy implementation has reduced conflict among municipal governments for federal resources. Because of the design of these two services, intergovernmental relations are now more common between the federal government and the municipalities rather than between the states and their municipalities.

Important to notice that since the military government and particularly after the enactment of the 1988 Constitution, taxes never stopped rising, reaching 33.47% of GDP in 2014, only a little less than the average of OECD countries. Tax growths were not necessarily a result of economic improvements but rather of increasing the rates of some taxes and/or creating new ones.

As the table also shows, the federal government administers the bulk of public resources. As it also happens with the interdependence of political parties for electoral results, the tax system is also closed intertwined. When macroeconomic measures started to be adopted to tackle the current economic and fiscal crisis, the federal government stepped in to sort out part of the states' debt. There are now pressures from mayors of large cities to receive the same benefits granted to the states.

The Brazilian experience can be used to test the often-quoted assumption of the fiscal federalism literature, i.e., that federalism constraints fiscal policy making. The Brazilian case can be an example 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 *i*) the way federal institutions are designed, in particular intergovernmental relations; *ii*) the degree of consensus toward the introduction of a new macroeconomic and social agenda; and *iii*) the interdependence of the different levels of government in policy making. In certain federal countries such as Brazil bargaining and negotiation among actors of the three levels of government toward changing fiscal policy making are possible, showing that the design of federal institutions is an important variable when it comes to changing the status quo.

## 6 THE PROS AND CONS OF THE CURRENT DESIGN OF THE BRAZILIAN FEDERATION

Recent theories on federalism have tended to dedicate more importance to what make federations stable and sustainable rather than what they are (their definitions) and their characteristics (the centralization-decentralization continuum) (Bednar, 2009; Filippov et al., 2004).

According to this literature, there are two major threats faced by federations: if the federal government surpasses its competences and if the states do not fulfil their commitments to the federation. As shown above, Brazil has been a stable federation throughout the centuries and federalism has survived the country's political and economic turmoils. This is not to say that there is no need for improvements.

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 first and in the domestic environment more recently have arisen, requiring tight fiscal control and budget surpluses. This, of course, affects the financing of policies by the three levels of government and increases tensions between them.

The functioning of federalism, however, became much more complex since the enactment of the 1988 Constitution. Brazil is now marked by federally regulated policies and by constraints on subnational freedom to introduce legislation, blocked also by juridical interpretation, with few constitutional authorities 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 that they had never enjoyed previously.

These characteristics beg some words about the views of the literature on fiscal federalism on the decentralization-centralization continuum. The literature on fiscal federalism is controversial. On the one side, there are those who claim that decentralization provides incentives for regional and local politicians to address different

demands from their constituencies. On the other side, centralization might decrease the veto power of subnational politicians against macroeconomic policies and the provision of public goods. In countries where regional imbalance is high, such as in Brazil, centralization of regulation and resources coupled with decentralization of implementation of public policies, in particular those designed as universal, may be one of the ways to preserve unity and to provide services on national standards. This feature, however, is rapidly affected when the economy slows down.

As for the literature on decentralization, Falleti (2005) has convincingly shown that decentralization policies in Brazil (in the fiscal, administrative, and political spheres) in the last two decades has produced significant changes to the intergovernmental structure given that more authority was devolved to governors and mayors. According to her, this was evident along the subnational share of expenditures and revenues and the distribution of policymaking authority. This is not to say, however, that subnational politicians control the federation as the literature on the early years of the enactment of the 1988 Constitution predicted.

Although the constitutionalization of a wide range of issues, in particular the earmarking of revenues, limits politicians' and governments' room to manoeuvre, it has been the way found by politicians to adopt national standards in a unequal polity. This constitutionalizations, however, is far from addressing many of the country's conundrums such as regional inequalities. History has shown that reducing this inequality is not a direct result of policies but rather a consequence of moments of economic growth.

The 1988 Constitution has strengthened the federation and provided for a broader role for government in key policy areas. The constitutionalization of several aspects of the country's life has resulted in tensions between the need for rapid responses to macroeconomic demands and the lengthy process of meeting these demands through constitutional change.

Although changing the status quo requires long negotiations with Congress, the outcomes are so far usually positive, as shown by several works.<sup>9</sup> Governors did not act as veto players in the approval of constitutional changes affecting their role and resources. As Cheibub et al. (2009) show, based on extensive data set of roll-call votes at the chamber of deputies between 1989 and 2004 in matters affecting the interests of governors, there is no indication that governors exert more pressure over national legislators than their political parties. Consequently, one cannot say that the federal system in Brazil introduces a bias toward the status quo that cannot be overcome by the national government on the basis of alternative institutional resources. The high degree of constitutionalization, however, gives rise to conflicts and judicial reviews requiring decisions from the Federal Supreme Court.

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9. See, for instance, Figueiredo and Limongi (2016).

The main problems currently facing Brazil's federalism concern three issues. First and most important, Brazil is a federation that has always been characterized by regional and social inequality. Although the 1988 Constitution and those preceding it have provided several political and fiscal mechanisms for offsetting regional inequality and tackling poverty, these mechanisms have not been able to overcome the historical differences among regions and social classes. If improvements on the provision of health care and fundamental education have been achieved, regional and class divide remains.

Second, there has been a trend toward uniformity in subnational orders of government. Although the 1988 Constitution provides more freedom to subnational governments as regards implementation, other political, economic, and juridical forces restrict this freedom.

This freedom, however, is more limited to the states than to municipalities. One of the crucial issues in the states' decision-making freedom is how to reconcile the need for fiscal adjustment with the need for more autonomy for the constituent units. The states' investment capacity is also bound by their debt payments.

In the division of labour in the Brazilian federation chain, the states might be considered the weakest one for three reasons. Firstly, they have been losing resources vis-à-vis federal and local governments. Secondly, a survey carried out in 2013 found that citizens perceived the relative position of governors in the federation as minor, as compared to that of presidents and mayors. Presidents were seen as the most important player by 51.3%, followed by mayors, with 22%. Governors were perceived important by only 7% of citizens interviewed (Arretche and Schlegel, 2014). This perception reflects both the concentration of resources at the federal level and the broad jurisdiction of the federal government to legislate on policies subjected to the scheme of concurrent authority. Thirdly, the states are solely accountable for fighting violence and drug trafficking, a crucial unresolved issue in Brazil for the last decades.

Summing up, since the 1988 Constitution it is difficult to describe the Brazilian federation as either centralized or decentralized. The way the federal structure works changed several times since the enactment of the 1988 Constitution. Reforming the operation of a complex and constitutionalized federal country like Brazil depends on the design of the institutions such as constitutions and federalism, both flexible enough to adjust to new socioeconomic and political environments. If Brazil has been a federation free from threats of secession, there is certainly room for improvements.

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## **PREFERENCES REGARDING THE VERTICAL DISTRIBUTION OF AUTHORITY IN BRAZIL: ON MEASUREMENT AND DETERMINANTS<sup>1</sup>**

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### **1 INTRODUCTION**

Since the 1970s, the territorial reorganization of nation-states has taken center stage in the domestic politics of many countries and has attracted significant scholarly attention. Political scientists have applied considerable effort to measuring whether and the degree to which particular countries are centralizing or decentralizing (e.g., Hooghe, Marks e Schakel, 2010; Kazepov and Barberis, 2013). Scholars have also engaged in extended debate about the consequences of changes in the distribution of authority in federal countries. Still another group of scholars has been concerned with explaining public preferences for various positions regarding centralization or decentralization of authority in federal systems.

Our purpose in this article is to contribute to this final line of scholarly inquiry, by using survey data from Brazil to test competing propositions in the literature regarding the determinants of support for individual attitudes toward the vertical distribution of authority. Brazil is an ideal country for such a study, because the vertical distribution of authority has been the subject of repeated debate and has undergone periodic rescaling in recent decades. The Brazilian military regime (1964-1985) was a highly centralized polity insofar as both taxation and the framing and implementation of nearly all policies were in the hands of central authorities (Draibe, 1994; Serra and Afonso, 1999). The transition to democracy was followed by increasing fiscal decentralization along with interregional redistribution of tax revenues (Abrucio, 1998; Arretche, 2005). In the Constituent

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Assembly held in 1987 and 1988, the scale of policy-making and decision-making were at the forefront, along with a fierce dispute over the rules of interregional income redistribution (Ferrari, 2013; Leme, 1992; Souza, 1997), which eventually concentrated authority to frame subnational policies and taxation at the federal level (Arretche, 2007), increasing the extent of income redistribution among states (Ferrari, 2013; Leme, 1992), and decentralizing policy-making toward states and municipalities (Rezende, 2007; Souza, 1997). From the mid-1990s on, rescaling further entitled the Union to regulate and supervise the constituent units' taxation and policy affairs (Almeida, 2005; Rodden, 2006). These decisions were approved peacefully in Brazil's symmetric bicameral system, meaning that the states' rights were not infringed (Arretche, 2013).

In conducting and analyzing a 2013 national survey of Brazilian citizens in this article, we make two main contributions to the scholarly literature on public opinion regarding vertical allocation of authority. First, we make a methodological contribution, by offering an original methodology to handle a pair of challenges the current literature faces. The first concerns how to observe such preferences. Many studies assume that citizens' choices are framed by a dual federation model, where increasing the scope of authority of one government tier necessarily means reducing the competencies of another. We argue this assumption does not hold for marble-cake federations where citizens are politically educated by multi-polar institutions. The second refers to a conceptual conflation – which reflects on operationalization measurement – of “wishes for change” and “preferences towards the architecture of the state”. Although both concepts refer to attitudes towards the vertical distribution of authority, we argue they do not grasp the same phenomena. We suggest that scholars would do well in future studies to frame survey questions and analyze the data in a way that takes account of these methodological concerns.

We also aim in this article to contribute to a longstanding theoretical debate about the factors influencing citizen preferences regarding vertical distribution of authority in federal systems, by assessing the level of support for leading propositions in the context of Brazil. Scholars have advanced a range of theories and propositions regarding the importance of territorial identity, the role of socio-demographic factors, and the geography of income in determining individual preferences. Our main conclusion is that in contrast with a number of studies of other federal systems that stress the importance of territorial identification, in Brazil divisions on preferences regarding vertical distribution of authority cannot be explained by territorial identification. Instead, socio-economic status, age, gender, and within-region inequality appear to be the best predictors of an individual's preferences.

This article proceeds according to the following outline. We first present the expectations of the literature regarding the origins of individual attitudes towards the vertical distribution of power. We then discuss conceptual and measurement

challenges and how they may hinder theoretical advances in research in this area. We then introduce the survey we conducted and our independent variables. We also discuss the way that we measure and analyze our dependent variable concerning preferences toward the vertical distribution of authority. We then report our findings regarding the main determinants of individual preferences regarding vertical distribution of authority and conclude with some remarks about implications for future research.

## 2 EXPECTATIONS IN THE LITERATURE

Empirical studies on public attitudes toward the vertical distribution of authority have shown that its distribution varies across countries (Kincaid and Cole, 2011), within countries over time (Kincaid and Cole, 2011; Mullin, 2008; Wolak and Palus, 2010), and across regions within countries (del Pino and van Ryzin, 2012; Wlezien and Soroka, 2011). In turn, explanations of the sources of public attitudes toward allocation of authority emphasize three main factors: political culture, the geography of income, and individual socio-demographic attributes.

Most studies advocate that political culture is the most important factor driving voters' preferences about the design of government institutions, although diverse meanings of this concept are adopted (Kincaid and Cole, 2011). In any case, the argument's theoretical foundation dates from Livingston's (1952, p. 84) statement that the essence of State design "lies not in the institutional or constitutional structure but in [the attitudes of] society". One strand of analysis equates political culture and territorial identification (Lijphart, 1968; Rokkan, 1975). According to this viewpoint – very influential in Europe –, demands for the rescaling of authority are mainly explained by the existence of deep-rooted communities with shared identity. Culturally heterogeneous societies create favorable conditions for claims that range from devolution to independence so that such nations may have a say in policy design (Henderson et al., 2013; Jeffery, 2009; Keating, 2013; Jeffery, Lodge and Schmucker, 2010; Moreno, 1997; Moreno and McEwen, 2005). An alternative approach – very influential in North America – argues that trust has important implications for the public's preferences towards the vertical distribution of authority (Chanley, Thomas and Rahn, 2000; Kincaid and Cole, 2011), although such a sentiment may express either enduring orientation in favor of a political system or the evaluation of incumbents (Citrin and Luks, 2001). For instance, citizen support for devolution can result from distrust in the federal government (Hetherington and Nugent, 2001).

A second strand of empirical findings shows that demographic factors at the individual level contribute to the structure of public opinion on issues concerning the vertical distribution of authority. Mullin (2008, p. 214) shows that in the U.S., the more highly educated are less likely to support the federal government

taking the lead on policy initiatives, along with white people and conservatives. Del Pino and van Ryzin (2012) show that in Spain the elderly favor centralization, whereas the more educated prefer decentralization. As it remains difficult to explain why individual attributes *per se* would generate confidence toward specific institutional arrangements, authors conjecture that such variables indeed express other latent variables such as concern for the delivery of specific policies (del Pino and van Ryzin, 2012); the socializing effect of previous institutions (del Pino and van Ryzin, 2012); and ideological preferences, whose association with specific arrangements depend on historical legacies (Mullin, 2008). As a result, the mechanism by which individuals' attributes affect their preferences depends on their interaction with other non-observed – although not necessarily non-observable – and (maybe) contextual factors.

An emerging approach, advanced primarily by political economy studies, presents the geography of income and inequality as the core determinant for voters' preferences. The argument states that voters foresee the distributive consequences of alternative arrangements and choose those which maximize their income (Bolton and Roland, 1997). Therefore, decisions over institutional design are also choices about territorial income redistribution, with individuals' preferences depending on interregional and intra-regional income inequality (Beramendi, 2012) or the jurisdiction's income (Dahlby, Rodden and Wilson, 2009).

Our purpose in this article is to determine which of these theories is best supported in the case of Brazil. As we have noted, political culture could be seen as the predominant focus of the literature but studies also point toward the role of economic and demographic factors as alternative explanations. Our intent is to test these theories in a way that overcomes some methodological challenges faced by prior research in this area.

### 3 METHODOLOGICAL CHALLENGES

As mentioned above, the empirical studies developed thus far have found a great deal of variation in our subject of interest. No doubt such a situation may hinder theoretical advances once the field faces the problem of “too many variables and not enough cases” (Przeworski and Teune, 1970). But another set of challenges – and our main concern in this article – have to do with concepts and the resultant ways of observation. In this section, we identify some methodological challenges encountered by studies of public opinion regarding the distribution of authority in federal systems.

Our first concern is that certain assumptions that hold true for some federal systems are not applicable to all them. Many studies of public opinion regarding the vertical distribution of authority assume a zero-sum game, where expanding

the power of a given level of government would necessarily mean diminishing the power of another level. Kincaid and Cole (2011) operated with this assumption in their comparison of USA, Canada, and Mexico. Such a zero-sum game assumption may be plausible in dual federations where policy-making authority is clearly separated among jurisdictions. However, the dual model is rare among federal states (Braun, 2000; Grodzins, 1966; Rodden, 2004).

Our contention is that researchers should take account of the differences between dual-federal and multi-polar federal systems when constructing and analyzing public opinion surveys in this area. In multi-polar federations, there is not necessarily a contradiction if respondents say they would like all government levels to do more/less, even if they are referring to the very same policy. Since all tiers can feasibly make decisions or deliver policies, it is plausible that voters envisage change as affecting all levels at the same time. Therefore, we cannot diminish the amount of those preferring “more” from those favoring “less” activity of any given tier and presume that the arithmetic result reveals the public opinion. Public preferences cannot be understood as the net value of a zero-sum game between groups of individuals and government tiers.

A second concern is that most studies on public preferences regarding inter-governmental responsibilities conflate “wishes for change” and “preferences toward the architecture of the state”, as if they were the same phenomenon. A number of studies have focused on citizens’ responses to questions asking whether the national (or the state, or the local) government should do more/less than they currently have, either in general or regarding specific policies (see Schneider, Jacoby and Lewis, 2010; Wlezien and Soroka, 2011). However, only those responding they want “more” or “less” are taken into account when data is treated. Neutrals are usually disregarded from the analysis. Such a way of handling survey responses captures how many want change, since only those that wish either to further empower or reduce the competences of a specific government level are considered. Nonetheless, respondents declaring that they are neutral when asked about wanting “more/less” policy responsibilities to be allocated to a given government simply mean that they do not want change, but these respondents can feasibly have certain preferences towards the architecture of the state.

Additionally, the number of neutral respondents is not negligible. They can reach up to 20 percent of respondents (see Kincaid and Cole, 2011, p. 67; Schneider, Jacoby and Lewis, 2010, p. 7). Given the sizable number of neutral respondents, it is important to be alert to the possibility that including neutral responses can change the profile of the public opinion obtained through surveys. Depending on the share of respondents preferring the status quo, ignoring their preferences risks a serious distortion of voters’ preferences, since we cannot assume they are evenly distributed among the available options of institutional design. Therefore, if we

want to measure preferences towards the vertical distribution of authority we need to know what those in favor of the status quo intend to preserve.

We suggest a methodology that truly takes multi-polarity into account and distinguishes preferences for change from the architecture of the state. As specified below, the former will be addressed by an original way of controlling the internal consistency of individual's answers regarding their preferences. Based on this methodology we can include the choices of neutrals into the analysis, and so assess the public opinion regarding the architecture of the state.

#### 4 RESEARCH DESIGN

On March 2013,<sup>5</sup> we conducted a national survey of Brazilian citizens' attitudes to key characteristics of the Brazilian federation. The questions were designed to allow comparisons with similar projects. Accordingly, we included many questions of the CANS<sup>6</sup> project questionnaire, with additional questions suitable to test propositions advanced by Kincaid and Cole (2011) and Del Pino and van Ryzin (2012) along with hypotheses related to the geography of income framework.<sup>7</sup>

Studies on Brazil usually aggregate states into five macro-regions. Although these have no administrative or political power, each macro-region encompasses states with similar characteristics and cultural identity. Accordingly, the survey developed a representative sample of these macro-regions: South (SU), Southeast (SE), North (NO), Northeast (NE), and Center-West (CW) of 2,285 interviewees, eighteen-years old or over.<sup>8</sup> Interviewees were distributed according to quotas on age, gender, and schooling, based on the 2010 Brazilian Census data. Circa four hundred interviews were conducted in each of the five macro-regions. Three states – selected based on their ranking in national income distribution – were also oversampled in two different macro-regions: the wealthiest state, São Paulo (SP); a poor and largely unequal state, Bahia (BA); and a poor and comparatively less-unequal state, Ceará (CE). Each was sampled so as to represent an independent, representative stratum, with a margin of error of less than 5 percent. Figure 1 shows how each state ranks in national income distribution whereas figure 2 displays declared territorial-cultural identity.

5. The period chosen to conduct the survey was scheduled so as to avoid proximity with the elections, which are suspected to affect voter's perception on the importance of government-tiers. The last Brazilian local government elections were held in October 2012, whereas general elections were scheduled for late 2014.

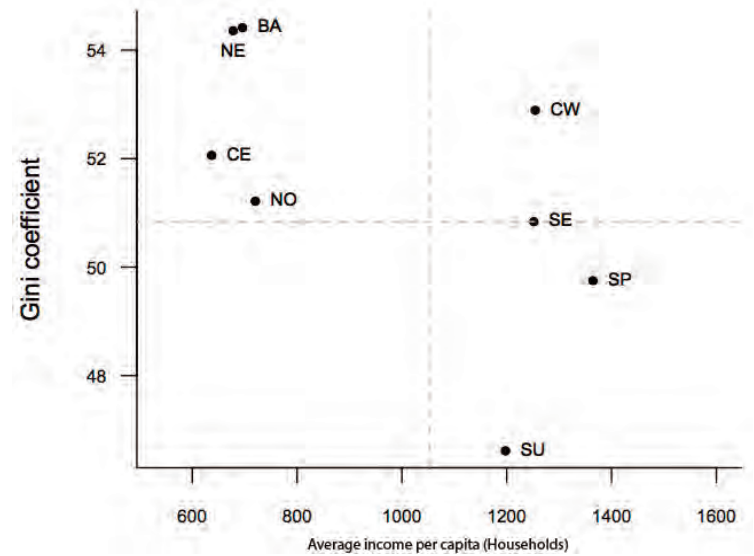
6. The CANS (Citizenship After Nation-State) project, led by Charles Jeffery and Ailsa Henderson, applied a common questionnaire to randomly selected samples of at least 900 respondents in 14 regions of five European countries, starting in 2009.

7. No doubt our findings can be affected by contextual factors since we gauged voters' perception only for one point in time. Therefore, we should be cautious on the generality of our results. It does not make them less important as an assessment of how preferences on the vertical distribution of authority are formed in countries like Brazil.

8. As in the CANS Project and part of the data employed by Kincaid and Cole (2011), interviews were conducted by telephone.

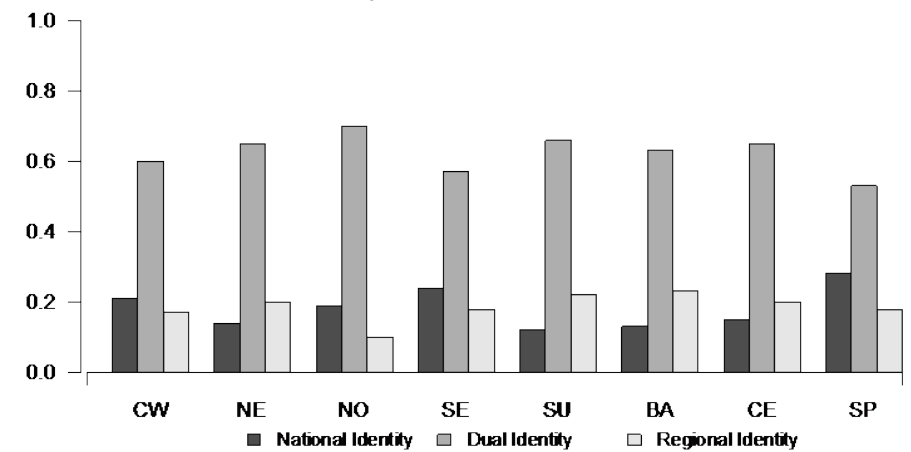


FIGURE 1  
Distribution of territories by income and Gini coefficient



Source: IBGE, Pesquisa Nacional por Amostra Domiciliar, 2013 (household survey).  
Obs.: BA = Bahia; NE = Northeast; NO = North; CE = Ceara; CW = Center-West; SE = Southeast; SP = Sao Paulo; SU = South.  
Publisher's note: Figure displayed in low resolution and whose layout and texts could not be formatted and proofread due to the technical characteristics of the original files.

FIGURE 2  
Distribution of identification by territories



Source: Survey Images of the Brazilian Federation.  
Obs.: National identity comprises respondents declaring to be more attached to Brazil than to their home state and those attached to Brazil only; Regional Identity gathers respondents declaring to be more attached to their home state than to Brazil and those attached to their home state only; Dual Identity refers to respondents equally attached to Brazil and to their home state.

In figure 1, units are distributed in two dimensions: inequality (Gini coefficient) and wealth (average per capita income of respondents' households, in Brazilian currency). The Northeast region (NE), the poorest and most unequal, returned average per capita income of less than BRL 700 (equivalent to US\$ 350 at the time of the interviews) and a Gini coefficient over 0.54. The Northeast (NE) and the North (NO) macro-regions both display levels of inequality above, and levels of wealth below, the Brazilian means (shown by dotted lines). Two of the oversampled states belong to the Northeast macro-region, and thus appear in the upper left of the chart. Bahia state (BA) is as unequal as the average found for the Northeast macro-region, whereas the Ceará state (CE) is slightly poorer and reasonably less unequal than Bahia.

The wealthiest macro-regions appear on the right side of the chart. Their average per capita income is over BRL 1200 (US\$ 600). The Gini coefficient for the Southeast (SE) macro-region practically coincides with the dotted line representing the Brazilian mean. The Center-West macro-region is more unequal, whereas the South macro-region is the least unequal. São Paulo (SP), a southeastern state and the wealthiest unit surveyed, has a Gini coefficient below the national average.

Figure 2 displays values for territorial identity. We applied the "Linz-Moreno question"<sup>9</sup> to ask respondents their feelings towards either their state of residence or Brazil, with five excluding options (Moreno, 2001). Options ranged from high regional identity to high national identity.<sup>10</sup> Answers were aggregated by assigning respondents to three categories. Those equally attached to Brazil and to their home state were considered as having a dual identity. Those identified with their own state, but not with the country, plus those who felt more attached to their own state than towards the country, were considered to have a regional identity (R). Lastly, a third category comprised those who reported attachment to Brazil, but not to their home state, plus those who declared greater attachment to the country than to their own state. These were considered to have a national identity (N).

The group with dual identity exceeds the two pole groups in every unit of observation. This is an important finding regarding the type of territorial attachment that best describes Brazil. In the CANS project none of the five countries surveyed returned similar scores for this dual attachment, revealing more polarized

9. In fact, what is known as the Moreno question is not Moreno's. The first to propose and use it were Juan Linz and his collaborators at DATA in public opinion surveys carried out in 1979. See Moreno (2006: footnote 3). Authors thank one of the Publius's anonymous reviewers for this remark.

10. Question: I am going to read several statements and you choose which one best describes your feelings. (1) I identify with my [state of residence], but not with Brazil; (2) I identify more with my [state of residence] than with Brazil; (3) I identify equally with my [state of residence] and with Brazil; (4) I identify more with Brazil than with my [state of residence]; or (5) I identify with Brazil, but not with my [state of residence].

identities (Jones et al., 2012, p. 22).<sup>11</sup> It also gives no support for Shayo's (2009, p. 158) conjecture that in less economically advanced countries, regions play a more prominent role than the nation for an individual's identity. Instead, this finding suggests that Brazil must belong to a group of federations where the majority of citizens display a dual territorial identity. One can observe that the geographies of identity and income do not seem to correlate. Poorer and wealthier regions display different patterns of feelings of attachment.<sup>12</sup>

We now turn to describe the methods we rely on to explain citizens' preferences regarding centralization and decentralization in Brazil. We start by introducing each of the independent variables in our study, explaining how we measure each these variables, and setting out our expectations for their influence on preferences regarding centralization or decentralization.

**Per capita household income:** Two different questions were asked about the approximate total income in the household and the number of people therein residing; accordingly, our per capita income measure refers to the respondent's household. In addition, a measure test conducted with the 2010 Census data returned values which, although not quite the same, are distributed in such a way that it strongly correlates with the values we collected. We are therefore confident that the geography of income returned by our survey is reliable as an independent variable. This variable aims to test hypotheses with a political economy approach and, combined with education, test Del Pino and Van Ryzin's (2012) proposition that the individuals' social class matters for preferences regarding institutional design.

**State GDP:** This variable was selected to test the proposition that the jurisdictions' revenue is what matters (Dahlby, Rodden and Wilson, 2009). Accordingly, we would expect that, regardless of their income, people prefer centralized authority if their own region's wealth is below the national average. Likewise, people living in wealthier regions are expected to prefer decentralized designs, regardless of their individual incomes.

**Gini Coefficient:** This variable aims at assessing whether within-region and interregional inequality interact when preferences for institutional design are at stake. We expect the rich and the poor to have variable preferences according to their territorial unit characteristics. In our poor and more unequal cases (NO, NE, BA, CE), and provided that they are entitled to obtain federal transfers – which is a

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11. Only 4 out of the 14 regions observed scored 50% or more on dual identity: Salzburg (Germany), Alsace (France), Galicia and Castilla la Mancha (Spain); no region in the United Kingdom and Austria showed comparable figures.

12. Migration history can be deployed in the endeavor to understand this territorial distribution of feelings of belonging. From the 1970s on, the three macro-regions where  $N > R$  were the destination of a massive wave of low-skilled immigrants seeking jobs either in flourishing industries in the Southeast or in the expanding mining and agricultural frontier of the North and Center-West. Meanwhile, there was emigration from the South and the Northeast. This is explained mainly by extreme poverty in the Northeast, and a combination of smallholdings and large families in the South.

constitutional provision in Brazil —, the poor would prefer authority to be decentralized since their pivotal position in decision-making would allow them to impose larger levels of redistribution. To avoid this outcome, the rich in turn would prefer a centralized design, because levels of redistribution would be lower if determined by the national (and therefore) less poor median voters. In our richer and less unequal cases (SU, SP), the poor and the rich would share the same preference for decentralizing authority. Being richer, they wish to avoid any kind of transfer out of the region, whereas lower inequality means that the median voter will impose less redistribution than if the pivotal voter were the national and poorer one. Finally, both the poor and the rich in our unequal case (CW) are expected to be in favor of centralization, but for different reasons. The poor would prefer centralizing decision-making as they would remain net beneficiaries, whereas the rich prefer the level of redistribution to be determined by the national and less poor median voter (Beramendi, 2012, p. 31ss).

We also built an interaction variable (Region\*Income) to test this proposition.

Trust in the federal government: People were asked how much they trusted several different government institutions.<sup>13</sup> Those declaring they had some or great trust in the federal government, were coded 1; those declaring little or no trust were coded 0. This variable was designed to control for the effect of appraisal of the federal government on preferences regarding the vertical distribution of authority, as suggested by Chanley, Thomas and Rahn (2000). We expect support for centralization to be positively associated with trust in the federal government.<sup>14</sup>

Education: Del Pino and Van Ryzin (2012) suggested that the role of education and social class in attitudes towards decentralization should be further explored, since both emerged as important predictors in their models. We believe that educational levels can be a reliable proxy for social status. In contemporary Brazil, educational system access up to the completion of the first eight school years is much less conditioned on the social background of young people than in the past. The same cannot be said for the highest education levels, for which the effects of social origin on the odds of progression among young people has had a historical tendency to be stable or even shown signs of worsening inequalities, as is the case with higher education (Arretche, 2015).

We expect the less qualified respondents to support a centralized design. Such preference can be explained by the trajectory of social policy in Brazil. Since the early decades of the 20th century, the central government has played a crucial role

13. Question: How much do you trust the following institutions? *i*) the city government; *ii*) the state government; *iii*) the federal government; and *iv*) the judiciary. Options were: (a) a lot of trust; (b) some trust; (c) little trust; or (d) no trust at all.

14. The questionnaire also included a question on who the interviewee voted for in the last elections in order to evaluate the role of party politics in voter's preferences, as suggested by Kincaid and Cole (2011). This variable revealed not to be valid to statistical treatment though, due to overconcentration of answers on current incumbents.

in ensuring working class rights. Social security and legislation to protect workers in the job market were introduced by the federal government in the early 1930s (Gomes, 1988; Santos, 1979). Most of the existing welfare structure, as well as high-visibility policies such as the Bolsa-Família cash-transfer program, unemployment compensation, and the raise in minimum-wage real values are supported by the central level and clearly associated with an important decline on income inequality (Neri and Herculano, 2012; Soares, 2010). Thus, the central government is the one to claim the most credit in protecting the most vulnerable. Conversely, we expect the more educated to prefer a decentralized design.

Gender: Del Pino and van Ryzin (2012) found that gender matters and suggest that this result is mediated by concerns about the delivery of policies. For them, this result may express Spanish women's concern with the education of their children. Therefore, we included this variable into our regression models, with the expectation that women will be more supportive of centralization.

Age: Del Pino and van Ryzin (2012) also found that age matters while Alesina and Giuliano (2011) found that women and young people display stronger preferences for redistribution. We therefore included this variable (continuous, in years) in our regression models. We expect the elderly to prefer centralization, for the same reasons presented above regarding education, meaning that this variable indeed reveals people's concerns over the delivery of policies. The central government is in charge of retirement policies in Brazil, and therefore elderly people might have this concern in mind when they declare their preferences toward the vertical distribution of authority.

## 5 DISCUSSION OF METHODOLOGICAL DECISIONS AND ANALYSIS OF RESULTS

We now turn to discuss and analyze our results, beginning with an explanation of how we have addressed the two main methodological challenges outlined above. We first need to operationalize the observation of two conceptually distinct attitudes toward the vertical distribution of authority: preferences for change and preferences regarding the architecture of state. Once both are disentangled, we can include neutrals' preferences into the analysis and know how institutional options are distributed among citizens.

### 5.1 Measuring preferences for change

As we discussed earlier when setting out methodological challenges facing researchers in this area, wishes for change and preferences toward the vertical distribution of authority are frequently conflated in the literature. However, they refer to different attitudes. As for the latter, the literature seems to ignore the fact that federations have more than one center of power and that this may affect citizens' answers regarding rescaling. This section suggests a methodology to observe preferences for change that seriously considers multi-polarity.

Brazil is a marble-cake federation, meaning that different levels of government are entitled to authority over the same policies. Accordingly, preferring both the Union and another tier to have more power cannot necessarily be understood as contradictory, since further empowerment of both may merely mean entitling public authorities to intervene in more policy areas.

Table 1 shows the single preferences on rescaling obtained in our study for further (dis)empowering a given level of government. It clearly shows the status quo as the single most preferred scenario. Over 40% of respondents would not concentrate more authority in any tier, nor would almost 49% limit the power of any of them. The status quo is the choice of at least two-fifths of the sample.

TABLE 1

**Single preferences for change – percentages of respondents answering questions regarding which level of government should have more power and less power**  
(Raw data)

	Who should have...				All	None	Total
	Presidency	State gov't	Local gov't	Multiple answer <sup>3</sup>			
...more power <sup>1</sup>	19.1	14.6	20.7	2.7	2.5	40.3	100
...less power <sup>2</sup>	13.1	14.2	19.7	0.8	3.4	48.8	100

Source: Survey Images of the Brazilian Federation.

Notes: <sup>1</sup> Question: Considering your local government, state government, and presidency, which of these levels of government should have more power than it has today? Multiple choice is allowed.

<sup>2</sup> Question: Considering your local government, state government, and presidency, which of these levels of government should have less power than it has today? Multiple choice is allowed.

<sup>3</sup> The respondent chose one of these combinations: i) presidency and local government; ii) state government and local government; and iii) presidency and local government.

On the other hand, most respondents would prefer alternative arrangements. Roughly, one-fifth would further empower the presidency, and nearly the same proportion would vest more authority in local governments; and almost 15% believe state governments should have more power. At the same time, one-fifth wanted local governments to have less power, 14% would restrict the authority of states, and 13%, the power of the presidency.

Hence, it seems there is no discernible majority in favor of either further centralization or further decentralization if we apply the criteria suggested by Kincaid and Cole (2011, p. 54), by which more than half of respondents would display support for any given option. This apparent inconsistency should be understood in light of the multi-scaled notion of power distribution, typical of most federations. Accordingly, citizens' preferences cannot be understood as the net value of a zero-sum game where extending the power of a given level of government would necessarily mean lessening the power of another.

To address this issue, we combined the questions in table 1 to build a variable we believe to be better suited for measuring wishes for change. Consistently opting for the status quo requires persons to say they would neither further empower nor

limit the current powers of any level of government. As a result, preferences toward the vertical distribution of authority result from the combination of wishes regarding further empowering one level of government and not empowering any other. Table 2 shows the distribution of our sample’s rescaling preferences categorized into four respondent profiles. “Centralists” are those who supported further empowering the Union and either wanted to limit the authority of the two other levels or felt none should have less power. “Regionalists” wanted both more power for states and either less power or no additional limitation for the two other levels. “Localists” advocated further empowering local governments and answered that powers of the central or state governments should be lessened or simply remain the same.

TABLE 2  
**Combined preferences for change – percentage of respondents in each territorial unity expressing a discernible preference combining answers regarding further empowering and further disempowering different government tiers**  
(% by row)

Region/State	Centralists	Regionalists	Localists	Pro status quo
Brazil (BR)	19.34	13.52	20.44	24.86
Center-West (CW)	17.81	14.38	18.49	23.29
Northeast (NE)	22.42	12.2	21	24.41
North (N)	18.59	16.67	15.38	25.64
Southeast (SE)	17.25	13.26	19.97	27.16
South (S)	14	16.67	23	22
Bahia (BA)	21.61	11.46	23.96	22.4
Ceará (CE)	21.35	13.02	22.66	24.22
Sao Paulo (SP)	17.19	13.02	22.14	24.74

Source: Survey Images of the Brazilian Federation.  
Obs.: Rows do not total 100% because part of the total sample does not express a discernible combined preference *Centralists*: Respondents in favor of more power to the Union and either less or the same power to other tiers; *Regionalists*: Respondents in favor of more power to the States and either less or the same power to the other tiers; *Localists*: Respondents in favor of more power to local governments and either less or the same power to other tiers; *Pro status quo*: Respondents against further empowering or limiting the power of any level of government.

Observe that the status quo group remains the largest. Roughly one in four respondents would not change the current distribution of authority in Brazil. Centralists and Localists are the second most frequent options: each group represents circa 20% of the interviewees. Regionalists comprise only 13.5%. Once again, although the ranking of preferences clearly shows a plurality in favor of the status quo, differences between the percentages in favor of each option are not that large.

Preferences for change are usually territorially concentrated, as in the cases of Quebec, Catalonia and Scotland. Therefore, national averages say little about them. Table 2 also displays the distribution of such preferences across our units of observation. It shows that the preference for the status quo is a plurality option in all of them but two, revealing that this is a choice shared all over the country.

In any case, those favoring the status quo stating they would not change the current arrangement are not negligible. Indeed, they represent a plurality. Therefore, to simply disregard their preferences towards the architecture of the state would distort our analysis.

Indeed, neutrals can feasibly have preferences toward the vertical distribution of authority. Their wish to keep institutions as they currently are does not mean they do not have preferences regarding institutional design. The empirical question then becomes what they would like to hold on to.

## 5.2 Measuring preferences regarding vertical distribution of authority

This section suggests a methodology to include neutrals into the analysis and so get a profile of the distribution of preferences regarding the vertical distribution of authority. Such methodology incorporates the main intuition of the “thermostatic model” (Wlezien, 1995) and Mullin’s (2008) suggestion. The first argues that the public adjusts its preferences for “more/less” policy in response to what policymakers do, at least in domains of substantial public salience. The second contends that when institutional preferences are at stake, citizens’ preferences are affected by how people perceive the existing distribution of government power. Thus, to observe the citizens’ perceptions of the current distribution of authority we suggest a way to observe the “importance” they attribute to each government level. Put simply, if we want to know what neutrals wish to hold on to, we need to know their perception of the status quo. In our view, this assessment requires understanding how they perceive the importance of each government tier.

What should we observe when trying to assess the importance citizens attribute to different government tiers? Wlezien and Soroka (2011, p. 42) found that, under marble-cake federalism, the public does not appear to distinguish sources of spending when registering their preferences. So, we dropped spending out as an indicator of the importance of government levels. Instead, we adopted two indicators we believe can reveal the importance citizens attribute to government tiers: which elections they deem as more important and which level of government they believe makes the more important decisions.

To address these two dimensions, questions concerning the importance of elections and the right to decide were posed to interviewees.<sup>15</sup> Individuals’ responses were combined with their preferences for change (as already shown in table 2).

15. Question 1: How important is the X election? Each time X was substituted by (i) mayoral; (ii) city councilor; (iii) governor; (iv) state representative; (v) presidential; (vi) senatorial; (vii) federal representative. Possible answers are (a) Very important, (b) Moderately important, (c) Slightly important, (d) Not at all important. The options “don’t know” and “didn’t answer” were accepted as well. The interviewees were asked then to rank the first and second most important elections. Question 2: How important are the decisions made by X? Each time X was substituted by (i) mayor of your city, (ii) governor of your state, (iii) president or the federal government. The possible answers for each case were as described above. Right after the question, they were asked to rank the first and second most important decision maker between these three.



As a result, in table 3 the distribution of preferences for change are displayed in the lines while interviewee's perceptions of the importance elections and decision-making of different government tiers are displayed along the columns. In table 3, percentages refers to the share of interviewee's responses that rank different government levels as the (first) most important election and decision maker.

Observe in table 3 that Federal elections are considered by far the most important. More than three-fifths of respondents think that voting in the federal elections ranks highest. Moreover, the group that gives more importance to local elections is nearly twice as large as the group that gives more importance to state-level elections.

TABLE 3  
Perceptions of tier relevance and preferences for change – percentage of answers according to respondents' profiles in terms of combined preferences

Which level of government has the most important...					
...elections?					
	Federal <sup>1</sup>	State <sup>2</sup>	Local <sup>3</sup>	All	Total (row)
Centralists	17.6	2.3	3.0	2.2	25.1
Regionalists	9.1	4.4	2.5	1.2	16.9
Localists	15.6	1.9	7.2	1.5	26.3
Pro status quo	19.6	2.7	5.6	4.0	31.8
Total (column)	61.9	10.9	18.3	8.9	100
...decision-making?					
	Central gov't <sup>4</sup>	State gov't <sup>5</sup>	Local gov't <sup>6</sup>	All	Total (row)
Centralists	15.7	3.0	4.3	1.7	24.6
Regionalists	8.4	4.5	3.9	0.7	17.5
Localists	14.6	3.7	6.9	1.3	26.4
Pro status quo	15.5	4.7	7.2	4.0	31.4
Total (column)	54.3	15.9	22.2	7.6	100

Source: Survey Images of the Brazilian Federation.

Notes: Percentages refer to the total of respondents with discernible combined preferences for change.

<sup>1</sup> Answers referring to either presidential or congressional elections.

<sup>2</sup> Answers referring to elections for governor or for state representatives.

<sup>3</sup> Answers referring to elections for mayor or for municipal councilor.

<sup>4</sup> Answers referring to decisions by the president or the federal government.

<sup>5</sup> Answers referring to decisions by the governor or the state government.

<sup>6</sup> Answers referring to decisions by the mayor or the city government.

Table 3 also shows that the majority within each group of preferences for change acknowledges federal elections as being most important. Whether preferring the status quo or any form of rescaling, they rank federal elections highest by a large margin. On the other hand, there seems to be some association between rescaling preferences and election ranking. Regionalists form the largest group of those who identify state elections as the most important, while those who ascribe most value to local elections are the largest single group among localists.

Table 3 also shows the combination between rescaling preferences and perceptions about the decision-making importance of different tiers. Figures are somehow different, but the results point in the same direction. The majority of interviewees see the central government as making the most important decisions. For all groups of preferences for change, most respondents perceive the President as making the decisions they care most about. The hierarchy of importance is also similar: after the president, mayors are seen as making more important decisions than governors.

We are now prepared to combine these variables regarding perceptions of the Brazilian federation and build a variable that captures preferences toward the architecture of the state that: *i*) includes the preferences of neutrals in terms of change; and *ii*) controls for citizens' perception of the current distribution of authority. As a result, those classified above as neutrals because they prefer the status quo can now be classified as "Centralists" (or supporters of a centralized design") if they believe the federation is centralized. The same applies for Localists and Regionalists.

The variable has four categories. Centralists are those who would like to further empower the Union plus those who prefer the status quo (as in table 2) and also perceive the current vertical distribution of authority as being already centralized (as in table 3). Regionalists are those who would give more authority to states plus those who favor the status quo and also perceive the state level as both holding the most important elections and making the most important decisions. Localists are those who advocate rescaling in favor of local governments plus those in favor of the status quo who also identify local power as prominent. The fourth category, the Indifferents, comprises individuals who have no discernible rescaling profile nor express any substantial opinion regarding the present degree of (de)centralization in the federation.<sup>16</sup>

Frequencies for this new variable are shown in table 4. Although most of our interviewees say the Brazilian federation is centralized, Centralists represent 30.6% of our sample while 23.8% can be considered to be Localists. Note that the ranking found from the outset did change. Centralists now emerge as a plurality.

TABLE 4

**Preferences toward the architecture of the State – percentage of respondents with profiles reassessed according to their perception of the relevance of different levels of government**

	Centralists	Regionalists	Localists	Indifferents
Brazil (BR)	30.6	14.7	23.8	9.1
Center-West (CW)	28.1	15.8	20.6	9.6
Northeast (NE)	33.9	13.3	24.5	8.3
North (N)	25.0	20.5	19.9	10.9

(Continues)

16. The categories are described in full in the Supplementary data on Publius on line.

(Continued)

	Centralists	Regionalists	Localists	Indifferents
Southeast (SE)	30.4	13.9	22.0	11.3
South (S)	23.7	17.7	28.3	6.0
Bahia (BA)	33.3	11.7	27.3	7.0
Ceará (CE)	32.6	14.8	24.7	9.1
Sao Paulo (SP)	27.9	13.3	24.0	12.0

Source: Survey Images of the Brazilian Federation.

Obs.: 1. Rows do not total 100% because part of the total sample does not express a discernible profile regarding the architecture of the State.

2. *Centralists*: respondents in favor of more power to the Union or pro status quo (as in table 2) who also perceive the central government as the most important (as in table 3). *Regionalists*: respondents in favor of more power to the States or pro status quo (as in table 2) who also perceive state governments as the most important (as in table 3). *Localists*: respondents in favor of more power to local governments or pro status quo (as in table 2) who also perceive local government as the most important (as in table 3). *Indifferents*: respondents who do not express a discernible profile in terms of combined preference for change plus those without consistent assessment regarding the relevance of government tiers.

The position of states *vis-à-vis* local governments did not change however. Localists still rank ahead of Regionalists in all units of observation except the North macro-region. Only circa 15% of the public thinks Brazilian states should be further empowered. Even in the wealthiest state, Sao Paulo, priority for the regional level does not outrank support for empowering other levels. As for localism, it is remarkable that the South is the only macro-region where those in favor of empowering local governments outnumber the Centralists. The next step is to better understand the factors behind this distribution of preferences.

## 6 EXPLAINING INDIVIDUAL PREFERENCES REGARDING VERTICAL DISTRIBUTION OF AUTHORITY

Given that support for centralization is unambiguous, whereas decentralization would involve either support for states or for local governments, we decided to take the former as the main dimension of interest. We recoded the original variable preferences toward the architecture of the state as a binary: 1 for those in favor of a centralized design, 0 for the others.

Table 5 shows the results of logit regressions using favoring centralization as the dependent variable (details in the Supplementary Data). The reference category for the logit are individuals who declared themselves as identifying equally with the whole country and their own state,<sup>17</sup> who express distrust of the federal government, who have less than elementary education and are male.

We built five different models using pooled data and including socio-demographic variables, those related to the geography of income and trust in the federal government. In Model (1), territorial identity is measured only by the variable

17. When the model includes identification with municipality or macro-region, the category of reference includes those who showed no identification with either municipality or macro-region.

related to the “Linz-Moreno question” and there is no interactive term. Model (2) takes attachment to city of living as the measure of territorial identification. Model (3) gauges the association of attachment to the individual’s own macro-region. Model (4) takes into account all territorial identity dimensions. These first four models are intended to capture different possible shapes of territorial attachment, taking into account the multilevel organization of the Brazilian federation, in order to check the robustness of the findings regarding the effects of territorial identity. Finally, model (5) includes an interactive term for macro-region and the individual’s income (details in the Supplementary Data on Publius on line). Table 5 shows the coefficients of the logit function, expressed in log odds.

TABLE 5

**Determinants of the preference for a centralized architecture of the State**

Testing the degree to which different factors explain individual preferences for centralization using five regression models					
	(1)	(2)	(3)	(4)	(5)
IdNational	0.051 (0.145)			0.010 (0.149)	0.005 (0.150)
IdState	-0.177 (0.143)			-0.198 (0.143)	-0.191 (0.144)
IdMunic		-0.184 (0.132)		-0.176 (0.150)	-0.155 (0.151)
IdRegion			-0.073 (0.130)	0.025 (0.147)	0.026 (0.148)
Income	-0.00003 (0.0001)	-0.00004 (0.0001)	-0.00004 (0.0001)	-0.00003 (0.0001)	-0.00000 (0.0001)
PIB State	0.017 (0.024)	0.015 (0.023)	0.014 (0.023)	0.019 (0.024)	0.012 (0.025)
Gini State	0.036* (0.021)	0.033 (0.021)	0.034* (0.021)	0.036* (0.021)	0.025 (0.023)
TrustGovFed	0.124** (0.053)	0.131** (0.053)	0.129** (0.053)	0.126** (0.054)	0.128** (0.054)
Educ - Elementary	0.013 (0.152)	0.015 (0.152)	0.009 (0.152)	0.022 (0.153)	0.030 (0.153)
Educ - High Sc	0.020 (0.141)	0.043 (0.141)	0.028 (0.141)	0.039 (0.142)	0.051 (0.142)
Educ - Underg +	-0.500** (0.233)	-0.467** (0.233)	-0.486** (0.233)	-0.477** (0.234)	-0.419* (0.236)
Female	-0.336*** (0.111)	-0.325*** (0.110)	-0.334*** (0.110)	-0.332*** (0.111)	-0.331*** (0.112)
Age	0.011***	0.012***	0.012***	0.011***	0.011***

(Continues)

(Continued)

Testing the degree to which different factors explain individual preferences for centralization using five regression models					
	(1)	(2)	(3)	(4)	(5)
	(0.004)	(0.004)	(0.004)	(0.004)	(0.004)
Center-					0.00000
-West*Income					(0.0002)
North*Income					-0.0003
					(0.0002)
Southeast*Income					-0.00001
					(0.0001)
South*Income					-0.0002
					(0.0002)
Const	-2.410**	-2.227**	-2.347**	-2.305**	-1.857*
	(0.966)	(0.959)	(0.959)	(0.977)	(1.053)
N	1,537	1,542	1,543	1,532	1,532
Log Likelihood	-1,000.282	-1,003.657	-1,004.947	-995.965	-993.401
AIC	2,024.565	2,029.313	2,031.894	2,019.930	2,022.803

Elaborated by the author.  
Obs.: Figures are coefficients of the logit function, expressed in log odds (figures in parentheses express standard errors); Asterisks express statistical significance: \*p < .1; \*\*p < .05; \*\*\*p < .01.

Two results are particularly striking: no variable related to territorial identity was associated with preferences for centralization, whereas inequality within states showed a consistent pattern. In three models, the more unequal the state of living, the larger the probability that someone would prefer centralization.

Individual attributes – schooling, age, gender – also appeared consistently connected to preferences for centralization. More educated people are less favorable to centralization. The elderly favor centralization whereas women tend to be against it.

Trust in the federal government is positively associated with preferences for a centralized institutional architecture. Centralization is 1.13 times more likely to be the preferred arrangement among people who trust this level of government than among those who do not. Results in the same direction were obtained for models with each macro-region as unit of aggregation and for those with income treated as a categorical variable expressed in quartiles.<sup>18</sup>

We also ran regression models with the groups obtained from the variable wishes for change (table 2), operationalized as a binary (1 for those in favor of

18. We have no room to display here the macro-regional models and those with income as a categorical variable, but we will gladly send them on request for those interested.

further empowering the central government). They are not shown for space reasons. Similar results were found for the socio-demographic dimensions: being older, graduated, and a woman remained significant and with the same signs. Within-state inequality again appeared associated with the preference for centralization. However, a remarkable contrast appears: trust in the federal government missed its significance, and income became statistically associated with the dependent variable. Independent variables regarding the importance of elections and decisions were included in this set of models and turned out to be significant predictors of wishes toward further centralization.

The two sets of regressions only differ regarding the role of individual's income. When preferences for change are at stake, income becomes significant and negatively associated with support for centralization. As for the interaction between income and region, people in the South and Southeast are less likely to support centralization, while in the three other regions the model with interaction showed even a positive sign for income, although not significantly different from the reference category. As we could not use Gini coefficients and GDP per capita at the regional level in the regression at the same time due to multicollinearity issues, and our model showed no significant difference in the interactive effect of income between the Center-West, North and Northeast regions, we suspect these results point towards the importance of within-region inequality on the preference towards the vertical distribution of authority.

Overall, regional identity showed no significant association with either dimension regarding the vertical distribution of authority, whereas socio-demographic individual attributes (education, gender, and age) are consistently associated with support for centralization. The geography of income brought about mixed signs: within-region inequality showed more consistent associations, whereas the individual's income only worked well as a predictor of wishes for change, not for preferences towards the architecture of the state.

## 7 CONCLUSION AND DIRECTIONS FOR FURTHER RESEARCH

Many studies regarding the vertical distribution of authority have implicitly assumed that preferences for change imply a zero-sum game, in which prescribing more power to one level of government necessarily means imposing limits on the others. Instead, we argue that consistency of individuals' preferences should seriously take into account the multi-polarity of marble-cake federations. Many studies have also conflated "wishes for change" and "preferences toward the architecture of the state". As a result, those supporting the status quo have been ignored in the analysis, although *a priori* they cannot be considered to be indifferent regarding institutional options on State design. It is not uncommon that this group makes for a plurality.

Our study used national survey data to examine preferences with regard to wishes for change and preferences towards the architecture of the state in Brazil. In doing so, it develops an original methodology to handle those two issues.

Our findings show that voters perceive Brazil to be a centralized federation, in that the vast majority of respondents regarded the federal sphere as holding more important elections and making more important decisions than either the states or local governments. Unlike other studies, we did not find a fit between such perceptions and either wishes for change or towards the architecture of the state though. Instead, a plurality (25%) supports the status quo while the remaining distribute themselves more or less evenly among those that would further empower either the central or local governments (nearly one-fifth each). When the preferences of those supporting the status quo are included into the analysis to measure preferences towards the architecture of the state, Centralists garner a plurality (31%) while Localists remain as the second most preferred option (24%). Given the widespread notion that states are powerful in the Brazilian federation it is perhaps surprising that the state sphere fared worst in terms of both wishes for change and preferred institutional design, garnering less than 15% of interviewees.

The way we operationalize the data and our results yielded evidence rejecting the claim that territorial identities explain preferences regarding the vertical distribution of authority in Brazil. It does not mean that we are in a position to discard the explanatory power of this theory however. Instead, we believe that it does not explain the formation of preferences in a country such as Brazil, where feelings of territorial attachment are not polarized between the center and the regional (or the local) level, and therefore voters display a consistent dual identity: they feel attached to their region and to the nation-state without unbearable tension. Citizens with a dual identity can be found in Spain or the United Kingdom, but they prevail in Brazil.

Additionally, we found evidence to support the proposition that socio-economic status and within-region/within-state inequality are associated with preferences for institutional design. Pro-centralization attitudes are more frequent in more unequal states, regardless of the individual's income, while such preferences garner less support in richer and less unequal areas. Roughly speaking, support for centralization was significantly more frequent among more vulnerable citizens (the poorer and less educated), regardless of the wealth of the region they lived in. Given the close association between access to education and social class in Brazil, we understand that this evidence provides support for the proposition that social status is a crucial dimension for shaping preferences when territorial matters are at stake. In sum, Brazilian voters clearly seem to be divided on intergovernmental issues, and such division appears to be driven by social status/income and within-region inequality.

Trust in the federal government seems to be a relevant condition for these preferences as well. This was the available variable more closely related to party politics and also capable of expressing the appraisal of federal authorities of the day. As expected, trust turned out to be a dimension one can hardly overestimate when discussing distribution of authority. Less clear are the mechanisms that might drive the clear position of women against centralization and of the elderly in favor of centralization. In any case, the geography of income and the connections of specific categories of individuals with the State seem to be a promising path for further research.

How do these findings add to the collective endeavor of better understanding the formation of preferences regarding the vertical distribution of power? In addition to the original methodology we suggested, we have good reasons to believe Brazil is not an exception among contemporary federations. It would appear to belong to a certain type of political unions where dual territorial identity is combined with within- and cross-region income inequality. Such federations can also be divided regarding preferences toward institutional design. However, not surprisingly, such a divide is not driven by territorial identity. Instead, in these (not so rare) polities, income, social status and the relationship of citizens with the State seem to play a crucial role. Hence, these factors seem to be promising avenues for further research.

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## **EXPECTATIONS AND FRUSTRATIONS: THE RECENTRALIZATION OF POWER AND THE EXPANSION OF FEDERATIVE CONFLICTS AND IMBALANCES**

Fernando Rezende<sup>1</sup>

### **1 INTRODUCTION**

The Brazilian federation is going through its worst moment in history. The crisis of the states has conquered space in the media in the wake of problems brought about by the economic recession long ignored by the majority of the population, albeit known to those devoted to studying the issue.

Encouraged by federal authorities, the states have recently entered a new expansion cycle of their debts, often in order to finance constructions for major sports events with no expectation for future usage or to engender relevant benefits to the population.

The resort to indebtedness already indicated the exhaustion of investment capacity due to the loss of dynamism of the ICMS and the shrinking base of constitutional transfers, but in some cases indebtedness was also used as an opportunity to give room to the concession of wage increases and other costing expenses.

The outbreak of the crisis unveiled the extension of the problem. Conflicts have multiplied, and interstate inequalities have taken on different colors, making it harder to reach an agreement about how to revert the process of progressive weakening of the states' position within the federation. Due to the impossibility of envisioning common interests, the independence of positions has been replaced with submission.

Municipalities were not immune to the problems engendered by the recession, but the problems they face are more diverse, and it is difficult to envision a single variable to identify common interests given the impact of the demographic and economic dynamics on the demands of the population and the lack of proper resource allocation to their respective responsibilities. With the concentration of the population and social problems in microregions and the lack of mechanisms capable of promoting intergovernmental cooperation in the provision of public services, the conditions for an effective management of said services have been seriously affected,

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which is reflected in the growing dissatisfaction of the population over what is received as the counterpart of the heavy taxes weighing upon their shoulders.

The moment no longer calls for topical and emergency measures to deal with the crisis in our federation. The moment requires a vital discussion on the need and importance of a fiscal federalism reform to contribute to the stability and strengthening of the federation, giving back to the Brazilian State the capacity to act in favor of the resumption of economic growth alongside the continuation of social progress.

This article explores the reasons for this reform and suggests the necessary steps to leave the “March of Folly” behind.<sup>2</sup>

## 2 WHAT IS NEW IN BRAZILIAN FEDERALISM?

The major novelty is the unusual degree of centralization of power in a democracy. Throughout history, Brazilian federalism has been characterized by alternating periods, associating centralization to authoritarian regimes and decentralization to the return of democracy (Rezende, 2016). This is the first time this association has been disrupted.

The reasons for this fact are those that have also contributed to the imbalances in budgetary priorities and the deterioration of the tax regime:<sup>3</sup> the planting of a seed, in 1998, within the tax arena to shelter holders of social security benefits, the provision of health services, and access to welfare programs.

The planting of this exotic species is the result of an important initiative geared at encompassing a substantial portion of the new agenda assigned to the Brazilian State by the Constitution and drawn up during the early stages of the country’s redemocratization. Termed as an exclusive financing regime for social security, a designation that universalized access to the same benefits provided by the former INPS and granted at the time only to formally-employed workers, the growth of this new tax species collided with the objective of strengthening the federation, advocated by the constituent parliamentarians, broadened the sources of conflict between federated members, and gave many colors to the map displaying their disparities.

In this new agenda, the priority assigned to measures promoting social convergence was accompanied by the abandonment of past policies to promote regional convergence, thus contributing to consolidate the chasm that chains the

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2. This is the title of an important work by the North-American historian Barbara Tuchman, who used it to comment on important wars in the history of mankind that did not always have an original motivation based upon national interest. I have used this work in a seminar about ICMS in order to speak of the folly that has been prevailing in the unsuccessful attempts at finding solutions to the federative conflict (Rezende, 2015a).

3. The other side of the fiscal imbalances. Is the new fiscal regime capable of increasing its visibility? Will the new fiscal regime be able to keep tracking the same thread and contribute to put an end to the tax chaos? Both authored by Fernando Rezende.

pursuit of solutions for federative conflicts to the age-old dispute between the states of the North, Northeast, and Midwest regions and the states that form the South and Southeast regions.

Left to their own devices, the Brazilian states got into a dispute for investments, which increased conflicts and contributed to the escalation of a fiscal war. The outbreak and the broadening of this war were occasioned by mistakes made by the states upon the elaboration process of the new constitutional text. Repeating the events of prior democratic restorations after the end of authoritarian cycles, the states assembled to approve changes targeting the decentralization of tax revenues through an agreement settled upon the increase of the main state tax basis – the former ICM – and the increase of the revenue quota of the main federal taxes shared with the states, which comprised a menu that served the interests of more developed states as well as others.

What seemed acceptable at the time soon proved a full-scale mistake. The increased base incidence of the state tax, along with its incorporation of former single taxes on fuels, electricity, and telecommunications, with a high fiscal productivity, provided the ammunition needed by non-industrialized states in order to grant generous ICMS benefits, thus attracting investments and rallying political support from their respective populations without compromising their budgets, which were being fueled by the revenues provided by the increase in the tax base.

The search for measures that would put an end to these conflicts collided with other issues neglected by the constituent assembly. Although in clear opposition to the applicable law at the time, which defined an unanimous approval of these benefits by CONFAZ, the suspension of the effectiveness of the penalties prescribed by this law, based upon further decisions incorporated into the constitutional text, has safeguarded the continuity of this practice despite resorting to the judiciary and recurring demonstrations of unconstitutionality issued by the Supreme Court.

The broadening of imbalances in the political representation of the states within the National Congress, initiated by the end of the 1970s with the slow transition to democracy and expanded with the constituent assembly, was also fundamental to underpin the federative dispute. After the creation of new states in the North and Midwest regions, the number of representatives in less developed regions in the Federal Senate gave them a comfortable majority in that House, whereas the lower and upper limits for the number of representatives within the lower house does not assure quorum for the approval of the laws needed to impose a new legal milestone capable of restraining this war.

Divided, the states abandoned any attempt to discuss an agenda grounded on solutions for general problems. Focused on social convergence, the enactment of the new Brazilian State agenda was centralized on the federal government, which concentrated financial resources for financing social policies and imposed, through

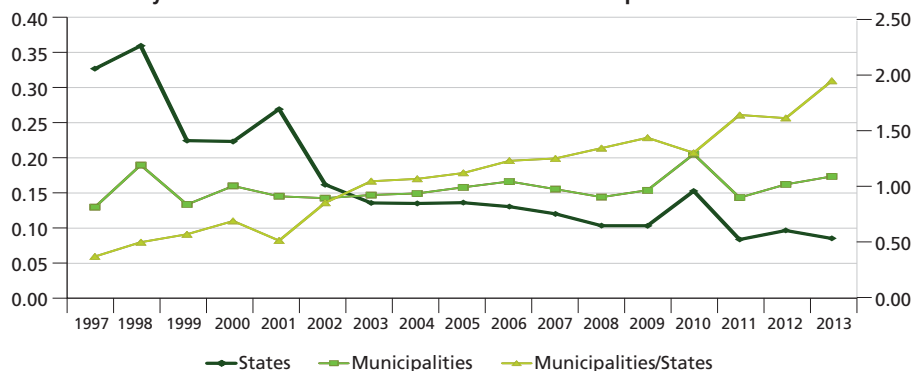
regulation, uniform patterns for the provision of education, health, public safety, and urban services at the same time it expanded the direct cash transfer programs to poor families.

The concentration of power benefited also from the new political status granted to municipalities in the 1988 constitutional reform. Now promoted to the condition of members of the federation on equal terms with the states, the municipalities were now within the federal government's direct scope of action. With the transformation resulting from the demographic and socioeconomic changes of the population in the last decades, the bonds tying municipalities to the federal government were strengthened and deeply felt in the political arena.

As the states got weaker, municipalities sought support from the federal government when dealing with their own problems, combining initiatives to compensate the emptying of the constitutional funds baseline by increasing the shared percentage and improved access to budgetary transfers. In 2007, the percentage of the Income Tax and of the Tax on Manufactured Products incorporated to the FPM grew one percentage point, reaching 23.5%. From 2009, the solid growth of budgetary transfers to municipalities inverted the preexisting situation in such a way that the volume of resources relayed to municipalities was twice as large as the volume relayed to the states (figure 1).

FIGURE 1

**Voluntary transfers from the union to states and municipalities**



Source: Rezende (2016), based on data from Afonso (2013).

The consolidation of municipal autonomy, with the elevation of municipalities to the condition of members of the federation on equal terms with the states, aggregated new elements that helped expand regional inequalities and engender new conflicts within the municipal level.



The main one was the increased importance of municipal elections within the national context, a process that may be qualified as the municipalization of state politics. With the swift urbanization of the country and the concentration of the population in metropolitan areas and other urban agglomerations gathering an expressive portion of the GDP, population, and voters, the state representatives in Congress focused their electoral strategy in the microregions that outline the main cores of the national urban network, directing their attention in Brasilia toward activities leading to the benefit of these regions, in an attempt to consolidate their influence and ensure the support of the local population.

The result of this strategy is revealed in researches that tried to assess the perception of the Brazilian population on the importance of national ballots. In this research, the weight of centralization is revealed in the importance given to national elections and the power of the federal government, which is related to the people's perception that municipal elections are more important than state elections, and that the power of their rulers is also greater (Arretche and Schlegel, 2014).

The strength of the direct relationship of the federal government with the municipalities is reflected in the new profile of federative disparities, in which intraregional differences are followed by inter-municipal disparities bearing no relation to the traditional rivalry dividing states through an imaginary line separating the north of the country from the south. Curiously enough, the tax benefits granted by the states to attract investments through fiscal wars have contributed to reinforce this new pattern of spatial concentration, given that the encouraged investments are concentrated on the same spaces that reinforce the municipalization of state politics.

Even though municipalities distanced themselves from old regional rivalries this did not contribute to a new development policy to gain space within the national agenda, which could have created a path toward the reduction of federative conflicts. This is another element that accounts for the estrangement between state and municipal interests for a necessary plan of action to reduce conflicts and federal disparities.

As for the states, the image of the past overshadows the vision of the present and compromises the future. It is no longer possible to distinguish clearly the differences between states based on the old regional schisms, especially when it comes to the position of the Midwestern states, which benefited from the expansion of agribusiness activities.

As for the municipalities, the old separation into two groups based on population criteria no longer mirrors the diversity of situations, leading to questions as to which variable may identify similar situations, allowing to group municipalities according to common interests. Population size? The GDP of the municipalities?

The inhabitants' income? Their region? None of them or a combination of some? In a situation in which the disparities are multifarious, how to address the representation of the municipalities' collective interests on a national level? And how is this difficulty experienced by the two main organizations acting in this area?

Besides a few episodes of fiscal competition on the municipal level based on the granting of benefits on the Tax on Service (ISS in Portuguese), there is no clear evidence of generalized inter-municipal conflicts such as the ones on the state level. The most striking phenomenon is in the metropolitan context, especially due to problems related to the provision of services that go beyond the political limits of jurisdictions sharing the management of public policies demanded by the population inhabiting the same territory.

The dim perception of inter-municipal conflicts does not mean that they no longer exist, but rather that they are not exposed as clearly and openly as what happens in the states. The approximation to the federal government has encouraged the pursuit of individual solutions for different problems and the resort to collective actions only happens when it comes to negotiating measures that benefit everyone collectively, although in very different degrees, such as with the demands to increase the base of the Municipality Participation Fund (FPM in Portuguese) or legislative changes addressing the list of services taxed by the Tax on Service (ISS).

For different reasons, individualism has also prevailed when it comes to the states, where, as previously appointed, the conflicts are more intense and antagonisms feed on long-lasting disputes. Differently from what happens with municipalities, which may unite forces to address diverging interests in the tax arena, such as increases on the Municipality Participation Fund and expansion of the base for the Tax on Service, the states express diverging interests when it comes to the ICMS, as well as the FPE (criteria for the division), associated, in both cases, to the old regional dispute.

The preponderance of individualism and the pursuit of aid from the federal government to alleviate the precarious financial situation of the federation members reinforce centralization, stimulated by the federal government. Granting new loans to the states, thus infringing fiscal prudence rules, is a clear example of this. The same applies to the expansion of the so-called national public policies system, which transfers resources to states and municipalities for specific applications defined in agreements that last up to 5 years.<sup>4</sup>

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4. For further details about the topics highlighted in this section, see Rezende (2016).

In line with the terminology adopted by Konrad Hesse for the German federation situation, the Brazilian federation would also be defined as a *Unitarian Federal State*.<sup>5</sup>

### 3 THE NEW STATE CRISIS – WHAT EXPLAINS IT?

The crisis faced by the Brazilian states in 2016 should not have come as a surprise. The economic recession merely unveiled a problem concealed behind emergency measures that had no way of changing the fragile framework already visible a few years ago. The problems are structural, and will not be solved without a debate aimed at rebuilding of a new model of fiscal federalism.

A central problem is the lack of perspective for the ICMS. The issue was the object of an important seminar promoted by the Association of Tax Auditors of the State of São Paulo (AFRESP), in the city of Guarujá, in September 2015. The seminar's theme, "ICMS and the Future of the States", settled the tone for the debates, which gathered representatives from the state tax authorities as well as specialists.

In this event, which took place right after intense negotiations hoped for an agreement on longstanding recommendations to end the fiscal war – a transition to charging taxes upon the destination of sales and validation of previously granted benefits –, new frustrations reinforced the argument that resuming this route would not lead to a safe harbor.

For about two decades, Brazilian states have insisted on resuming the March of Folly. In spite of repeated failures, every time the topic of a tax reform is mentioned and the federal government announces its intention to support changes to the ICMS, the states become involved in endless debates to reach an agreement contingent on the federal government's real intention to pay the bill for the compensations required, and the states try to find means to avoid social problems stemming from the impossibility of fulfilling the benefits it has granted.<sup>6</sup>

Upon every frustration grows the feeling that an understanding is impossible to reach, which creates an environment favorable to the escalation of folly. The states' schism grows stronger and each one pursues isolated and specific solutions for their problems, maintaining the states in continuous dependence of extraordinary revenues, access to credit, and the Union's financial aid.

A new strategy is urgent. The crisis of the states cannot be reduced to the loss of dynamism of the ICMS, which faces a decreased participation of the industry in the GDP, the erosion of the bases sustaining the three pillars

5. *El Estado Federal Unitario*, 1962, translated from German to Spanish by Miguel Azpitarte.

6. The agreement does not depend only on financial refunds, but rather also on conditions to avoid that companies settled in other states on account of the advantages they could obtain should close doors and go back to where they were, or else to another country.

of tax revenue – telecommunications, energy, and fuels – caused by the new technologies and the outflow of these inputs to other countries due to their high cost, as well as a reduction in the value added by important sectors of the productive activity resulting from the loss of competitiveness. Not to mention the non-application of this tax to the provision of services.

The crisis is broader and is the result of the impact of the duality of tax regimes adopted in 1998, which created an exclusive financing regime for the universalization of access to benefits provided by the former INPS – social security, health, and assistance – until then restricted to formally-employed workers.

The effects of this tax regime to the states are known, especially to states more dependent on resources originating from the constitutional funds – FPE – because of resorting to social contributions to sustain fiscal adjustment and the subsequent emptying of the fund base.

Running against the deceleration of revenue growth, expenditures have increased at a stronger pace, rebounding the cascading effect of readjustments granted to federal civil servants across all powers, including inactive ones, the increased responsibilities in the field of social policies, the commitment to the debt burden, and the adherence to constitutional bounds. The combined results of these effects manifest themselves in the states' incapacity to address societal pressures for better living conditions in the cities, aggravated by the problems of urbanization and population concentration in metropolitan areas and other urban agglomerations. The public security crisis and the deterioration of health services (the sector resources also suffer from the loss of revenue dynamism) face the same aforementioned problems and occupy the leading positions on the list of problems that most afflict the population.

Greater responsibilities with fewer resources worried governors and stiffened the dependence from the federal government. The drop in constitutional transfers gave way to the expansion of budget transfers processed through agreements to mitigate problems, which gained momentum while the economy still gave some relief to the federal budget, but began to show signs of collapse from 2012.

While the issue of renegotiating the parameters applied to the renegotiation of debts with the federal government, which took place in the mid-1990s, has been the center of conversations for some time as well as the subject of a proposal prepared by a commission instituted by the then President of the Federal Senate, José Sarney,<sup>7</sup> the matter did not advance at that moment. This may have been because of the difficulty in finding a solution that would satisfy everyone due to the vast differences between large and small debtors, which now repeats itself as the subject returns to the table.

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7. The report with the proposals prepared by the Commission, established by Act No. 11 of 2012, by the President of the Federal Senate, was sent on October 1, 2012.

In the meantime, several expedients have been used to postpone dealing with the root of the problem, among them the sale of assets, the renegotiation of tax debts, and the securitization of receivables in a move that reveals an unfounded belief that the crisis of the states may be resolved if the economy returns to grow at reasonable rates.

The drama of the new crisis may raise awareness as to the huge reiterating mistake. As the situation now reaches a point where it becomes impossible to pay wages on time, and even the retention of bank transfers from consigned credit installments discounted from employees becomes part of the measures to address the problem, a different approach becomes mandatory.

The recent approval of an agreement by the National Council of State Finance Ministers (CONFAZ) to authorize a 10% reduction in the amount of tax and financial benefits granted by the states, yet another recent attempt to aid the states with the crisis, seems like a roadmap for a surrealistic film. The granted benefits are the object of several unconstitutionality complaints and dependent upon the STF issuing a binding docket that leaves all its beneficiaries in abeyance. The agreement is currently under fire for being an unconstitutional measure, an unusual situation in which one evokes the unconstitutionality of a measure that attempts to change the subject of an unconstitutionality complaint.<sup>8</sup>

The elaboration of a new strategy for the federative crisis must take into account the new scenario fashioned over the years, which now presents very different traits from those that inspired the changes introduced in 1988 and the subsequent minor modifications.

Conflicts and disparities gained new colors, merging the effects of the population's demographic and socioeconomic dynamics with changes in the economy and the political structure, thus demanding that we broaden our understanding of the problem to define the direction of the reforms. The longstanding conflict that divided the Brazilian states into two groups by an imaginary line separating north from south no longer explains modern disparities, although the focus of the debates on particular changes in the ICMS further promotes this distinction and conceals the multifaceted nature of regional disparities, which has since been publicized by scholars on the subject.<sup>9</sup>

Within this new scenario, economic and political changes contribute alongside to strengthen the municipal power. On the one hand we have the economic and population concentration in regional poles, which benefited from the fiscal

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8. Agreement 42 of the CONFAZ authorizes the creation of a tax balance fund with the values derived from the reduction of benefits.

9. The theme was the subject of a seminar organized by the Ministry of National Integration in March 2013, in Brasília, in partnership with international and national organizations.

war itself as well as from the investment policy of constitutional funds to allocate investment resources in the North, Northeast, and Midwest; and, on the other hand, we have electoral concentration reinforcing the ties of state representatives in Congress to their municipal bases, contributing to reduce the influence of the states in national politics (Rezende, 2016, chapter 4).

The March of Folly thrusts the states downhill and leaves scars that show the decrease of the states' participation in the national tax burden; the loss of decision-making power regarding their budgets; the blockage of the legislative power by the multiplication of federal norms that regulate the exercise of concurring responsibilities; and the intensification of conflicts that obscure the perception of the states' collective interests and hinder the construction of a federative agenda.

We must stop the March of Folly and introduce rationality in the federative debate to recover the importance of states in the federation. To this end, we must:

- concentrate the initial efforts in understanding principles, concepts, and practices, to design alternative paths to retake the March;
- defend the importance of reopening negotiations on the necessary changes to correct the federative disparities, preceded by an agreement on a new proposal for a National Regional Development Policy; and
- explore the lessons learned by the modernization of tax administration to improve the quality of taxation and the federative balance, taking into account the challenges brought by the new digital economy when redesigning the tax system.

Contrary to what it might seem, the promotion of the municipalities to the status of a federated entity did not contribute to the expansion of municipal power, but rather the role they played in the recentralization of power, with the expansion of their direct relationship with the federal government and its subsequent repercussion in national politics, the subject of our next section.

#### **4 THE MUNICIPAL QUESTION? WHAT CHANGED WITH THE NEW STATUS OF MUNICIPALITIES WITHIN BRAZILIAN FEDERALISM?**

Even though the new status of federate entities acquired by the municipalities in 1988 was criticized for being a unique case in the realm of federations, we should bear in mind that the issue of municipal autonomy has deep historical roots, dating back to colonial times and to the model adopted in Portugal with a centralized regime and strong local support.

This particularity was addressed by Krell (1995) when he investigated the origins of Brazilian Municipalism underlining its differences from the German case. Based on previous analyses by Brazilian scholars, he argues that, unlike Europe, the

basis for Brazilian municipalities was not the city, but rural property. The vastness of the territory and the communication difficulties contributed to provide them with real political power, which drove Emperor Pedro I to demand that municipal councils should solemnly approve the 1824 Constitution to grant it further legitimacy. The acknowledgement of its importance contributed to preserve the municipal organization formed during the colonial period in the new Constitution.

The situation changed with the proclamation of the Republic and the adoption of the federative regime, but municipal autonomy was not ignored. The 1891 Constitution, in article 68, thus addressed the matter: “the states shall organize themselves in such a way as to ensure the autonomy of the municipalities in all their peculiar interests”.

With the exception of some minor changes, this legal resolution was not substantially altered in the subsequent constitutions, despite the difficulty in finding a practical meaning to this expression, including the enormous heterogeneity of Brazilian municipalities.

Notwithstanding the difficulty to translate the meaning behind the expression “peculiar interests”, the reiteration of municipal autonomy reinforced the demand by Brazilian municipalities for financial autonomy and stirred the Municipalists movement.

The starting point of the strengthening of financial autonomy may be traced back to the 1934 Constitution, which, together with the universalization of direct elections for mayors, expanded the municipal tax jurisdictions and gave them autonomy to dispose freely of their revenues. In 1946, financial autonomy was reinforced by the expansion of its taxing power and the institution of its participation in federal and state revenues.<sup>10</sup>

It is no coincidence that the year 1946 also witnesses the creation of the Brazilian Association of Municipalities – ABM, which according to an important study on the history of Brazilian Municipalism (Municipality, the stage of life, CNM, 2012) mentions the association as a crucial milestone in the efforts to organize politically the representation of municipal interests in line with the spirit of the new Constitution promulgated that same year.

From the outset, however, the ABM struggled to reconcile the interests of those who wished to maintain its technical nature, steered by political neutrality, and those who advocated the opposite as they believed that the Municipalist campaign demanded political force to be effective (Fontes, 2003).

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10. The tax on industries and professions became the responsibility of the municipalities, which also acquired jurisdiction to institute a stamp tax. Municipalities also began to receive 10% of the Income Tax and 12% of single taxes on fuels, minerals, and electric energy charged by the federal government. The states had to deliver 30% of the excess to the municipalities, over the municipal collection, the state collection, excluding the levy coming from the taxation of exports in the respective territories. For further details, see Brasileiro, 1973 and Varsano, 1997.



The need to reconcile these two positions eventually led to the creation of IBAM, in 1952, during the II Congress of Municipalities, organized by ABM in the city of São Vicente, in the State of São Paulo. The creation of IBAM hoped to improve the municipal administration by providing technical assistance to local governments and organizing training programs for the technical and administrative staff of the municipal executive and legislative branches. Thus, its goal was to promote studies and research on themes related to the responsibilities of municipalities as well as to establish partnerships with international institutions devoted to the same purpose.

Since the beginning of its activities, IBAM established solid ties with the Getúlio Vargas Foundation. In 1954, Luiz Simões Lopes, then president of FGV, was elected to the board of directors of the institute as well as its presidency. At the other end was the Brazilian School of Public Administration (EBAP), which became involved in IBAM's activities by providing technical support and participation in training programs for municipal employees.

In the activities report for the biennium 1958-1959, the IBAM Executive Director, Cleantho de Paiva Leite, emphasized the institute's status as a technical organization at the service of the municipal administration, establishing contacts with international organizations for partnerships, agreements with the federal government, and considerably increasing relations with municipalities as well as the publication of the magazine *Municipal News*.

One interesting fact mentioned by the director was the production of a film by the United States Embassy's film service, titled *New Mentality*, which underlines IBAM's contribution to the improvement of the cities' administrative practices and the formation of a new mentality in municipal administrations.<sup>11</sup> The evolution of the Institute's activities reflects the expansion of its budget. According to IBAM's 1960 and 1965 reports, in 1958, from a total of 5.6 million cruzeiros, the federal government subsidy represented circa 50%. Six years later, the budget was at 112 billion cruzeiros, whereas the whole amount came from activities performed by the institute.

The Municipalist movement showed its power in the debates and in the subsequent processing of the tax reform proposal drafted by the Reform Commission of the Ministry of Finance set up at FGV in 1963. The commission's original proposal predicted the replacement of the old municipal tax on industry and professions for the tax on services of any nature – the current ISS – in addition to providing the municipalities with 15% of the revenue from the new state tax – the ICM. In the

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11. The film was an initiative by Ponto IV and the production was assigned to Jean Manzon Filmes S / A, and screened with significant success in cinemas across the country. The São Paulo Cinemateca shows record of this film in its collection.



final version, the municipalities gained jurisdiction to apply a rate not exceeding 20% over the state tax base in operations within the municipal territory, replacing their grossing of 15% of the ICM's revenue. They also guaranteed the sharing of the fund, distributing 20% of federal tax revenue to states and municipalities into two, withholding half that percentage (Rezende, 2012).

The reform implemented in 1965 took a step forward in the financial autonomy of municipalities, with the expansion of tax and transfer jurisdictions, through the adoption of the ISS, the creation of the FPM, and the 20% allotment to municipalities of the new state tax – the ICM. The combination of sharing the ICM tax revenues and the creation of the FPM sought to balance the interests of larger municipalities, which concentrated the incidence base of the state tax, and the smaller municipalities, which benefited from the allocation criterion of the FPM, a measure resembling a tax equalization regime.<sup>12</sup>

The expansion and consolidation of the IBAM occupied a technical space, which became an important incentive for the creation of the Brazilian Association of Municipalities, but the representation of municipal interests in the political arena endured the limitations faced by the ABM to act politically due of its dependence on the federal government, further intensified during the military regime (CNM, 2012).

The dissatisfaction of the municipal association leaderships in the states with this circumstance motivated the creation of the National Confederation of Municipalities (CNM), in 1980, which played an important role during the Constituent Assembly for advocating the ideals of municipal autonomy.

However, in spite of the changes in the municipal geography, which in the late 1980s already seemed very different from the 1970s, the changes adopted in the 1988 Constitution did not take into account the need to review the FPM allocation into two funds – one reserved to capital municipalities and one accredited to others, named hinterland municipalities.<sup>13</sup> At the same time, in an attempt to address the concentration of the ICMS base in cities concentrating industrial activity, the 1988 Constitution accredited to a state law the jurisdiction to define the criteria for allocating one fourth of the 25% tax revenue shared with the municipalities in each state. These changes gave rise to an expansion of inter-municipal disparities, which gradually expanded as urbanization concentrated the population in metropolitan regions and major urban agglomerations, leading to the formation of a new political grouping under the name National Mayors Front (FNP).

12. At least until the abandonment of the principles that steered to the reform implemented in 1965 and the impact of the swift and profound changes in the Brazilian demography over the course of the second half of the XX century.

13. The 1991 census already showed that 35% of the Brazilian population was concentrated in municipalities with over 250,000 inhabitants. In the 1970 census this percentage was 21%.

The year of 1999 marked the birth of the FNP, which consolidated a group that had been meeting informally to defend common interests. Circa 240 municipalities are part of this Front, including all 26 capitals and over 100 medium and small-sized cities. The emphasis on the financial dimension explains the diversity of the group and the main criterion that binds its members together: the composition of their revenues. Small municipalities with a strong economic base, generally located in the main metropolitan regions, are not largely dependent on the FPM, which differentiates them from other municipalities with the same population size when it comes to municipal budgets.

The main reason for the increase of inter-municipal disparities regarding budget size was the disparity revealed when comparing the political autonomy attained by the municipalities in 1988 with the decision to distribute the FPM in two stages: the first distributes the national total per state and the second distributes the state quota of this fund based on the criteria of the current legislation. Added to this was the state law now accredited for defining the criteria applied when allocating the fourth part of the ICMS to the municipalities.

Politically speaking, the municipalities left the states' orbit, but financially they continued to revolve around it. Regardless of the motivations for adopting these rules, the consequence was the proliferation of several situations due to changes in the demography and the economy, in a period in which the rules remained unchanged and the overlapping effects of the adopted criteria engendered preposterous situations. With the enormous changes in population distribution among states, the concentration of economic activity and population in some microregions, and further leeway for the creation of new municipalities, the increase of municipal diversity comes as no surprise.

The focus on revenue has left aside the issue of responsibilities. The creation of the G-100 serves as an example of the problems arising from the disconnection of factors contributing to revenue distribution, from factor that explain the amount of responsibilities that befall on certain groupings of municipalities. The G-100 brings together one hundred municipalities with large populations located in metropolitan areas away from major centers, or in pole cities in depressed regions, which stand out in the FNP group as they show low per capita budget revenue and contain populations with high socioeconomic vulnerability.

While certainly not an isolated case, it is for now the only known experience. The group is defined by the contrast between the size of their responsibilities and their budgets, but the explanation for the lack of adherence to resource responsibilities results from the sum of factors explaining their revenues. What unites this group results from two contradictory situations: similar responsibilities, under a national scope, with similar resources under a state scope. This difference cannot be solved by never-ending patches in the existing rules. What we need is to promote a sweeping review of Brazilian fiscal federalism (Rezende, 2015b).

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## FISCAL COMPETITION: DECENTRALIZATION<sup>1</sup>

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### 1 INTRODUCTION

Federalism may be defined as a system in which a central government and several decentralized (to a certain degree, autonomous) units cooperate, to some extent, in order to achieve common goals. Fiscal competition occurs in a situation where each federated unit decides independently on a tax or expenditure policy. It does not prevent concomitant cooperation in other fiscal and non-fiscal policies.

This is a more general definition to fiscal competition because it encompasses not only countries that are formally organized as federal constitutions, but also those whose public services and taxation are decentralized, as well as sovereign units that constitute an economic union. Furthermore, it indicates that fiscal competition is an event related to one extreme of the chain of possible combinations, specifically the hypothesis in which autonomy is completely exerted and there is no perfect coordination between units.

Competition between jurisdictions may be passive, meaning that independent actions are not intended to influence the conditions faced by the unit or other jurisdictions; or active, in the sense that taxation or expenditure is deliberately applied as an instrument to achieve a certain goal. Fiscal competition may be horizontal, when it involves governments that are at the same level; and vertical, when higher and lower levels of government are competitors. In all cases, one cannot predict whether competition will increase welfare or be detrimental to it.

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1. This text reproduces, with few changes and updates, work originally presented at the International Conference on Federalism 2002, organized by Forum of Federations, initially published in 2002 and later divulged by Ipea in January 2015, under the title "Fiscal Competition: a Bird's Eye View" (available at <<https://goo.gl/a4cY95>>), also published in the Brazilian Journal of Political Economy, in 2005, under the title "Inter-jurisdictional fiscal competition: a review of the literature and policy recommendations".

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This is the main issue addressed by the traditional literature on fiscal competition, as in the cases of articles by Tiebout (1956) and Oates (1972). There is no simple answer to such a complex question. It depends on several aspects, such as: the goals of the competing governments; what they are competing for; how they compete; the behavior of economic agents, especially their mobility in response to fiscal stimuli; and the characteristics of the economic environment, in particular the possibility of interjurisdictional externalities stemming from governmental actions.

Drawing from the old and immense literature on fiscal competition, this article seeks to establish the basis for tracing typologies and some assessments and results that might help organize a debate on the subject. Therefore, the next section deals with the objects and instruments of fiscal competition. Section 3 gathers some empirical evidence of the existence of fiscal competition and the response of economic agents to interjurisdictional differences in taxes and benefits that come from public expenditures. Section 4 focuses on the main tools that may be used to avoid or neutralize possible harmful effects of fiscal competition. Section 5 summarizes the arguments presented in this paper.

## 2 NATURE AND OBJECT OF COMPETITION

The traditional fiscal federalism theory discusses the attribution of the public sector's economic functions – allocation, distribution and stabilization – to different levels of government. The overall conclusion is that central governments should be responsible for macroeconomic stabilization and income redistribution, as well as the provision of public goods on a national level – i.e. those [goods] whose benefit area covers the entire country (or the entire economic union).<sup>5</sup> The economic issue concerning decentralized governments lies in the requirement for public goods whose benefits are restricted to a specific area or a subset of specific population (local public goods).

Local public goods financing in federations derives mainly from three sources: locally levied taxes, intergovernmental transfers and debt. Transfers are, by their very nature, cooperation instruments that may be useful, when properly assigned, to several different purposes in a federation. On the other hand, decentralized taxation – unless there is some level of harmonization – is independently exerted and might distort resource allocation when economic agents are mobile. In order to avoid distortions, the theory recommends that only user fees should be applied to potentially mobile tax bases. But in the real world, such fees are not the rule (because most public goods do not have a well-defined recipient; because revenue

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5. Typically, decentralized units do not possess monetary policy instruments and, if they are highly open, they are unable to influence macroeconomic conditions using fiscal devices. Income redistribution policies, on the other hand, are limited by the mobility of economic agents. Higher income niches would tend to abandon a jurisdiction and the arrival of poor families would be stimulated if a policy of "taxing the rich and benefiting the poor" was locally applied. Nonetheless, decentralized government units often perform functions, financed by the rich or by all, whose benefits are mainly collected by the poor; and local programs that offer cash or in-kind relief to the poor are not uncommon.

collection from user fees is potentially low, and because taxes are not only destined to finance public goods), and general taxation is often used as an instrument for active governmental competition.

According to this object, fiscal competition may be divided into three categories. In the first, decentralized units compete to provide a set of public goods and services, trying to improve their quality, reduce their costs and adjust provision in order to meet the residents' preferences. In the second, they compete for funds, in order to finance public goods provision at the lowest possible tax price for residents. And in the third, competition may have investment attraction as its object, in order to increase production, employment and income rates within the jurisdiction.

### 2.1 Competition with public goods

Competition in public goods provision is the subject of the original Tiebout model (Tiebout, 1956) as well as of newer and richer models (Oates and Schwab, 1988), which conclude, according to a set of strong premises, that this kind of competition increases efficiency. In short, a non-coordinated decision-making would result in the provision of a variety of fiscal packages (a set of public goods added to a tax price) so that mobile individuals (or companies) may have their preferred package by choosing, as residence, the locality in which it is provided ("foot voting"). It is also said that competition promotes innovation in public goods provision and diffusion and, by means of *comparison* with governments of other jurisdictions, minimizes organizational costs in the public sector and reinforces responsibility.

Shah (2001), among others, reports that in Chile and Canada, school financing mechanisms encourage informal comparison by citizens in order to guide their choice between schools.

Models that relax the strong premises mentioned in the previous paragraph illustrate the reverse of the coin. For example, the models that employ game theory relax the premise that there is no strategic interaction in response to neighboring jurisdiction policies, and they obtain effects that involve suboptimal levels of public spending (Wildasin, 1988).

When there is strategic behavior, competition may stimulate the underprovision of merit goods and social policies. The case of Brazilian healthcare is a good example. Municipalities directly execute a large portion of national public health expenditures, financed in part by earmarked federal block transfers and by their own revenues. People frequently commute between cities and, as eligibility for public health services is not contingent upon residence, municipalities that provide higher quality services are likely to attract clients from neighboring cities – often transported

in ambulances and other official vehicles from the municipality of origin.<sup>6</sup> The overall result is the underprovision of public health services in the metropolitan area.

Another interesting example is provided by the United States welfare system. A reform occurred in 1996 decentralized their welfare policy. Each state now possesses a great level of autonomy to decide on the manner and degree of its assistance to the poor. However, if a state decides to increase its welfare benefits, it risks attracting poor people from other places; such immigration increases state expenditures with social assistance, but not the inflow of tax revenues. In order to avoid becoming a “welfare magnet” – and thereby increasing the tax burden on state residents who find themselves in a better financial situation – each state tends to reduce the value of granted benefits. As Brueckner (1999) points out, “as the concern with assistance-based migration reduces benefits in each state, no state can send away the poor while keeping their benefits low, and each of them ends up being less generous than it would if there was no migration”. This reasoning points to a negative bias in relation to the value of welfare benefits according to current institutional arrangements.

Oates (1999) acknowledges the failings of decentralized systems of assistance to the poor, but argues that a decision was taken to accept such bias as a price to be paid for the possibility of abandoning unsatisfactory federal assistance programs and seeking alternatives in superior, locally formulated policies. He states, “In a scenario of imperfect information, of the learn-by-doing kind, there are potential gains in experimenting with a variety of policies in order to address social and economic problems. And a federal system can offer some real opportunities to stimulate this experiment and thereby promote ‘technical progress’ in public policies”. He calls policy experimentation in decentralized units “laboratory federalism”.

## 2.2 Competition for funds

The second category of fiscal competition – competition for funds, in order to finance public goods provision to residents at the lowest possible tax price – includes policies intended to expand tax (or revenue) bases, as well as disputes over zero-cost or low-cost funds, [which are] usually scarce, provided by a higher level of government.

When personal income tax is attributed to subnational governments, such units can attract the wealthy from other jurisdictions by reducing tax rates or providing a package of public goods that are suited to their needs. As pure (or near pure) public goods are provided – and, therefore, additional consumers do not represent an increase in the total cost of production – newcomers reduce the tax bill for other residents.

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6. Ferreira (2002) found that municipalities near the city of Rio de Janeiro spend less than expected on public health services, both in per capita terms and as a percentage of their respective tax revenues. In turn, the Rio de Janeiro City Hall, acting in accordance with the principles of maximizing welfare to its residents, does not seem to take into account the positive externalities, generated by its expenditures, on residents of neighboring municipalities.



Such a “beggar-thy-neighbor” policy, if successful, would result in higher tax prices for public goods in other localities, and, therefore, in their underprovision. It could also weaken the power of income redistribution policies. On the other hand, tax-induced mobility might result in a more homogeneous population in each jurisdiction and lead to a closer balance between provision and demand of local public goods.

Switzerland offers the best conditions for an empirical assessment of these points. Although there is a small federal income tax, cantons possess the basic powers to tax income and wealth, while local jurisdictions levy taxes on real estate and a surcharge on direct cantonal taxes. Public expenditures are very decentralized and social assistance is an attribution of local and cantonal governments only.<sup>7</sup>

Feld and Kirchgässner (2000) focused their work on the question of whether there is fiscal competition and what its effects are. They conclude that in Switzerland, there is competition both between cantons and between cities; that taxes are more important instruments than social transfers; and that competition in taxation is stronger at the local level rather than the cantonal one. The choice of place of residence by people who earn high incomes depends on the amount of income tax they are supposed to pay. Self-employed people are more responsive to tax stimuli than dependent employees and retirees. As for the latter group, public service provision plays a more important role than taxation in decisions concerning residence. Feld and Kirchgässner could not find any evidence that population homogenization resulted in any improvement in efficiency. Fiscal competition, on the other hand, did not negatively affect decentralized income redistribution.

When origin-based taxes are levied on goods, a jurisdiction can attract consumers, rather than residents, by setting their tax rate below that of neighboring units. In this case, residents of higher-taxed areas may escape taxation by incurring the cost of the transportation needed to acquire that specific good in the lower-taxed jurisdiction. They will do it whenever the tax differential exceeds the extra cost incurred. There is evidence that this occurs in New York City, for example, where residents shop in Newark (the neighbouring city, located in the state of New Jersey), where sales tax is lower.

Although cross-border trade and distance selling have always been a problem for tax planners, the recent expansion of electronic commerce made the need for a solution more pressing. One solution to that is the adoption of consumption-based taxation on *consumer goods*. In that case, cross-border shopping and e-commerce would compete on equal terms with local retailers. Nonetheless, schemes based on the principle of consumption are difficult to implement administratively.<sup>8</sup>

7. It must be noted, though, that welfare spending constitutes a small fraction of the overall spending.

8. On these projected schemes, see Poddar (1999); Varsano (2000); Bird and Gendron (2000); McLure (2000); and Keen (2000).

When taxes on sales, capital income or goods are in force in decentralized governmental units, depending on the economic conditions, tax exportation may occur. Taxes on income and goods may be exported to non-resident owners of local companies and assets. General business taxes (which include taxes on sales, profits or value-added taxes) may be diverted, by means of increasing local production prices, to residents of other jurisdictions that consume the goods. Tax diversion is more likely when a given location produces a highly specialized good, such as natural resources or tourist attractions. When tax exporting occurs, residents of a specific area do not bear with the total cost of the public goods provided by the local government. This may lead to an inefficient overprovision of such goods.<sup>9</sup>

Vertical fiscal competition may provide additional revenue to a subnational government, with no extra costs to its citizens, whenever central and decentralized units levy a tax on the same tax base and the lower level tax can be credited against the federal tax obligation. If the compensation takes the form of a deduction from the federal tax base, there will be some increase in the total tax charge to the taxpayer. This may result in a decrease in the tax base available to both units, amplifying the loss of revenue of the central government and reducing gains for the decentralized unit.

As reported in Wilson (1999), the negative consequence imposed by the subnational unit – reduction of the tax base – does not necessarily mean that, in the new balance, taxes are excessively high in an inefficient way. Under certain conditions, the federal government may use its policy instruments to partially compensate inefficiencies at the subnational level or even, in some cases, to obtain an effective balance.

Another way to reduce payments by residents in relation to public services is to compete for access to low-cost or zero-cost funds granted by higher levels of government. Shah (2001) notes that such funds are often allocated to programs with vaguely described objectives and a lack of focus on service delivery and responsibility toward residents. This may give rise to pork-barrel policies (allocation of governmental funds for local improvements with electoral goals) and waste.<sup>10</sup>

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9. Brazilian municipalities provide an example of tax exporting being preceded by tax-base importing. These units impose an origin-based tax on services (ISS). The tax base is determined on the national level by means of a list of taxable services; and municipalities are autonomous to set the tax rate. Most units charge a rate of 5% or close; but some, which in normal conditions would hardly have any tax base, charge a lower rate, of 2% or less, in order to attract tax base. Note that, contrary to the type of fiscal competition to be considered later on, a lower tax rate does not attract investments or production to the unit's territory, but only the corporate tax residence. In order to qualify as a resident, all that a company needs, besides the nameplate, is a rented space with a chair, a desk, a telephone and an attendant, costs that may be shared with several other companies. After the tax base is imported, business continues to occur elsewhere; but the tax on services provided and consumed there is paid to the municipality where the company's "headquarters" is located.

10. Shah illustrates his arguments with examples from Pakistan, in which the prime minister would usually allocate a substantial portion of the available resources to his constituency of origin; and from South Africa, where provinces would strategically overspend on functions at the local level and then claim that they had no funds to perform functions, which they administer, at the national level, such as healthcare and education.

Naturally, it does not mean that intergovernmental transfers are undesirable. On the contrary, transfers between well-defined federation entities play important roles in federal systems, including that of counterbalancing possible ill effects of fiscal competition.

### 2.3 Competition for productive investments

Fiscal competition may aim to attract investments and increase production, employment and income rates within the jurisdiction. The instruments of this type of competition may be the tax structure, a mix of expenditures and regulatory policies, as well as fiscal incentives and public services provided to specific companies.

Fiscal competition by means of reducing business income tax has been one of the main fiscal issues in the European Union (EU) for several years now. Those who fear that fiscal competition might result in capital income taxes at unduly low levels call for a certain level of tax coordination. Another large group takes the opposite stance, i.e., that fiscal competition is Pareto-superior to the absence of competition and, therefore, business income tax should not be harmonized.

Zodrow (2001) provides an overview of what the economics literature has to say in support of each of these opposing stances. Zodrow begins with the basic model (Zodrow and Mieszkowsky, 1986) which, according to a set of premises, concludes that fiscal competition leads to an inefficiently low level of public services in all jurisdictions. Then, he examines a wide variety of extensions of the basic model that alter one or more of its premises. The results are varied: some identify potential gains, and others point to losses due to fiscal competition, and little is said about the magnitude of each of them. Combining these results with the noticeable reluctance of countries to give up their fiscal sovereignty and the fact that some countries would ultimately be losers due to tax harmonization, Zodrow therefore concludes that it is a sensitive case. He suggests that modest initiatives, such as the Code of Conduct on Business Taxation (European Commission, 1997), should be preferred over attempts to fully harmonize income tax.

However, the unbridled fiscal competition within the EU was analyzed under the lens of redistributive policies in the area (Sinn, 1994; Oates, 2001). Although redistribution should be preferably attributed to central governments, the European Community budget is too small to provide for such programs, and the idea is to keep it small in the future. Therefore, each member will have to support its own programs. The controversy is that the rise in factor mobility within the Union, in the absence of income tax coordination, will force countries to rely more acutely on tax benefits, which rules out redistribution programs, or to incur significant costs in terms of economic growth due to the taxation of mobile factors to finance such programs. Furthermore, since capital supply is in general more elastic in prices

than labor supply, and skilled labor is more mobile than the unskilled one, it is to be expected that a wage tax will fall more heavily on unskilled labor than on the skilled one, and that capital income taxation will be low, resulting in a more regressive tax system.

Another interesting issue addressed by Keen and Merchant (1997) concerns the composition rather than the level of public spending in a context of fiscal competition. They divide public spending into two categories, those that increase utility – public goods that complement private consumption, such as recreational facilities, or redistribution payments to some poorer groups – and those that improve production – public contributions, such as infrastructure or training in general. Since they assume that citizens are immobile and businesses are mobile, their conclusion is quite intuitive: in their own words, “fiscal competition results in too many trade centers and airports, but not enough parks or libraries”.

Was that the tendency observed in federal systems? And what is the impact of spending competition between countries in a world with growing capital mobility across borders? These are open questions. But Keen and Merchant’s findings (1997) suggest that there is a condition for coordination not only of mobile tax bases, but also of domestic public spending.

There may also be a condition for the coordination of regulatory policies. The aim of regulation is to correct market failures, such as externalities and monopoly power. But it may affect a jurisdiction’s competitiveness. Specifically, if profit-maximizing manufacturers take into account the costs of complying with local regulations, governments may use tax regulation to attract business to the unit’s territory. For example, there is a current in the literature on fiscal competition that considers the impact of environmental regulations on a business area (Levinson, 1996). In addition, a financial regulation project may be potentially used as an instrument to attract portfolio investments. As banking regulations are usually stipulated at the federal level, this competition in general occurs between sovereign governments.

Instead of reducing taxes in an attempt to attract business, decentralized governments may resort to the concession of fiscal incentives, subsidies and public input provisions to specific companies. These are typical instruments of regional development policies. When used in relation to decentralized industrial policies, they might result in destructive competition. The so-called fiscal war between Brazilian states may illustrate this aspect.

The practice of reducing value-added state taxes to attract investments has been illegal in Brazil since 1975, except in cases when the intended reduction is unanimously approved by the 26 states and the Federal District. Although still

in force, the complementary law was disregarded and fiscal competition between Brazilian states intensified and reached the richest units in the early 1990s – due to the dispute over the wave of new automotive factories that had been searching for a place to settle in the country since 1995.<sup>11</sup> Legislation from 2017/18 pardoned irregularities committed since then, but it tends to trigger a new wave of fiscal war – because it allowed for one state to “mimic” the benefit offered by another.<sup>12</sup>

From the point of view of any specific state, the granting of fiscal incentives to attract investment seems to be worthwhile. Unless the recipient prefers to settle their business within the state, even in the absence of the incentive, the value of tax revenue waived would not exist anyway. Also, apart from its direct impact on production and employment, the newly attracted companies induce additional economic activity, by creating even more jobs and income and, naturally, some tax revenue. If it stopped there, fiscal state incentives would be a valuable instrument for development. However, when other states repeat the successful experience of one of them, a destructive fiscal competition begins.

As the practice of granting incentives spreads, its effectiveness weakens. Once taxes are equally reduced in all localities, the fiscal benefit ultimately loses its power to induce production transfer. But revenue decreases in all states. When the process reaches this stage, companies consider only market and production conditions to choose their location.

Under pressure for higher spending and lower taxation, the financially weaker states, which are the least developed, become unable to provide the services and public works needed to attract new companies. In the final stages of a fiscal war, the most developed states win all the battles, and disparities – already very large in the Brazilian case – naturally tend to grow.

The costs of the fiscal war for the country are very high. A dissertation that analyzed three cases of vehicle factories settled in the country (Silva, 2001) concluded that, in two cases, the current value of the subsidy chain exceeds the sum of private investment. In addition, it does not seem to be a cost incurred to attract investments to the country. These factories would probably be located in Brazil, in the absence of tax exemption.<sup>13</sup> On the contrary, this is the cost of attracting investments to a specific location within the country that, if the incentive had actually been effective, would not be the recommended one according to considerations over effectiveness.

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11. See, among others, Mora and Varsano (2001), Nascimento (2008) and Afonso et al. (2014).

12. See, among others, Kotzias (2018).

13. A possible, though improbable alternative place – because Mercosul is the main market to provide for – would be Argentina. If this alternative had been really considered and dismissed due to incentives, it could not be said that the fiscal cost had been in vain. But the Brazilian state policy would be unduly imposing loss to its partner.

An implicit assumption in most of the previous discussion is that governments are benevolent, i.e., they act in the best interests of the jurisdiction's residents. The literature on public choice argues that a more realistic hypothesis is that public and political officials have their own objectives, acting in their own interest or serving the ends of powerful interest groups. In both cases, instead of maximizing welfare to the population, they seek to maximize the size of the government budget. In this case, fiscal competition counteracts the Leviathanic state tendency toward excessive expansion. In this context, the harmonization of fiscal policies would serve the interests of bureaucrats, securing monopoly power to keep government revenue higher than it otherwise would be.<sup>14</sup>

### 3 SOME EMPIRICAL EVIDENCE

Do companies and individuals – as recipients of social assistance programs, consumers of public and private goods or factor owners – respond to fiscal stimuli? That is an important question. A negative answer would mean that we should not expect benefits – or worry about costs – from fiscal competition. Although there is substantial theoretical material on how economic agents react to differences in taxes and expenditures in the various jurisdictions, there is not much empirical work concerning the elasticity of tax bases in relation to differences observed in the pattern of public expenditure or taxation.

One issue that is widely debated in the literature on competition over expenditures is whether there is welfare-induced migration, i.e., whether welfare recipients move from low-benefit to high-benefit jurisdictions. Considering the case of benefit-induced migration across U.S. states, six out of a sample of eight studies found evidence of migration, although two of them concluded that its magnitude is small.<sup>15</sup> In contrast, Walker (1994) and Levine and Zimmerman (1995) failed to detect any evidence of welfare-induced migration. Thus, evidences moderately support the hypothesis that there is migration, which may indicate that U.S. states stand in a non-cooperative balance, insufficiently providing shelter to their poor when compared to what would be the optimal result. However, the sensitivity of welfare-induced migration is not high. Meyer (1998), for instance, found that a \$1,000 raise in annual welfare benefits increases single-women migration to a given region by only 6 per cent over a five-year period.<sup>16</sup>

14. Some formal models of the Leviathan type are presented in Sinn (1992), Edwards and Keen (1996), Rauscher (1998) and Gordon and Wilson (2001).

15. Southwick, 1981; Blank, 1988; Peterson and Rom, 1988; Borjas, 1997; Enchautegui, 1997; Meyer, 1998.

16. Most of these studies are based on the AFDC (Aid to Families with Dependent Children), in which cash is given to the single mother. Meyer (1998), for instance, observes that single mothers migrate more rapidly in response to welfare benefits than single women with no children, who are not eligible to collect the benefit. This is an additional evidence of welfare-induced migration.

Instead of reducing the overall spending on welfare, states may protect themselves against the immigration of the poor by limiting access to public goods. This is usually done by limiting conditions for residence. It may be said that welfare spending becomes similar to a “club good,” since some people may be excluded from its consumption, although the marginal social benefit of such exclusion is close to zero. This measure reduces incentives for the poor to move, and consequently it should lead to higher rates of welfare-induced mobility when compared to a situation with no exclusion. Evidences of such restrictions are common in the history of the United States.<sup>17</sup> The existence of eligibility conditions may partially explain why empirical studies do not find greater effects of the differences in welfare benefits on the migration of the poor.

Instead of focusing on the responses to transfer differences due to social assistance, studies by Figlio, Kolpin and Reid (1997) and Saavedra (1998) directly test the existence of a strategic independence between different states.<sup>18</sup> They provide strong evidence that the welfare benefit level in neighbouring states affect the choice of benefit level adopted by a given state.

Back to fiscal competition, since there are not many federal systems in which subnational governments possess considerable freedom to set tax rates, the existing evidence concerns just a few countries.<sup>19</sup> Most literature does not test the existence of fiscal competition, but rather the sensitivity of a given tax base to the tax rate level.

There is a broad set of empirical studies that evaluate the impact of capital taxes on several different measurements of commercial activity. Most studies are focused on the United States, studying the impacts of different income tax rates in the various states and the different taxations on goods within a given state.

Table 1 summarizes the findings from a survey concerning the United States (Wasylenko, 1997). The table cells report the number of studies in which a measure of elasticity was estimated; the number of such studies in which tax elasticity was statistically significant (in parentheses); the scale of elasticity estimates (in brackets); and the medium elasticity.

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17. Brueckner (1999) notes that some states had imposed severe restrictions, denying any assistance benefit to poor migrants during a one-year waiting period. Such restrictions were nullified by the Supreme Court in 1969, but states reacted by establishing a “two-level” benefits scheme, in which the benefits collected by migrants during the waiting period were equal to the level of benefits of their state of origin”. The most notorious case was that of Wisconsin, that protected itself against migration from Illinois, traditionally a less generous state.

18. In the presence of fiscal competition, one must expect strategic complementarity between governments. For example, when a neighbor increases the capital tax rate, a given state (or country or municipality) will act in the same direction, and vice versa.

19. The OECD countries about which there is available data are the United States, Canada, Germany and Switzerland.

TABLE 1  
Summary of econometric results of fiscal effects on business location

Dependent variable	Interregional or interstate studies		Intra-regional studies
	Overall tax elasticity	Business tax elasticity	Property or business tax elasticity
Gathered data			
Total employment	6 studies (5) [-0.85, 0] -0.58	3 studies (2) [-0.16, 0] -0.11	4 studies (3) [-1.95, -0.81] -1.85
Manufacturing employment	13 studies (8) [-1.54, 0.05] -0.10	2 studies (1) [-0.26, 0]	1 study (1) -0.79
Investment in manufacturing	6 studies (3) [-1.02, 0.54] -0.60 ou 0	7 studies (6) [-0.36, -0.10] -0.20	
GDP, income or value added	12 studies (7) [-0.88, 0.27] -0.07	1 study (0) -0.14	
Microdata			
Factory – origins or location	3 studies (2) [-0.40, 0] -0.18	19 studies (15) [-15.7, 0.6] -0.20	5 studies (4) [-2.70, 0.62] -1.59

Elaborated by the author.

Estimates in Table 1 indicate what the percentage reduction in the dependent variable is when tax rate in a given location is 1% higher than in a nearby location. For example, the impact of a general business tax on local companies that is 1% higher in a given state, when compared to other states, means a 0.11% decrease in employment rates in that state (column 2, row 1). The main conclusions are:

Estimates of response to fiscal differentials vary widely. Intraregional differences in tax rates have a greater impact on a company's location than differences between states (or interregional). One surmises that, once chosen the locality (a set of regional attributes such as agglomeration, labor cost, market size, quality of education, transport infrastructure, etc.), the specific location (including neighborhood or surroundings) will be strongly determined by fiscal aspects.<sup>20</sup>

The wide range of estimates on elasticity has less to do with the type of activity being measured than with variations in data, time periods and other variables used in the estimating equation. In fact, results depend on which variables are included in the estimating equation or which time period is analyzed.

20. At the inter-provincial level, two papers on tax competition in Canada should be mentioned. Locke and Tassounyi (1996) found that business migrates from metropolitan Toronto to a neighbouring area that levy lower taxes on non-residential property. Slack (1994), researching data from Ontario, observed that higher taxes on non-residential property may discourage businesses from settling in certain counties. She also concluded that property tax differentials are not an important factor in the decision to settle in one metropolitan area or another; but once a metropolitan area is chosen, [differentials] have an influence on the decision regarding which specific municipality to settle in.



Specifically, adding controls to the type and level of public good provided by each location significantly affects econometric results. Business-friendly regulations and public spending that increase productivity allow for a particular location to set a higher tax rate on capital and/or property. In other words, local attributes increase the “taxing power” of a given jurisdiction and must be taken into account when estimating business responses to taxation differences.

Taking a different approach, some studies test the existence of strategic complementarity in business tax-setting among jurisdictions. Ladd (1992) found statistical support for the hypothesis that neighboring jurisdictions mimic one another when it comes to fiscal policy in the United States. Büttner (1999) tests the existence of fiscal competition due to interactions between capital income tax rate levels in German districts. As in Ladd (1992), he finds evidence that tax rates are positively related to neighbouring tax rates.<sup>21</sup>

Some evidence on cross-border purchases can also be found in the empirical literature on fiscal competition. Due and Mikesell (1994) believe that, in relation to data from the United States, a one percent differential in sales taxes results in a one to six percent shift in purchases, from higher-tax areas to lower-tax ones. In Canada, a study about this phenomenon found little evidence of cross-border trade in the Ottawa-Hull area in the 1970s, when the rate differential between provinces was of 3% (Dufour and Vaillancourt, 1982).

In Europe, some tax exemption regimes for non-residents lead to out-of-country purchases. For example, on the Schleswig-Holstein border between Denmark and Germany, Germans usually buy cars in Denmark, while the Danes buy spare parts in Germany. This is a consequence of regulation and taxation, which led to completely different final prices in the two countries (The Economist, November 29th, 2001).

#### 4 COPING WITH FISCAL COMPETITION

One challenge faced by the areas – countries, federations or even the whole world – where there is fiscal competition is how to reduce the welfare losses that stem from its many facets, with no sacrifice to the benefits of decentralization.

A country may impose restrictions to policies of the “beggar-your-neighbor” kind, by means of a constitutional disposition or national laws that bind the decentralized units. However, restrictions may be difficult to put into practice. Authorities would have to look closely at a wide variety of fiscal instruments, including those that are masked. It would be difficult to tell whether these

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21. The explanation for a positive correlation between neighbouring tax rates may be a classical competition result, since the tax base is volatile. Alternatively, this could be a political competition result. Voters compare policies from the neighboring district with those in their own district. The mayor fails to be reelected if his/her policy is worse than that of the neighboring district (Besley and Case, 1995).

instruments were steered toward competition or to other goals they could also serve. And long judicial battles could be needed in order to determine whether the actions of one decentralized unit caused any harm to another's business.

A high level of taxing power centralization combined with transfers to decentralized units, as is the case in Argentina, or the attribution of tax legislation to the federal government, as in Germany, are possible solutions. They have the common inconvenience of eliminating an important facet of federalism, i.e., the autonomous budgeting of each subnational unit. Vertical coordination – tax collection agreements, tax base sharing, abatement of subnational [portions] from federal taxes – widely used in Canada, results in more uniform tax bases, leaving room for a decentralized decision regarding the budget size, but also for some competition.

Intergovernmental transfer mechanisms may be designed to reduce the harmful effects of fiscal competition without sacrificing the benefits of decentralization. The fiscal competition theory is concerned with the existence of externalities generated by the actions of one jurisdiction over the residents of another, and with the consequences when tax and expenditure decisions do not take these externalities into account.

The economic theory prescribes the use of an interjurisdictional transfer system, so that a particular unit will pay taxes on negative externalities and will receive transfers related to the positive externalities it promotes. In theory, this “Pigouvian” transfer system would lead the system to an efficient decentralized balance (Varian, 1992). Unfortunately, implementing this ideal transfer scheme is impossible, and federal countries make use of non-optimal schemes.

In the case of spending competition, the underprovision of transfers to the poor resulting from decentralization may be partially compensated by earmarked transfers from central governments to subnational ones. Such is the case with the decentralized provision of public education and healthcare in Brazil, and also with the direct assistance of U.S. states to families below the poverty line.

Earmarked transfers may occur in the form of block grants or matching grants. In a block grant design, each jurisdiction receives a single amount from the central government whose magnitude is independent of the jurisdiction's level of contribution to the public good provision. As for matching grants, individual jurisdictions determine their expenditure level, and the central government pays a fixed portion of a jurisdiction's total disbursement. The theory of spending competition prescribes a combined transfer system because it reduces the marginal cost (borne by states) of providing welfare programs, resulting in a higher level of expenditure balance. In the block grant system, states would tend to spend only the equivalent to the single amount transferred by the Central Government.<sup>22</sup>

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22. The 1996 social welfare reform in the United States shifted from a matching transfer system to a block transfer system, and gave states more freedom to define their own policies. Brueckner (1999) argues that such a shift may cause a reduction in long-term welfare spending, and could only be corrected by going back to the matching transfer mechanism.

Fiscal harmonization policies may also be used as a tool to reduce the negative effects of fiscal competition, while preserving the advantages of decentralized policies. In the case of economic unions, where “central governments” have a very small budget and decentralized units are sovereign jurisdictions that cannot be legally obliged – unless by voluntary adherence to a treaty – harmonization may be the only instrument to cope with the undesirable effects of fiscal competition.

As mentioned in the introduction, fiscal competition constitutes an extreme case in which members of a federation act independently, without any room for cooperation. Harmonization constitutes a shift to a position where there is some cooperation. It can range from symbolic coordination, which is the present situation in regards to EU corporate income taxes, to total integration, a situation in which the units give up their autonomy or sovereignty, as is the case with the monetary policies of the members of the European Monetary Union (EMU).

Much has been said about the need to harmonize fiscal policies among European countries as they engage in a deeper integration. And much has been said against harmonization, especially by those who believe in Leviathan. But even if the hypothesis that harmonization will be the instrument to ensure a large government is dismissed, one must acknowledge that implementing this coordination scheme is far from trivial, especially in the economic union.

First, a contract between sovereign countries must take into account a wide range of possible non-cooperative strategies that should be discarded. Probably, it is impossible to cover all alternatives. For example, tax structure harmonization may be jeopardized by an indulgent execution in a given jurisdiction.

Secondly, in the case of sovereign countries, this “federalist pact” is not feasible in case one party chooses to act in a non-cooperative manner. Therefore, setting up an agency with supervisory and executive roles must precede the drawing of such a contract. The question is: are EU members prepared to give up their fiscal sovereignty? This is a *sine qua non* condition for deepening the harmonization process.

The answer to this question depends on several factors, and important among them is the answer to another question: how much are the gains to be collected from tax coordination? There are few answers to this question in the economic literature, most of them provided within the context of highly simplified models.

Sorensen (2001) has developed a fiscal competition model that weakens several of the restrictive premises of previous model development efforts, in an attempt to provide more reliable guidance to policymakers. Sorensen uses his model to provide quantitative estimates of welfare gains from fiscal coordination. He considers the cases of global coordination – when all countries in the world coordinate their fiscal policies – and regional coordination – when only a subset

of countries (the “union”) coordinate their policies. His main conclusions are “that the gain collected from regional fiscal coordination will be only a small fraction of the potential gain from global coordination if capital mobility is perfect. With imperfect capital mobility between the tax union and the rest of the world, there is a greater space for regional fiscal coordination, although the gain in welfare is almost certainly well below one percent of total GDP and occurs mainly in countries with high capital income tax rates”. In short, the reward for relinquishing fiscal sovereignty seems to be rather small.

## 5 FINAL OBSERVATIONS

Fiscal competition is a natural companion to decentralization. Potentially it always exists, since it is a consequence of differences among jurisdictions, not necessarily of intentionally promoted discrepancies; and there are no two identical government units in the world. In practical terms, the manifestation of fiscal competition depends on the intensity of divergences and the reaction of economic entities in face of the set of options offered by decentralization.

Fiscal competition takes many forms, uses a variety of instruments and may cause a variety of different results (Section 2). A significant amount of theoretical work attempts to give shape to the phenomenon. Above all, results are quite sensitive to the set of premises that is adopted in the assessment. So there are results for almost every taste. The technical status, as expressed by Wilson (1999), is that “competition among governments is presently seen as a less direct phenomenon than it was perhaps originally envisaged”. And, of course, there is room for more shaping, with the introduction of complexity that may address the ideal for the real world.

It is an important step to prove the practical existence of fiscal competition and to verify its impact on production factors and consumer mobility across jurisdictions (Section 3). Knowledge of the effects of competition on economic agents and on the intensity of their reaction to fiscal stimulus is useful to develop mechanisms to curb or reinvigorate government competition, whichever the case may be. But which is the case?

The insight offered by what may be called traditional tax competition models is that fiscal competition tends to distort resource allocation, promoting welfare losses. Acknowledging that these losses exist, they must be weighed against possible gains that come from spending competition – that is, the ideal environment for public policy innovation and a closer combination between public goods provision and local preferences – which are concomitant. The existing literature provides almost no evidence of the magnitude of these gains and losses. More research on this difficult empirical problem is needed in order to fill this fundamental void.

In the absence of clear conclusions from the literature, both theoretical and empirical, it seems that the wisest attitude in regards to fiscal competition is to avoid extreme measures either to prevent or to encourage competition. Consequently, control mechanisms or recentralization may be measures that reduce welfare to the extent that they eliminate political competition between jurisdictions or create the environment for Leviathan to emerge. Naturally, the best course of action is, whenever possible, to adopt measures that reduce welfare losses without sacrificing the benefits of decentralization. Carefully designed intergovernmental transfers and cautiously conducted harmonization processes seem to be the most promising instruments (Section 4).

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## **FISCAL FEDERALISM AND FISCAL EFFORT IN BRAZIL: THE DILEMMA OF THE TAX ON URBAN TERRITORIAL OWNERSHIP (IPTU)**

Marcelo Piancastelli<sup>1</sup>

### **1 INTRODUCTION**

Brazil is a federative republic composed of 26 States, one Federal District and 5,570 Municipal Governments. It has a vast territory and a population of about 208 million inhabitants (2018), according to the Brazilian Institute of Geography and Statistics Foundation (FIBGE). This population is irregularly distributed throughout its territory, and with more than 80 percent concentrated in urban areas.

The Country is governed by a constitution promulgated in 1988 with the aim of consolidating democracy, decentralizing government and improving the population's social conditions. Constitutional norms have been altered over time in order to adapt, in particular, to changes in the economic context.

Brazilian municipalities have become full members of the Brazilian federation after the 1988 Constitution. It must be noticed, however, that since its inception in 1891, the federative republican system has shown remarkable stability as a form of government.

This paper aims at continuing and deepening two texts published by occasion of the Global Dialogue on Federalism of the Forum of Federations and the International Association of Centers for Federal Studies – IACFS (Majeed, Brown and Watts, 2005; Steytler, 2007).

The first one deals with the construction of federation and social welfare (Piancastelli, 2005), showing that fiscal federalism has not corresponded to the need to improve social welfare. The second text addresses the theme of Brazilian municipalities and metropolitan regions and the economic and institutional obstacles to cooperation (Ribeiro and Garson, 2007). Similarly to the management of social welfare, the text shows that the results are unsatisfactory.

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In that sense, this paper's specific goal is to approach fiscal federalism with a focus on the need to increase tax revenue (fiscal effort). In dealing with the fiscal effort and its determinants, it focuses on a specific tax, the Tax on Urban Territorial Ownership (*Imposto sobre a Propriedade Territorial Urbana* – IPTU) and its particularities in Brazilian municipalities.

## 2 BACKGROUND: FEDERALISM IN BRAZIL

The current Brazilian constitution has just turned 30. Its drafters had the objective of obtaining a decentralized government organization, in such a way as to strengthen the democratic process in the country. Numerous constitutional amendments were approved, but none of them has altered the government's federative structure or the independence of the three levels of government.

History has shown that the form of Brazilian federalism has been neither centralization nor decentralization. Practice shows a consistent movement of adjustment according to each time's political and economic context.

The public outcry is that Brazilian federalism be always led towards better public management of metropolitan areas and public services, especially the provision of services such as water, sewage, public health, education, social assistance, child and elderly care and budget development.

The improvement of the budget system in Brazil is of fundamental importance. This is now a recurring theme for decades and one of the main challenges of the Brazilian federation. There are three independent budgets, one for each level of government and not inter-coordinated. Their priorities are different. The coordination of macroeconomic policy in the context of the decentralization of the 1988 constitution has become more difficult.

Two important challenges for Brazilian federalism still remain for the future: the decentralization of social services, without the appropriation of resources for their financing, and the substantial increase in intergovernmental transfers, for States and Municipalities.

Over the 30 years of the current constitution, the social nature of these goals has never been the subject of dispute, but the exact source of funding for them has always been. After the 1988 constitution, public finances have not yet reached a sustainable fiscal balance.

The Federal Government has made efforts to raise tax revenue and reorganize its expenses. The rise in revenues always faces opposition because of the controversy over the increase in government presence in the economy, as will be seen in the next section. The States and Municipalities have constitutional and statutory powers to

increase revenues, although they do not always do so correctly, as is the case with IPTU in Municipalities. It is an important tax, neglected in the current Brazilian tax context, as will be dealt with in section 3 below.

### **3 FISCAL EFFORT AND THE NEED TO INCREASE TAX REVENUE: GLOBAL VIEW**

Fifty years ago, Kaldor (1963) asked: “when developing countries would learn to pay taxes?” In an exceptional work, he intuitively established the bases for most tax systems in force today.

He made it clear that knowledge of the determinants of tax revenue and fiscal effort undertaken by different levels of government is a basic requirement of public administration. It is even possible to affirm that the success of a tax reform depends basically on the knowledge one has of the evolution of the tax revenue and the level of fiscal effort undertaken by the government. There is a complementarity between these two kinds of studies and the resulting knowledge.

There are numerous reasons for the existence of such complementarity: the elimination of the fiscal war, the proposal of a tax reform that seeks the simplification and revision of tax exemptions; a reform that seeks the generating of more resources to finance the country's development while at the same time reducing the tax burden on companies; that seeks to reduce the individual tax burden on the payroll and on goods and services; that increases progressiveness over income and wealth, and, naturally, that also reduces the fiscal regressivity incident on the lower income brackets. In addition, a tax system that always seeks to incorporate technological innovations at a faster pace.

Nearly every country – whether developed or developing – needs a greater tax revenue for the provision of public goods and for tackling poverty. Expenditure on infrastructure, utilities, health and education all depend on the increase in tax revenue in sufficient quantity (Kaldor, 1963; IMF, 2011). Otherwise, governments must make loans, increasing the public debt and causing future fiscal crises if the public debt reaches an excessively high proportion in relation to the GDP (gross domestic product) and the countries meet adverse payment conditions. Table 1 below shows the ratio of tax revenue/GDP (hereinafter revenue ratio) and the ratio of public debt/GDP (hereinafter debt ratio) for a group of 26 developed countries in 2010 and 2015, compared to a sample of 43 developing countries (table 2), for the same period.

TABLE 1  
Developed countries

	Total revenue (% GDP)		Total debt (% GDP)	
	2010 <sup>1</sup>	2015 <sup>2</sup>	2010 <sup>1</sup>	2015 <sup>2</sup>
Australia	23.3	22.1	29.3	47.4
Austria	25.8	26.7	83.7	83.5
Belgium	24.3	24.6	99.7	105.7
Canada	11.7	12	81.1	91.1
Denmark	32.7	34.1	42.6	45.5
Finland	35.4	37.7	47.1	53.5
France	43.3	44.7	85.1	88.6
Germany	27.7	28.1	80.9	68.2
Greece	40.1	48.7	146.2	181.7
Iceland	20.7	23.6	105.3	52.7
Ireland	21.8	18.6	72.8	91.8
Italy	22.2	23.5	115.4	143.8
Japan	8.1	11.4	162.3	196.6
Korea, Rep.	14.5	13.9	33.9	39.9
Luxembourg	24.9	25.1	19.8	20.8
Malta	20.7	21.4	67.6	83.6
Netherlands	21.3	21.4	59.3	70.6
New Zealand	25.7	27.5	34.9	28.3
Norway	26.8	22.4	34.9	29.9
Portugal	19.7	22.8	96.2	138
Singapore	12.9	13.6	102.9	108.7
Spain	13.9	14.2	53.6	104.8
Sweden	33.0	33.0	38.6	42.2
Switzerland	16.4	18.9	21.6	23.0
United Kingdom	34.8	35.4	82.8	107.6
United States	16.5	18.7	85.6	97.8
Average	23.8	24.8	72.1	82.5

Source: International Monetary Fund, GFS Yearbook and data files.

Notes: <sup>1</sup> World Bank -WDI. Up-dated 06/30/2016.

<sup>2</sup> World Bank -WDI, 2017, PG 68-72.

Elaborated by the author.

**TABLE 2**  
**Developing countries**

	Total revenue (% GDP)		Total debt (% GDP)	
	2010 <sup>1</sup>	2015 <sup>2</sup>	2010 <sup>1</sup>	2015 <sup>2</sup>
Argentina	12.8	12.3	42	53.3
Belize	23.6	23.3	80.2	76.6
Bolivia	23.3	34.7	37.6	46.2
Botswana	23.6	25.9	21.6	15.2
Brazil	28.8	29.5	61.3	73.5
Cameroon	16.5	18.2	14.7	31.5
Chile	17.3	17.5	8.6	21.0
Colombia	12.2	15.1	72.3	58.6
Congo, D R	7.6	13.5	30.9	16.8
Costa Rica	23.1	24.8	28.3	44.9
Dominican Rep	12.2	13.7	23.7	35.0
Egypt	14.1	12.5	85.8	96.8
El Salvador	13.6	15.7	57.5	46.5
Fiji	21.7	23.6	56.2	46.5
Ghana	17.5	19.4	..	73,4
Guatemala	10.4	10.9	24.4	24.8
India	11.8	12.6	52.2	50.9
Indonesia	10.5	10.3	26.2	31.4
Iran	25.4	16.0	11.7	48.9
Jordan	31.0	23.8	67.1	95.1
Kenya	19.8	20.1	44.4	53.5
Madagascar	9.7	13.6	31.7	38.4
Malaysia	13.3	14.2	49.6	54.5
Mauritius	18.0	18.9	36.8	60.1
Mexico	18.0	19.8	42.3	56.8
Morocco	22.8	26.8	50.9	64.7
Namibia	26.9	33.1	16.9	23
Nepal	13.4	16.7	33.9	27.3
Pakistan	13.8	11.0	60.6	67.6
Panama	23.5	20.1	38.6	37.1

(Continues)

(Continued)

	Total revenue (% GDP)		Total debt (% GDP)	
	2010 <sup>1</sup>	2015 <sup>2</sup>	2010 <sup>1</sup>	2015 <sup>2</sup>
Paraguay	19.9	22.2	15.6	24.9
Peru	15.4	14.9	23.7	22.6
Philippines	12.1	13.6	52.4	45.4
Poland	16.5	15.5	53.1	55.6
Romania	16.4	18.9	30.8	41.5
Sierra Leone	8.9	18.9	46.8	54.9
South Africa	25.4	27.2	26.0	51.6
Sudan	16.4	18.9	64.4	91.4
Thailand	16.4	15.6	26.9	30.2
Tunisia	20.1	14.9	40.7	61.2
Turkey	19.4	18.9	47.4	31.9
Uruguay	29.9	36.1	44.2	51.1
Venezuela	21.2	15.7	36.5	31.3
Zambia	13.9	18.1	18	49.4
Average	17.9	19.0	40.3	47.4

Source: International Monetary Fund, GFS Yearbook and data files.

Notes: <sup>1</sup> World Bank and OECD. Up-dated 06/30/2016.<sup>2</sup> World Bank and OECD. Up-dated 08/28/2018.

Elaborated by the author.

It can be seen that the ratio of revenue in developing countries is lower than that of developed countries. On average, the fiscal drag in developing countries is around 5.8 percentage points lower. It can also be seen that the debt ratio is also lower in developing countries, reflecting the difficulty of poor countries in making loans to finance government expenditures. Countries with real difficulties would be the ones with low tax revenue/GDP ratio and high public debt/GDP ratio.

Fiscal policy is always affected by economic, social, political, historical and international determinants, among others. One shouldn't speak of a single determinant. Thus, the analysis of fiscal effort is never out of date. It must always be updated and, whenever possible, methodologically improved.

There are some basic variables that affect fiscal performance. The farm production / GDP ratio, industrial production / GDP, services / GDP, international commerce / GDP are the variables that stand out the most. Numerous others, of a political and social nature, can be proposed, at a considerably higher cost of gathering information whose reliability demands greater care.

When a structure of fiscal federalism is applied in public administration, it is an important extra component. Proper mechanisms of fiscal incentives and fiscal exemptions start to coexist. It becomes nearly impossible to measure the specific effects in each federative entity individually. The analysis of individual fiscal effort can be a proxy, not necessarily the ideal or perfect one. But it can show the extent to which a particular country or federated entity (or entities) are distant from the performance of the group of country (ies) or federative entity (ies) under analysis.

In addition, and as stated above, the analysis of the fiscal effort of a federated entity must be a recurrent activity that, in principle, would follow a periodicity close to the budget periodicity. In other words, in each period, members of the government and citizens should have a clear notion of the fiscal effort they make, at the same time that the budget seeks to allocate the resources raised in the most efficient way possible.

### **3.1 Previous studies: tax revenue determinants**

In order to estimate the determinants of tax revenue as a proportion of GDP and the fiscal effort, several independent explanatory variables were used in the past.

Lotz and Mors (1967) were the first to measure the fiscal effort of a group of countries by taking a sample of 72 developed and developing countries for an average of years in the early 1960s. They compare the current tax revenue ratio of countries with the ratio estimated from cross-section regressions that relate the tax revenue to the level of national income per capita (GNI) and the share of exports and imports in the GNI. The “fiscal effort” is measured as the percentage difference between the current and the estimated ratios. The influence of GNI per capita is estimated both separately and together with the trade ratio (sum of exports plus imports over GNI). The scheduling of the fiscal effort (ranking) differs significantly when the trade ratio is introduced in the estimates.

Shin (1969) takes a sample of 47 developed and developing countries for the years 1963-1965 and adds three other variables, such as the GNI per capita and trade participation in the GNI, in order to explain differences in the relations between countries. These are: agricultural income as a measure of industrialization, commercialization and urbanization; the price rate of change; and population growth. It is expected that the agricultural sector will have a negative effect on tax revenue because of the smaller surplus to be taxed. Inflation, on the other hand, should represent a positive contribution to taxation if it promotes the movement of taxpayers into higher income brackets and also increases profits. Population growth tends to reduce the revenue ratio by increasing population dependence that leads to higher tax exemption rates. For the 47 sample countries as a whole, the statistically relevant variables became the GNI per capita, the agricultural revenue

ratio and population growth. Fiscal effort, as in Lotz and Morris, is measured by the percentage deviation between the current and the estimated revenue ratios.

Bahl (1971) used a sample of 49 countries in the period 1966-1968, making use of three main variables to explain differences in the revenue ratio, namely the volume of foreign trade measured by the GNI export ratio, the GNI import ratio and the trade volume ratio, imports plus exports on the GNI; the status of economic development measured by per capita income or by the share of agriculture in the GNI and by the sectorial composition of added value measured by the share of the mining sector in the GNI. The share of total exports and mining sector in the GNI are highly correlated. Fiscal effort in this paper is measured as the current tax revenue / estimated revenue ratio. A country with a ratio above one would be considered as performing a “good fiscal effort”.

Chelliah, Bass and Kelley (1975) use basically the same equation as Bahl (1971). They take a sample of 47 countries in the period 1969-1971 and use as independent variables the per capita income not (originated from) export; the percentage share of the mining sector in the GDP and the share of the agricultural sector in the GDP, with the variables being used in five different combinations. The best result, with an  $R^2$  of 0.442, comes from the correlation between tax revenue and the mining industry (positive) and the share of the agricultural sector in the GDP (negative). Twenty-three countries have a greater-than-one ratio of fiscal effort, while the other twenty-four have a less-than-one ratio.

Tait, Gratz and Eichengreen (1979) updated the study of Chelliah, Bass and Kelley (1975) using the same equation and the same 47 countries, in the period 1972-1977. The authors also used a new sample of 63 developing countries. The authors do not adopt the term “fiscal effort”, preferring rather to label their results as “international tax revenue comparison”. The ranking is relatively stable. The preferred equation to perform the “international comparison” of indexes is:

$$T/GNP = 9.99 - 0.0008 (Y_p - X_p) + 0.407 (N_y) + 0.194 (X_y) : R^2 = 0.413$$

(6.15)      (0.34)                      (5.61)                      (3.52)

where  $Y_p - X_p$  is the per capita income without exports,  $N_y$  is the share of the mining industry in the GNI and  $X_y$  is the share of non-mineral exports in the GNI (statistical  $t$  in brackets). It must be noted that there is a substantial difference in the revenue ratio that is still left unexplained.

Piancastelli (2001) estimated a model using a fixed-effects data panel for 75 countries in the period 1985-1995, with a total of 825 observations. The tax revenue ratio and the fiscal effort were estimated from an equation with logarithm of per capita income (PCY); the share of foreign trade in the GDP ( $X+M/GDP$ ) and the share of agriculture in the GDP as independent variables.



The estimated equation is:

$$T/Y = 1.742 + 0.102 (PCY) + 0.158(X+M/GDP) - 0.113(A/GDP); R^2 = 0.83$$

(5.43)      (3.69)      (4.30)      (3.84)

The T-statistic is in brackets. A high robustness of estimation in the results can be noted when compared with the studies of Chelliah, Bass and Kelley (1975) and Tait, Gratz and Eichengreen (1979). There is also a greater proportion of countries with a good fiscal effort index, 41 of them with greater-than-one indexes and 34 with lower-than-one indexes. Latin America has a particularly poor performance, with a greater-than-one index in only 4 of the 17 countries.

Gupta (2007), in the IMF, examines the determinants of tax revenue using a data panel with 105 countries in the period of 1980 to 2004, and presents results with both random and fixed effects without using the Hausmann test to discriminate between the two. “International aid” as share in the GDP and a corruption index are included among the independent variables along with the logarithm of per capita income, the share of agriculture in the GDP and the share of imports in the GDP (the share of exports is not considered). Although it is the most significant variable, per capita income is more important in high-income countries than in low-income countries. Fiscal effort indexes are constructed and, as in other studies, are weaker in Latin America and stronger in Africa.

Such econometric results are important when considering the determinants of the IPTU, as will be seen in the next section. Regardless of the negative impact of the agricultural sector on the revenue, the impact of the mineral sector has been favorable to the increase in revenue, a performance already considered traditional in natural product-exporting developing countries. This shows that each tax has specific characteristics and should be analyzed in its own context.

#### 4 POSSIBILITIES OF IPTU INCREASE

The review above shows the context in which a better IPTU revenue performance can occur, both in terms of federative and economic aspects. This section briefly addresses some of these determinants.

The federalist fiscal structure of the public administration enables each federated entity to be free to establish its own fiscal policy. In the case of the IPTU, these entities are the municipalities. Thus, whether or not to increase the collection of this tax is conditioned to the social, political and historical context in each municipality.

Among the economic factors that influence the revenue of the IPTU, we can point out the municipality's population size, the income brackets and the IPTU's per capita collection brackets.

Table 3 shows that the IPTU corresponds to 28% of the average revenue of Brazilian municipalities, reaching 30% in large cities and 29% in capitals. In the micro-cities, this tax corresponds to only 12% of the total revenue.

The ranking of the municipalities is the same as that adopted in the excellent work by Afonso, Araujo and Nóbrega (2013) on which this section is based, namely: micro = up to 5,000; small = 5,001 to 20,000 inhabitants; medium-sized = 20,001 to 100,000; large = over 100,001 inhabitants; capitals = state capitals.

TABLE 3

**Brazil 2007: municipal revenue by tax and population size**  
(In %)

	ISS	IPTU	ITBI	Fees	Others
Average Brazil	46	28	7	8	10
Micro	38	12	16	8	26
Small	40	19	11	11	19
Medium-sized	40	27	8	12	13
Large	41	30	7	10	13
Capitals	52	29	7	5	6

Source: Afonso, Araujo e Nóbrega (2013, p. 27).

Table 4 shows the importance of high income for the collection of the IPTU. Low income and dynamic income show little relative importance. Such evidences demonstrate that the management aspects of the IPTU (administrative inefficiency, periodicity of revaluations of the most valuable real estate, lack of qualified personnel, poor information technology, political interference) are important, but the income determinant can be paramount. The lack of income capable of meeting the tax burden is not negligible.

Table 5 shows two interesting opposites. The first one in the contribution bracket of up to USD 2.50 per capita. A high concentration of municipalities up to the medium-sized ones. On the other hand, in the contribution bracket above USD 20.00 per capita, the concentration is obviously in large cities and state capitals. Such evidences reinforce the thesis that IPTU revenue has the local income as its main determinant.

TABLE 4  
**Brazil 2007: relative importance of the IPTU according to income bracket and population size**  
(In %)

	Total	High income	Stagnant	Dynamic	Low Income
Average Brazil	28	30	21	11	4
Micro	12	15	12	3	2
Small	19	25	19	7	3
Medium-sized	27	33	23	15	4
Large	31	32	23	11	7
Capitals	28	29	14		

Source: Afonso, Araujo and Nóbrega (2013, p. 35).

TABLE 5  
**Brazil 2007: distribution of municipalities per IPTU collection bracket *per capita* according to Population Size**  
(In %)

	Up to 2,5	< 2,5 to 5	< 5 to 10	< 10 to 20	< 20
Average Brazil	43	12	16	14	15
Micro	41	19	23	13	4
Small	50	12	16	13	10
Medium-sized	41	8	10	15	25
Large	8	5	9	14	64
Capitals			8	23	69

Source: Afonso, Araujo and Nóbrega (2013, p. 45).

Obs.: Collection bracket per USD per inhabitant.

Table 6 is thus conclusive in relation to the effect of income in the determination of IPTU collection. The concentration of municipalities per per capita IPTU collection bracket is extremely high in those municipalities with stagnant income, dynamic income or low income. On the other hand, the taxpayers with contributions over USD 20.00 per capita are concentrated in the high income municipalities. From the fiscal point of view, IPTU revenue recovery should be concentrated in these municipalities (medium-sized, large and state capitals, with high incomes) where there are probably human and material resources to equip the public administration.

TABLE 6

**Brazil 2007: Distribution of municipalities per IPTU collection bracket per capita according to the income brackets**  
(In %)

	Up to 2,5	< 2,5 a 5	< 5 a 10	< 10 a 20	< 20
Average Brazil	43	12	16	14	15
High income	6	10	22	24	38
Stagnant	41	17	19	14	8
Dynamic	77	11	7	3	2
Low income	94	4	2	0	0

Source: Afonso, Araujo and Nóbrega (2013, p. 45).

The IPTU's dilemma is therefore not confined to administrative measures related to the modernization of the register, the periodicity of revaluation of real estate and the streamlining of payment procedures. Undeniably these are essential measures that cannot be absent from any modern and efficient administration. The advance of information technology has opened up opportunities still unexplored for the modernization of the systematics of this tribute.

On the other hand, the public administration needs to be attentive to the income determinant. There is little point in charging the taxpayer who does not have sufficient income to pay. Therefore, the zoning by income bracket is essential so that the levels of tax default are not distorted.

In this respect, it must be noticed that even in large metropolises worldwide, such as London, for example, the absolute value of the urban territorial tax has to be subject to a ceiling fixed by law. There is a percentage rate on the value of real estate. If the amount to be paid exceeds the ceiling fixed by law, the ceiling prevails.

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