

DISCUSSION PAPER **384**

Governance Reform and
Institutional Change in Brazil:
Fiscal Responsibility and Tax

Aaron Schneider
April 2006

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Institute of Development Studies
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Aaron Schneider

Summary

This paper contrasts two processes of governance reform that occurred in Brazil in the 1990s, one in relation to fiscal responsibility, the other in relation to tax. It illustrates that the degree of institutional change possible depends on whether changes in the positions of actors and their relative powers have occurred to the extent that a new social pact can be built.

Brazil's Fiscal Responsibility Law of 2000 followed on from a series of subtle but significant shifts in the positions of actors and their relative powers, which produced a change in the social pact supporting federal relations. This shift in the social pact allowed for a wholesale change in federal institutions. Major changes in fiscal and administrative policy ensued, and the outcome is that federal institutions have been imbued with greater capacity and accountability.

The process of tax reform was similar, in that it occurred slowly and gradually. But the social pact that supports the tax regime has changed only marginally. In this context, the scope for institutional change was limited within the boundaries of existing institutions. Policy changes that were implemented did lead to an increased tax take, but the tax system remains inefficient and inequitable.

This paper highlights that although governance reforms can take multiple forms, wholesale institutional change was a necessary prerequisite for an increase in the capacity and accountability of government. Wholesale institutional change was only possible because of the articulation of a new social pact.

Keywords: governance; fiscal policy; tax; institutions; Brazil.

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Executive summary

In Brazil during the 1990s, several major governance reforms were necessary, but only a few occurred. The current study contrasts two reform processes. The first process involves the change in Brazilian federalism marked by the Fiscal Responsibility Law of 2000. The law followed subtle and incremental shifts in the positions of actors and their relative powers that together produced a change in the social pact supporting federal relations. Once this pact had shifted, a wholesale change in institutions was possible. This wholesale change has produced major advances in fiscal and administrative policy, and it has imbued federal institutions with greater capacity and accountability, the two dimensions of governance. In contrast to this process, the process of tax reform has been marked by less significant changes. Instead, the social pact that supports the tax regime has changed only marginally. As a result, it was not possible to adopt wholesale change within tax institutions, so only policy changes within existing institutions occurred. These policy changes have expanded Brazil's tax take, but this has been at the cost of worsened efficiency and continued inequity. Three main concepts can be used to organise this argument: institutions, political agency, and state-society linkages.

Formal and informal political institutions set the rules of the game for interaction among different actors. These rules include the incentives and disincentives to make different choices, and they determine the probability and risk of different outcomes. Bringing about changes in institutions requires deft political agency. This is the strategic behaviour by which opponents are weakened, supporters strengthened, coalitions formed, and institutions eroded. This Machiavellian political artistry establishes a new social pact by bringing new actors and interests together, and forming a new set of state-society connections. These connections are the channels and the principles by which social actors articulate, mobilise and influence the state. Frequently, these channels run in both directions as states mould societal actors into groups, interests and associations. Once a new social pact exists, wholesale institutional change can occur. Without such a shift in social pacts, only changes within existing institutions are possible.

In the case of the Fiscal Responsibility Law, the formal and informal institutions of federalism had evolved over time and took on new relevance after the 1988 Constitution. The Constitution greatly expanded the resources and discretion of state and local governments and protected them with a number of institutions such as the Senate. Throughout the 1990s, a series of gradual shifts occurred in terms of the actors, interests, and relative powers of those engaged in the federal covenant. Repeated interactions, driven forward by the strategic decisions of actors in central government, weakened local actors, strengthened the treasury and the presidency, altered preferences, formed new coalitions among governors, and set the basis for a new social pact. Societal actors and their representatives adopted a new principle – the hard budget constraint – and incorporated it into the basis for relations among federal units. This change represented a shift in the social pact, and set the stage for a shift in federal institutions. The final push came at a historical moment marked by external economic crisis. This tipped the balance and made it possible to legally enshrine a new set of rules for federal relations in the Fiscal Responsibility Law.

Tax reform was similar in that it occurred slowly and gradually, but it did not rest on a new pact, nor did it lead to entirely new rules of the game. Institutional legacies of the military regime and the transition to democracy remained rigid and relatively difficult to change. The military began with a relatively modern tax regime but allowed it to deteriorate over time with a series of incentives, exemptions, and attempts to patch these holes with distortional instruments. The 1988 Constitution did little to change these trends, and in fact exacerbated the situation by earmarking large portions of federal revenues to subnational expenses. Over the course of the 1990s, central government actors were unable or unwilling to attempt a fundamental reform of the social pact around tax. Instead, their strategic manipulation of actors, interests and relative powers mostly sought to repair the holes in federal coffers. In this, they were successful, and there was a major expansion of tax revenues

with the introduction of a number of cutting-edge tax practices. On the other hand, there was virtually no movement in the social pact that supported tax institutions. The expanded revenues were possible only through tightening the screws on those handles that government could easily access, and these handles were not always the most appropriate to a modern, growing economy. The result was that the increase in the tax burden occurred in a way that was inefficient and inequitable. In short, tax reform might have been more successful had a new social pact around taxation been possible. Instead, only policy changes within the boundaries of existing institutions occurred.

The main point to be drawn from this comparison is that changes in governance can take multiple forms. In both cases examined here, the pace of reform was slow and gradual. Only in one case, however, was strategic behaviour able to articulate a new social pact. A new pact was necessary to undertake wholesale change in institutions; otherwise, change occurred only within existing institutions. Wholesale change is required if there is to be an increase in the capacity and accountability of government. Within-institution change allowed for small-scale reforms but no fundamental advance in governance.

1 Governance reform and institutional change in Brazil: fiscal responsibility and tax

‘Politics is a strong and slow boring of hard boards.’

(Max Weber 1946 [1921])

Governance is ‘the manner in which the State exercises and acquires authority’ (Campos and Pradhan 2003: 1). Two dimensions allow us to differentiate manners of governance: capacity and accountability. ‘Capacity’ refers to the bureaucratic, technical, fiscal and coercive authority of government leaders to impose their will on private and public actors. ‘Accountability’ refers to the mechanisms of linkage that allow ‘principals’ within society to monitor and control the actions of government ‘agents’. Changes in one or both of these dimensions constitute governance reform. An interesting point to note about governance reform is that it can occur in a continuous fashion (e.g. a technical increase in the capacity of the tax authorities) and/or in a discontinuous fashion, in which accountability and capacity are achieved and combined in new ways (e.g. a switch from traditional/charismatic authority to rational-legal regimes). To be sure, this second kind of reform represents a change in the degree of accountability and capacity, but more important is the change in the kind, type or manner in which authority is exercised and acquired. This represents a fundamental change in the institutions of government.

1.1 Institutions and pacts

Despite significant attention given to institutions in causal and comparative historical studies, few have paid sufficient attention to the nature of change within institutions. Most often, studies focus on divergent paths charted by different institutions (Moore 1966; Skocpol 1992) or the critical junctures at which institutions break down and are replaced (Collier and Collier 1991). Comparative study of institutions, therefore, has often highlighted national-level differences in the ways several cases respond to similar challenges. This has produced important insights, and many institutional analyses operate on the basis of a ‘punctuated equilibrium’ model, in which moments of upheaval are followed by new institutions that provide long periods of stability and sustain themselves through feedback mechanisms, self-enforcement, and positive-sum games (Mahoney 2000; Pierson 2000; Mahoney and Reuschemeyer 2003).

As a result of these analyses, some working understandings of institutions have become widely accepted. For most, institutions are the ‘rules of the game’ that bound the interactions of various actors (North 1991). As a result of institutional rules, the interests and relative powers of actors take shape, especially by limiting the strategic options available and defining the pay-offs to different strategies. As organisational theorists have demonstrated, actors adjust their own system of preferences as a result of the practices and norms of institutions (March and Olsen 1984).

Functioning institutions require the agreement of relevant actors. These actors form an agreement – a pact – to abide by certain rules. The task of forming pacts is difficult, and the breakdown of pacts is provoked when institutions cease organising routine behaviour. In such situations, actors routinely break rules, prefer not to play, or otherwise operate outside the boundaries of institutions. The ability of institutions to accommodate potential disruptions varies. By definition, they are not infinitely malleable, yet there are wide variations in their propensity to adapt or accept change. To understand institutions, therefore, is to understand the process and difficulty of getting multiple and competing actors to agree to a given set of rules.

Various theories have attempted to explain how institutions change. One theory, the rational choice approach, sees pacts emerging when all actors rationally accept a set of rules as an efficient solution to problems. Institutions thus reflect a state of equilibrium that emerges when all actors recognise that certain rules of interaction would benefit all of them. Institutional creation and change, in this view, is a consensual process that takes actors from less efficient to more efficient equilibria solutions (North 1991; Bates, Avner, Levi and Rosenthal 1998).¹

Slightly different than rational choice approaches, historical institutionalists emphasise the legacies and limitations (sometimes less than efficient) of previous institutions and historical events. Actors do not choose the most efficient solutions to problems; rather, they choose from a set of options constrained by prior choices. As a result, moving from one institution to another is a path-dependent trajectory in which early decisions affect later events (Collier and Collier 1991). The pattern of institutional change may or may not improve efficiency, and it may not occur even when it would be in the interests of all actors.²

What both rational choice and historical institutional approaches share is the notion that institutions rest on durable pacts. Actors may be in conflict; but, when they enter pacts, they agree to play by formal and informal rules that govern interaction. From a rational choice approach, the pact is chosen because it is efficient. From an historical institutional approach, the pact is related to the contingent decisions of actors operating within previously existing institutions. Both approaches consider institutions to be underlined by pacts, and understand change as the dynamic of various actors pacting, un-pacting, and re-pacting.

Pacts themselves are important concepts to characterise. Their key dimensions are the actors involved and their relative powers and interests. The number and types of actors can be broad or narrow. The interests represented can be those of poor people, rich people, workers, industrialists, agriculturalists or others. Their relative powers can be symmetrical among equals or asymmetrical among unequals.³

1.2 Change in institutions

Here, we are primarily concerned with two patterns of change in institutions: within-institution change and wholesale institutional change. Both kinds of change are difficult to identify when they occur gradually. Minor adjustments by actors, small shifts in their relative powers, and gradual alterations in their interests can be barely perceptible. Observers can rarely tell if gradual changes are building up to a wholesale change or if they will be confined to the boundaries of existing institutions.

Some changes are limited in scope to the boundaries of existing institutions. Significant consequences can result from these changes, but there is no fundamental altering of the rules of the game and no large-scale change in governance. Actors adjust at the margins to

1 For example, in 1789, when the American states were faced with a collapsing Articles of Confederation, they came together and designed a constitution that provided a new set of federal rules to provide a unified national market and enhanced national security (Weingast 1995).

2 In the example of the early American federation, historical institutionalists stress some of the efficiency-reducing aberrations in the new constitution that reflected political contingency or residues from earlier institutions. For example, the electoral college remained in the constitution as a legacy of the Articles of Confederation, and has not changed for 200 years (Elazar 1991).

3 The case of US federalism is once again instructive. A pact had to be formed between Southern slave states and Northern non-slave states. Their relative powers and interests were relatively balanced at first and were reflected on the original constitution. Over the next 100 years, the relative power of Northern states expanded as they industrialised, and the federation expanded westward far beyond the original 13 colonies. The players, interests, and relative powers changed, and old institutions were decaying. A new pact had to be forged, and it took a civil war to negotiate (Moore 1966: 111–58).

fit changing circumstances but leave intact the underlying pact and the basic rules of the game. Though major policy changes can occur, within-institution change does not signify the formation of a new pact and does not significantly alter the institutions themselves (Thelen 2003).⁴

Within-institution changes differ in degree from wholesale institutional changes. Wholesale changes are bigger, and are also different in kind; one set of institutions replaces another. In terms of governance, replacing existing institutions with new ones allows for a quantum leap in accountability and capacity.⁵

The triggers of wholesale institutional change can be both external and internal. Exogenously driven economic crisis or world events can cause ruptures. Also, endogenous events such as institutional decay and Machiavellian manoeuvres by actors can shift preferences and powers. The presence of such stimuli does not mean that change will necessarily occur. Wholesale change is actually quite rare, as it implies a new pact in which there are new actors, greatly altered interests, changed relative powers, and new potential strategies of interaction.

When wholesale change occurs gradually, marginal and incremental shifts pass a threshold. At this threshold, old institutions fall away, new actors and interests emerge, a new pact is formed, and new rules of the game are established. Recognising that incremental changes are occurring is often difficult; the changes only become visible when the threshold is passed (Pierson 2000). Still, it would be a mistake to recognise only the threshold. Each of the marginal shifts is a necessary but insufficient step towards the ultimate institutional change.⁶

1.3 Two patterns of change in Brazilian institutions

These two patterns shape the current study of governance reform in Brazil. Institutions inherited from the military regime, faced with the transition to democracy, were imperfectly suited to the challenges of the 1990s, especially the challenges of fiscal adjustment. Still, institutions were resilient and difficult to change, and adjustment occurred marginally and gradually. In one case, the case of tax reform, these adjustments were made within existing institutional arrangements but did not replace them. No new pact was formed. In the other case, the Fiscal Responsibility Law, the adjustments brought about pressure that ultimately led to the elimination of existing institutions, the forging of a new pact, and the construction of new institutions. A brief summary of the argument follows.

The first reform, the Fiscal Responsibility Law, was gradual, but it reflected the tipping point of a cumulative process that eventually breached a threshold in Brazilian federalism. Reform fundamentally renegotiated the interests and relative powers of parties to the federal covenant. While the Fiscal Responsibility Law marked an important threshold in the construction of a new federal pact, it was not the unprecedented, watershed event that many portrayed. Rather, it was the culmination of a series of minor shifts that altered the institutional terrain in which actors operated. These repeated interactions largely did the hard work of weakening certain actors, strengthening others, altering preferences, eroding previous institutions, and setting the architecture of a new federalism. A particular historical moment, marked by external economic crisis, tipped the balance and made it possible to

4 For example, in the original US federalism, a change in tariff rates was not a particularly momentous institutional change, though it may have reflected the growing power of Northern states and it certainly had large impacts.

5 One can contrast changing tariff rates to the abolition of slavery in the US in the mid-1800s. Abolition implied an entirely new set of institutions and required a new pact among social actors, especially member states.

6 The notion of necessary and sufficient causes was usefully raised by Poul Engberg-Pedersen and has been discussed extensively by Goertz and Starr (2002).

pass the threshold in which new institutions were constructed in the Fiscal Responsibility Law.

It is important to note the cumulative nature of the reforms leading to the Fiscal Responsibility Law. Like tax reform, this was a governance reform that contributed to meeting the fiscal adjustment challenge in Brazil. What sets the Fiscal Responsibility Law apart is the fact that it culminated in a wholesale change in institutions. There were a series of incremental shifts that occurred within existing institutions, just as there had been for tax. The difference was that these incremental shifts over time were building to a critical mass that would result in a wholesale change in Brazilian federalism. It was possible to create a new pact among relevant actors, and, as a result, wholesale institutional change was possible.

Tax reform was a slow and gradual process of change that did not rest on a new pact, nor did it lead to entirely new rules of the game. Institutional legacies of the military regime and the transition to democracy remained rigid and relatively difficult to change. The actors involved, their interests and their relative powers, did not significantly change. No new pacts were formed around taxation. Interestingly, on the one hand, minor adjustments both within inherited institutions and at their margins did allow significant policy changes. There was a major expansion of tax revenues that brought Brazil to developed-country levels of tax and introduced a number of extremely modern tax practices. In the context of fiscal adjustment and market liberalisation, such changes were a major priority and represented important achievements.

On the other hand, political and economic elites were unwilling or unable to renegotiate the actors involved in a pact based on tax, so tax institutions remained largely unchanged. Expanded revenues were possible only through tightening the screws on those handles that government could easily access, and these handles were not always the most appropriate to a modern, growing economy. The result was that the increase in the tax burden occurred in a way that was inefficient and inequitable. In short, tax reform might have been more successful had a new pact around tax been possible. Instead, only moderate reform occurred, limited to the boundaries of existing institutions.

The following sections compare the dynamic process of change in tax and the Fiscal Responsibility Law in Brazil. The case of gradual reforms that ultimately breached a threshold and produced a new pact is illustrated by the reform of federalism brought about by the Fiscal Responsibility Law and its antecedents. The case of gradual reforms that operated within existing institutions without transcending them is illustrated by the reform of the tax system. Both kinds of governance reform are significant, but they differ in important ways. By comparing them, we can understand the nature and difficulty of pacting new agreements among multiple and potentially competing actors.

The main point to be drawn from this comparison is that governance reform can take multiple forms, though there are important commonalities. The main commonality between these two cases was that governance reform was a gradual and cumulative process. The main variation between them is that one operated within existing institutions based on relatively constant pacts, while the other passed a threshold and resulted in the construction of a new pact and new institutions. Both within-institution and wholesale change can lead to important policy results. But only wholesale institutional reform involves a fundamentally new pact among actors based on new rules of the game.

1.4 Prior pacts and institutional arrangements

To understand these two processes of change, it is necessary to establish a reference point. Basic social pacts and essential institutions were established in the waning years of the military regime that ended in 1985, and in the 1988 Constitution. One of the most significant aspects of these pacts and institutions was the increased autonomy they gave to Brazilian subnational government.

1.4.1 Subnational power

Subnational governments have always been important in Brazil's federal system, even during the military period (Hagopian 1996). In particular, after historic election defeats in 1974, the military sought to legitimate itself and hold onto power by decentralising power and resources to state governments. Elections for subnational executive office opened long before those at national level. Governor power was further enhanced when the first elected president died shortly after assuming power, and his vice-president, José Sarney, rose to power indirectly. Sarney thus began with a relatively weak hand, and he bargained away additional power during the 1988 Constitutional Convention in an effort to secure an extra year on his mandate (Souza 1997).

The 1988 Constitution gave states residual powers (areas not left to the central government or municipalities), and imbued them with several policy domains that included tax, spending and administrative autonomy. In particular, governors gained further control over the single most important tax, the ICMS (*imposto sobre circulação de mercadorias e prestação de serviços*) (similar to a subnational value added tax), which accounts for approximately 30 per cent of all revenues. Governors could now set sales tax rates, and they gained control over certain areas that had previously belonged to central government, such as electricity, fuel, minerals and telecommunications. The states and municipalities also expanded their portion of shared taxes which include a proportion of federal income and manufactured goods taxes. The proportion transferred to states grew from 9 per cent each in 1979 to 21.5 per cent (states) and 22.5 per cent (municipalities) in 1988 (Afonso 1995; Serra and Afonso 2002).

But the 1988 Constitution did not specify what was to be done with shifted revenues. Various functions were either left as shared between states and the federal level, or given to both (Camargo 2001; Shah 1991). The result was that certain aspects of subnational outlays greatly increased, partly as a result of pressure to undertake policy areas that the federal government was abdicating (Arretche 2002). Though central government retained primary responsibility for transfers to individuals (80 per cent of the total) and public debt interest payments (90 per cent of the total), subnational units accounted for 68 per cent of active civil servants and other current expenditures, and 80 per cent of fixed investments (Serra and Afonso 2002).

Especially pertinent to the current discussion is the fact that states controlled banks and public enterprises. The developmentalist strategies pursued by the military regime had included government action in banking, production and distribution. During the 1970s, when the military regime sought to hang onto power by distributing poles of development to dispersed political allies, many states established both credit and commercial banking interests (there were 35 state banks in 1994), as well as important energy companies and other enterprises. As the states gained greater autonomy, especially after the 1988 Constitution, governors secured further control over bank and enterprise directors. This control gave access to infrastructure projects, employment, and credit that were often oriented towards political patronage needs rather than developmental goals. State banks offered cheap credit to the private sector, financed state enterprises and development projects, and most significantly, purchased bonds issued by state treasuries. In effect, each governor controlled a bank that could cover state deficits and thus soften its budget constraint (Dillinger 1995).

The role of subnational units was exaggerated at the national level by the over-representation of certain territorial units. While all federal systems engage in some degree of malapportionment (deviation from one-man one-vote), Brazil represents an extreme case of 'demos-constraining' federalism (Stepan 2000). States with smaller populations are systematically over-represented by equal representation in the Senate (three senators per state). Though this is not uncommon in upper houses of federal systems, over-representation in the lower house, the Chamber of Representatives, exaggerated malapportionment. In the Chamber, representation is proportional to population, but a floor on the number of representatives per state and a ceiling on representation for the most populous states lead to an over-representation of smaller states (Samuels and Snyder 2001).

The interests of subnational units, especially states, are also exerted through informal governor power at the federal level, through state representatives. In the Chamber of Deputies, governors influence the deputies from their state. This impact is likely to be greater for deputies of the governor's coalition than opposition parties, and likely to vary across parties and states and by issue area, but there is evidence that governors acted as occasional veto players in the Chamber (Abrucio 1998).

The Senate was a particularly important site in which governors exerted influence. Senators were frequently ex-governors, and they paid special attention to regional demands with an eye on running for future office as governor (or even mayor) after leaving the Senate. In addition, there was an informal practice in which senators approved requests to benefit colleagues' states, expecting the same treatment when issues affecting their own state emerged.

1.4.2 Weak discipline

Parties might have served to counteract these pressures from subnational governments, but Brazilian parties have been characterised as extremely fragmented and inchoate (Mainwaring 1999; Mainwaring and Scully 1995; Mainwaring and Shugart 1997; Haggard and Kaufman 1995; Ames 1995, Ames 2002). An extremely permissive electoral system sets low thresholds for participation, with automatic free access to the mass media. Coalitions in multi-member, proportional elections are allowed and ballots are open-list. Further, party members are free to switch their allegiance up to a year before elections. These rules weaken parties as institutions, and strengthen the power of governors in influencing electoral outcomes. Some have argued that governor 'coat-tails' are important to state and federal deputies (Samuels 2003).

Organised interest groups might have provided an alternative source of discipline to the fragmenting qualities of Brazilian politics, but these have also been characterised as pulverised and unable to exert influence (Schneider 1991: chapter 6). The Brazilian tradition of organising interests in vertical corporatist associations tied to the state served to limit autonomous capacity for negotiation and weaken the utility of social sectors as counterparts in forging broad pacts (Schmitter 1974). In addition, the liberalisation of the 1990s further fragmented weak social interests, and few could provide the disciplined oversight that might have been necessary to forge a new social pact.

1.4.3 Potential countervailing institutions

Despite these factors, several aspects of the Brazilian political system create countervailing tendencies. Inside the Congress, party leaders play an important role assigning members to committees, influencing the legislative agenda, and imposing discipline on party members for certain votes (Alston, Melo, Mueller and Pereira 2004).

The most important institutional mechanisms to impose discipline on the party system operate through a powerful president. Presidents have had little difficulty building governing coalitions in Congress, and only one president failed to build such a coalition on reaching office (Collor, who was later impeached) (Figueiredo and Limongi 1999; Meneguello 1998).

Additional mechanisms that strengthen presidents and impose discipline include veto power, budget power, power to influence the legislative agenda, and in particular decree power, inherited from the military regime (Figueiredo and Limongi 2002; Figueiredo and Limongi 1999). Decrees are provisional and, until 2001, could be re-issued indefinitely. Unless Congress acted upon them within 30 days, they went to the top of the agenda. In addition, presidents could leap their legislative priorities to the top of the agenda by issuing emergency legislation. Hundreds of emergency laws were issued, and Congress simply allowed a similar number of decrees to continue (Power, Pereira and Renno and 2005; Pereira and Mueller 2002).

This changed in 2001, when Constitutional Amendment 32 altered the use of provisional decrees. These can no longer be renewed, except by the vote of Congress, and only one renewal is now possible. The number of decrees is now somewhat limited as a result, but they now clog up almost the entire legislative agenda and give the president even more control over the order of business, as no other legislation can be passed until they have been resolved.

Presidents also exert influence through the use of the veto (including line item veto) and exclusive power to initiate legislation in the area of budgeting, as well as limitations on the kind and amount of legislative amendments (Giacamoni 1997). Amendments are governed by formal and informal rules that allow presidents to decide if and when funds will be released. The result is that many amendments are mere symbolic efforts, while moments of parliamentary support-building are preceded by the release of numerous projects.

In sum, several aspects of the Brazilian federal system were solidified in 1988. In fiscal terms, subnational units greatly benefited at the expense of central government. States and municipalities expanded their resources and autonomy, and states in particular gained control over enterprises and state banks. At the federal level, the entities that might have overseen state behaviour were particularly unsuited to the task. Congress, particularly the Senate, was heavily influenced by governors and state interests. Parties were unable to moderate the behaviour of subnational units, as electoral and institutional rules weakened them as institutions. Interest groups were equally unsuited to the task, as they were weak and tended to organise vertically to secure benefits from the state, instead of horizontally, to forge new social pacts on major issues.

To achieve the largest possible governance change, a new pact would have to be formed around a set of institutional rules of the game. The wise use of existing countervailing institutions allowed marginal and subtle repositioning among supporters and opponents of reform during the 1990s. These shifts were sufficient to allow wholesale change in federalism, but only within-institution change in tax. It is useful to understand both the similarities and differences in these patterns of change.⁷

2 Wholesale institutional change – a new pact around fiscal responsibility

In the last few years, Brazil has achieved a high degree of fiscal transparency, together with major improvements in the management of public finances... The cornerstone of these achievements has been the enactment in May 2000 of the Fiscal Responsibility Law which sets out for all levels of government fiscal rules designed to ensure medium-term fiscal sustainability, and strict transparency requirements to underpin the effectiveness and credibility of such rules.

(International Monetary Fund (IMF) 2001: 1)

2.1 Background to the Fiscal Responsibility Law 2000

As the IMF observed, the Fiscal Responsibility Law of 2000 changed the nature of fiscal management in Brazilian federalism. It was an important event that can be understood as the culmination of a repeated series of interactions between central government, the

⁷ Some of the key insights for this discussion came from Yasuhiko Matsuda.

executive branch, Congress, and subnational units, especially states. Few who looked at Brazil in 1988 might have suspected that the federal order would be completely changed in little over a decade. The actors and institutions that favoured retaining a chaotic federal system of powerful states seemed unlikely to change, and the few actors who wished to establish a degree of fiscal coordination were weak. Over the course of the 1990s, actors adjusted their strategies in response to a series of interactions that altered their positions, relative powers and choices. Over time, the pact and institutions that sustained the previous federalism arrangement progressively weakened. The Fiscal Responsibility Law represented a new set of rules of the game, supported by a renegotiated pact among federal and state players.

For the designers and supporters of the law, it marked a sea-change in the nature of Brazilian federalism. The Brazilian political elite now frown upon repeated crises and bailouts. This signals more than obedience to legal prohibitions, of which there were many, but rather a change in cultural behaviour that recognised the spirit of the law. Such a change was only possible through a pacting process that could generate the consensus to make the new practices feasible.⁸

The current analysis views the Fiscal Responsibility Law as the tipping point for, or culmination of, a series of cumulative, gradual changes that crystallised a change in federal institutions. The starting point for the federal pact can be traced back through generations of Brazilian federalism, and reference will be made to historical legacies. For the current analysis, the most marked round of interactions began with the legacies of the 1988 Constitution.

2.1.1 Starting positions: the 1988 Constitution

The most important of these legacies was the relative power of subnational units. Governors wielded constitutional power, controlled significant resources, and manipulated state enterprises and banks. These factors had national macroeconomic implications. Governor pressure at the national level operated through state delegations in Congress and the Senate, and the Senate as an institution held important powers in relation to the executive in the area of subnational debt. Each of these factors was directly linked to the chaotic and feckless character of the system commonly noted by observers of Brazilian politics. Multi-member districts, undisciplined parties and a weak civil society reinforced the generally fragmenting impact of the incentives created by post-1988 institutions. It is this period that most observers are referring to when they characterise Brazil as a 'demos-constraining', extreme federalism.

The Senate had constitutional authority to set limits on debt, establish debt-service ceilings, and approve credit requests by individual states. Though the Central Bank provided an evaluation of requests for additional debt, it was the Senate that held ultimate authority. Collegial rules and influence exerted by powerful Senate presidents meant that senators from states seeking credit were frequently assigned to the committee charged with evaluating those very same requests. As one would expect, it was extremely rare that such requests were denied.

The fiscal scenario of the federal system was extremely precarious. Many of the states had made their own situations even more difficult by locking themselves into major spending initiatives. In part, this had begun in the early 1990s to cover reductions in federal investments. But the situation was exacerbated because most states had engaged in a rapid expansion of public employment during the late 1980s and early 1990s, as disconnected municipal, state and presidential electoral cycles resulted in seven elections in ten years (1985, 1986, 1988, 1989, 1990, 1992 and 1994). The fiscal impact of the hiring binges was compounded by the 1988 Constitution, which placed all public employees on regulated

⁸ Selene Nunes, one of the architects of the legislation, has made this extremely clear in personal communication and in several of her published evaluations (Nunes 2003).

labour contracts that included complicated demission and generous pensions. Pensions were also extended to rural workers, and many states found themselves carrying some of this burden as well. Several found themselves with over 90 per cent of their budget dedicated to public sector personnel (Varsano 2002).

The states turned to temporary stopgaps to finance their expansion. They indexed taxes to inflation while delaying and failing to index many expenditures. They also floated financial assets through state banks that essentially allowed governors to give loans to themselves (Giambiagi and Além 1999). At least for a time, they could cover some of these fiscal illusions with increasing transfers from the federal government, but states repeatedly defaulted on their debts. They were forced to turn to the Central Bank for bailouts, which they were summarily granted.

2.1.2 First movement: the Real Plan

The realignment of federalism was a drawn-out battle for positions in which the existing institutions, actors and interests had to be chipped away. The few institutions that could counter the general fragmentation and indiscipline of the federation had to be used selectively and strategically to move the federation towards reform. The opening salvo in the battle for positions was marked by the Real Plan of 1994. It was a successful monetary stabilisation effort, though the fiscal adjustment that might have sustained the effort was not immediately clear. The federal government made a serious effort to secure its own fiscal stability, and in so doing, greatly undermined the practices (many of them dubious) that subnational units had used to sustain themselves. For example, the federal government raised interest rates by 60 per cent in three years to help sustain the value of the currency, thereby limiting state government ability to float financial assets (Alston *et al.* 2004). The inflation tax disappeared, and the Real Plan coincided with an agreement by which central government retained 20 per cent of all revenues that were meant to be shared revenues (Giambiagi and Além 1999).

To some observers, the Real Plan was principally a transparency shock that exposed the financial use state governments had made of inflation. In the words of one observer, 'When they ended inflation, there was greater clarity on the skeletons'. Malan put it best when he said: 'In Brazil, the past is more unpredictable than the future' (interview with legislative aide).

The most immediate implication of this transparency shock was a rapid deterioration of state accounts. State governments were forced to depend even more significantly on transfers from central government and new credit operations, often from fragile state banks. Subnational debt increased by 85 per cent from 1990 to 1996 and increased as a portion of total national debt (Mora and Varsano 2001).

In sum, the fiscal implications of the Real Plan of 1994 can be understood as an important adjustment within the federal institutions established by the 1988 Constitution. The main actors involved – central government and subnational governments – may not have been conscious of the (not-so) subtle adjustments stabilisation would imply, but the shift was significant. In particular, the way in which stabilisation was achieved spelled fiscal crisis for state governments. On the one hand, the unexpected end to inflation intensified their fiscal insecurity and made them extremely dependent on the federal government. On the other hand, the sudden end to inflation and its unexpected character legitimated many of their demands, at least in the short term, for debt workouts.

2.1.3 Shifting power and institutions: state debt workouts

The ensuing debt workouts negotiated between states and the federal government were both indicators and causes of the gradual shift in actors' power and interests. Crisis and workout occurred in 1989, 1993, and post-1994. At each moment, individual states or several states simultaneously could not meet their debt obligations (Pereira 1999).

The workouts arranged for the different states shifted over time. They were widely criticised by most observers for softening the budget constraints faced by states and encouraging future defaults (Dillinger 1995). What was less obvious was that each framework was building central government capacity to hold states to account.

The first major state debt crisis can be traced to before 1989, when oil price shocks and interest rate increases led to national defaults on international debt. Subsequent state government defaults to the federal government were followed by a renegotiation of approximately US\$11 billion. Debts were rescheduled for 20 years with a 5-year grace period and interest rates equal to the original contract. States were expected to undertake privatisation to cut expenses and pay off some of the debt.

The second crisis occurred prior to 1993, when most of the debt was owed to federal institutions, especially the federal housing and savings bank. The federal government absorbed approximately US\$40 billion of state debt, again rescheduling for 20 years, this time at below-market rates.

The third crisis occurred post-1994, when states mostly owed debts to their own state banks and to private banks on short-term state bonds and loans in anticipation of revenues (AROs). A new framework for debt workouts was established in 1997, law 9496, which set the framework for workouts for the largest portion of state debt, state bonds. These bonds had been issued at high interest rates on short-term, even overnight, markets, and states eventually defaulted. The bonds were the largest component of the post-Real debt crisis, and they were owed principally by the largest states and municipalities. These governments had the most privileged access to the market, but their unpayable state bonds reached over R\$30 billion (Goldfajn and Guardia 2003).

The framework was followed by agreements with 24 states for US\$82 billion, with 30-year repayment schedules and low, fixed interest rates. The ceiling on debt service was also set somewhat generously, not to pass 15 per cent of current revenues (Rezende and Afonso 2002: 16). The law also established ceilings for personnel, and targets for growth in revenues and privatisation (Guimarães 2004). Failure to meet conditions could be punished with retention of state constitutional transfers. It was a measure that 'gave the government a stronger mandate to withhold transfers from states that failed to meet their agreements' (Webb 2004: 7).

2.1.4 Shifting positions of actors: federal/state

The process of debt restructuring during the 1990s appeared to many observers as a never-ending cycle. States would default, and the central government would bail them out by absorbing debts and extending the timeline for payment. The basic pattern of these crises was that the federal government assumed the payment of subnational debts, states paid back (some of) the costs at privileged interest rates, and states were presented with conditionalities for structural adjustment. Restructuring without eliminating old debt or seriously undertaking fiscal adjustment meant that another debt crisis would loom after a few years. The repeated crises and bailouts suggest, at first glance, that the federal government was simply providing a soft budget constraint to states that increased moral hazard problems and led them repeatedly to fail, and that the central government was unwilling to change the incentives (Dillinger 1995; Perry and Webb 1999; Rodden, Eskeland and Litvack 2001; Ter-Minassian 1997).

In fact, what had occurred by the end of the 1990s was a basic weakening of state government power to secure new credit from central government.⁹ What was not visible was the subtle repositioning of the different levels of government and redefinition of the

9 Fernando Blanco offered useful insights on this point.

rules of the game over the course of each negotiation. For example, in the early bailouts, the federal government negotiated with states en masse, largely setting the same conditions for all states and negotiating partly through the Senate. After 1994, the President and Ministry of Finance sought to divide the states by negotiating with each governor individually. Though restructuring agreements were passed as a group in the Senate, the conditions varied slightly across states and the timing of the agreements differed according to when they were agreed by each governor. In particular, the large states were targeted early, strengthening central government's hand in later negotiations with smaller states (Webb 2004).

One indication of this process can be found in the terms of the workouts. They were linked to fiscal adjustment programmes in which states were required to secure a downpayment on debt equal to 20 per cent of the total. In general, funds for this downpayment were to come from privatisation, and the federal government pressured states to privatise the most common underwriter of debt, their state banks. Within a few years, almost all state banks were either made purely developmental banks or eliminated entirely. To this end, the President had used decree power in 1996 to establish a fund (PROES) which eventually spent R\$62 billion to eliminate the bad debts of state banks and prepare them for sale, absorption by the centre, or extinction (Lopreato 2002). The total obtained through state-level privatisations reached US\$34.7 billion.

Another indication that the relative power of centre and states had shifted occurred in 1999. In January of that year, the new governor of Minas Gerais defaulted on the debt service agreement signed by his predecessor. Publicly, there was no renegotiation of debt service contracts, and the President retained federal transfers of shared taxes from the Minas government. Meanwhile, in private, the President manoeuvred patronage and debt negotiations to ensure that other states would not default also. The hardline stance taken by the President was partly possible because all the states were vulnerable following the Real Plan. Further, repeated bailouts and workouts had weakened their bargaining positions.

More importantly, the hard line taken with Minas was no coincidence. The governor of Minas, Itamar Franco, had been president from 1993-4 and was a political rival to President Fernando Henrique Cardoso. The Minas default was Itamar's calculated move to test the resolve of both president and opposition. Unfortunately for Itamar, he had not calculated the political winds particularly well. Though a few other opposition governors threatened defaults of their own, they soon resumed payments with much less fanfare, and other governors failed to support the move for en masse renegotiation (Samuels 2003: 554).

The President had prevailed due to numerous political weapons in his arsenal. One such weapon was the result of the 1998 Kandir Law. This law had exempted exports from the sales tax collected by states. The loss in revenue led to complaints by governors, and they pressed to receive compensation. Shortly after Itamar's gamble, the President agreed to a compensation fund for the Kandir Law. For the numerous states that were net exporters, especially the poorer states with agriculturally based economies, this compensation promised potential benefits. Such compensation had been one of Itamar's demands, but the President passed the legislation through decree and then left the amounts to be haggled over later, leaving exporting states somewhat dependent on continued goodwill.

2.1.5 Shifting positions of actors: executive/legislative

In addition to the shift in federal-subnational relations, another important shift in the positions of actors occurred in the executive-senate relationship during the 1990s. According to the 1988 Constitution, principal responsibility for setting state debt limits, debt service caps, and approval of new loans fell to the Senate. In particular, the Economic Affairs Committee evaluated, and generally approved, subnational requests for new debt and debt service levels. Frequently, members of this committee used their power to support allies in

state government or to promote their own election to executive positions in the states in subsequent years. In 1997, evidence emerged that the Senate, with grudging Central Bank approval, had been approving state and municipal bonds issued to cover subnational court obligations. These bonds were issued with inflated values, and worse, they were marketed through a series of poorly regulated brokerage houses at large discounts. As the bonds exchanged hands, the gains realised from the discounts were skimmed off and laundered, some even finding their way into campaign coffers. The scandal barely touched the important politicians involved, but it was enough to force the Senate to recognise its own culpability in creating a moral hazard of repeated state fiscal crisis.

Senate Law 78 in 1998 greatly restrained Senate tendencies and power to favour states in debt negotiations. It handed first-mover power to the Ministry of Finance in evaluating requests for subnational debt. Instead of exerting political pressure to secure positive evaluations, senators now largely accept the positive or negative evaluation of creditworthiness provided by the Ministry of Finance (Webb 2004). The new law prohibited loans to states holding primary deficits, reduced admissible levels of debt, and set a trajectory for gradual reduction of debt/revenue ratios (Rezende and Afonso 2002: 16).

2.1.6 Shifting positions of actors: local preferences

An additional shift was evident in the changing preferences of state leaders themselves (Cortez Reis 2004). In his first term, Cardoso had spent political capital (and some dubious patronage) to secure an amendment to the Constitution that would allow re-election in 1998. In the context of renewed currency instability and the popularity of the Real Plan, Cardoso was reelected. On his coat-tails rode several governors: 21 of the 27 governors were members of Cardoso's party or governing coalition. Even the rogue governor Itamar mentioned above was from the allied Brazilian Democratic Movement Party. More important, the key state, São Paulo, was governed by a close Cardoso ally who shared his concern with fiscal discipline. The result was that most governors owed at least part of their political success to Cardoso, and many of them agreed with his strategy of fiscal adjustment.

As they entered power in 1999, many of the governors were looking for an excuse to implement the types of personnel cuts and privatisations that central government was pressing for. The debt agreements and federal legislation gave these new governors some cover to soften the political impact of having to impose cuts.

2.1.7 The tipping point: fiscal shock

The 1998 elections were framed by a series of final shocks that tilted the balance in favour of a wholesale change to federal institutions. Just prior to the elections, the Russian currency crisis shook world markets. Shortly thereafter, the Asian financial crisis suggested the possibility that numerous middle-income and emerging market economies could also be hit. Many considered Brazil to be due a crisis, partly because it had already weathered no fewer than seven crises since the mid-1980s, but also because the Real Plan had fixed a currency band that most observers knew to be overvalued. Cardoso negotiated an agreement with the IMF to get Brazil past the elections, and agreed to 51 conditions of financial and structural adjustment (though few were actually met). Even with the inflow of credit, Brazil's situation was fragile, and the Minas default sparked a speculative crash that saw the currency fall by a third of its value.

The crash was significant for several reasons, not least the disappearance of billions in Brazilian reserves and the apparent mismanagement of an exchange rate liberalisation that resulted in some dubious fortunes. Brazilians, especially those close to the President in the federal government, stressed the need to send firm signals to external creditors that the stabilisation regime would not be threatened.

2.2 Wholesale institutional change: the Fiscal Responsibility Law

The signal was sent in the form of the Fiscal Responsibility Law. This law aggregated measures that were already on the books, repackaged them, and added more firm commitments (Tavares 1999). In addition, it created new institutional mechanisms to manage the behaviour of different levels of government and the relationships between them. The moment and manner in which this reform was introduced was also strategic, occurring in the first year of Cardoso's new administration and packaged within the positive sounding title of 'responsibility'.¹⁰

One area that was repackaged and reformed in the light of previous attempts was personnel policy. Attempts to control personnel expenses had been made before, with little success. The 1995 Camata Law set a ceiling of personnel expenses equal to 50 per cent of current net revenue, and scheduled a timetable for states and municipalities to eventually comply with that ceiling. The federal government quickly moved to obey, but many states did not. The caps reappeared at 60 per cent of current revenues in the debt service agreements post-1997.

Even for governors who wanted to obey the limits, however, they were frequently unable to oppose pressures from inside their own governments. After meeting with most of the governors, Justice Minister Nelson Jobim had explained, 'The biggest problem is that the state executives lost control over their legislative and judicial branches...' (*Folha de São Paulo*, 1 November 1995). Legislatures and judiciaries expanded their personnel and administrative costs and governors could do little to stop them. With the Fiscal Responsibility Law backing up the debt workouts and the Camata Law, governors could finally bring their personnel costs in line. There was a rapid decline in personnel expenses from 65 per cent of state revenues in 1999 to 54 per cent by 2002 (Alston *et al.* 2004: 73).

The context in 1999 included the following ingredients that had built up over time: vulnerable states in fiscal crisis, strengthened central government as a result of debt renegotiations, a senate chastened by scandal, an emboldened president starting his second term, a majority of governors from the president's coalition, and personnel regulations that moved states towards a reform of their civil service. The currency crash of January 1999 gave the final push in favour of a wholesale change to federal institutions. Many parts of the law were already written in debt workouts with the federal government and the Camata Law, but this moment marked a threshold in which multiple changes were codified and established in laws requiring a super-majority in Congress to be revoked.

The law was presented to Congress in April 1999 after several months of internet consultations. It passed through Special Committee in the Chamber of Deputies in December and passed the floor in January 2000 with only 30 amendments. After passing in the Senate, it was signed into law on 4 May. Parallel to the Fiscal Responsibility Law, though somewhat slower in speed, a Fiscal Crimes Law was eventually passed in October that year and established penalties for public officials who failed to obey fiscal responsibility. These penalties included administrative, financial and political penalties and even prison time. Most observers agree that the criminal component of the law will largely hit only municipal or minor officials, but it sends a clear message about the seriousness of fiscal control.

The law stipulated that limits would be established on public debt as a percentage of current receipts for the federal, state and municipal levels. The limit for states has been set at 2 times current receipts, for municipalities 1.2 times, and discussions are underway for the federal government. If indebtedness levels exceed the ceilings, measures must be taken within 12 months to reduce the excess by at least 25 per cent within the first 4 months. Later, the Senate added a provision that states over the limit by the end of 2002 will have

10 I am indebted to José Guilherme Reis for this and other extremely useful observations on the inner workings of the Cardoso administration.

15 years to adjust at 1/15 each year. The law also stipulates a golden rule for credit operations, that they cannot exceed capital expenses. In addition, the law specifically forbids bailouts of one level of government by another. Finally, the law controls one of the mechanisms of state finance that had been most abused prior to the debt workouts: the refinancing of loans in anticipation of receipts. Such anticipations have been forbidden entirely in electoral years (Rodden 2003). Within the last year of a term, there is a further limit on new payment obligations unless administrations can demonstrate that the expenses can be fully paid within the term or there is sufficient cash for unpaid obligations in the next term.

The law also established rules for transparency in accounts. All levels of government have to publish fiscal targets for receipts, expenses, nominal balance, primary balance, public debt, and estimates of state enterprises, pension systems, and other obligations. These accounting and planning exercises are now codified and regulated according to standards set by the National Treasury and had to be published in the first phase of the budget process when the Budget Directives Laws were passed. There are also norms for consolidating and disseminating annual accounts and for producing quarterly reports on fiscal performance, published according to a common set of concepts and available on the internet (interview with senior officials at the National Treasury Secretariat).

Following the Camata Law, the new law also placed limits on personnel expenses as a percentage of revenue for the three levels of government and all branches of government. At federal level, the maximum limit is 50 per cent of current net revenue, while at the state and municipal levels it is 60 per cent. There are also ceilings for each branch of government. The executive branch at the federal level is allowed 37 per cent, legislative 2.5 per cent, judiciary 6 per cent and Attorney General 0.6 per cent. At the state level the percentages are 49 per cent, 3 per cent, 6 per cent and 2 per cent respectively, and at the municipal level 54 per cent executive and 6 per cent for city councils. In the case of a level of government or a power failing to meeting personnel targets, the law stipulates a pattern of transition, and contains sanctions for failure to comply that include retention of federal transfers and administrative penalties. All provisions are enforced through both individual and institutional sanctions. In terms of the latter, if 95 per cent of the maximum limit for personnel is exceeded, the granting of new benefits to revenue officers, the creation of offices and new admissions and overtime will be suspended, or, if officials fail to implement, collect and charge levies under their jurisdiction, voluntary transfers to their jurisdiction will be suspended. With regards to personal sanctions, officials may be removed from office, prevented from occupying public posts, forced to pay fines and serve prison sentences (Serra and Afonso 2002; Tavares 2001).

These personnel limits attracted some civil society and partisan opposition. Public sector workers, sensing a threat, mobilised, and their chief partisan ally, the Workers' Party, articulated their concerns. Several factors made this civil society and partisan opposition weak, however. First, the public sector most able to influence Congressional proceedings was at the federal level. Administrative reform there had preceded the Fiscal Responsibility Law and the new law would not imply additional cuts (interview with legislative aide). As a result, federal public workers were not easy to mobilise to defend workers at subnational levels, and there was only limited pressure during Congressional proceedings.

The partisan opposition of the Workers' Party was also relatively ineffective. For one thing, many party members agreed with basic tenets of fiscal responsibility, and most of their executives at subnational government (with a few notable exceptions) were already well within limits stipulated by the law. There were elements of opposition to what was branded an 'IMF-style' or 'externally-driven' piece of legislation (Bruno 2000: 111–13), but this opposition was really only lukewarm. Even had they mobilised to oppose the law, Congressional rules gave the executive and the governing coalition a strong position to push the legislation through. For example, the rapporteur of the Special Commission, Pedro Novais, had been chosen as favourable to the spirit of the law, and he used his position to limit the number of amendments. The members of the Chamber presented 110 amendments, of which Novais accepted only 30. In addition, the law required only a simple majority, and the parliamentary majority of the governing coalition passed the law easily (Bruno 2000: 386–87).

As a result of pressure and negotiation, several caveats have been inserted in the law. Over 90 per cent of the municipalities are relatively small, with fewer than 50,000 citizens and limited administrative capacity. They operate under slightly looser accounting requirements. In addition, some elements of the personnel regulations were left open to interpretation and have been rescheduled. These were initially meant to be attained by 2000 but they were allowed to slip to 2001 and then 2002 (Guimarães 2004: 90–1). An escape clause was also inserted for ‘exceptional circumstances’. If gross domestic product (GDP) grew by less than 1 per cent for four trimesters, the limits on debt and personnel would be extended, as would the time required for adjustment. In addition, the Senate could provide extensions if it judged there had been a drastic change in the monetary and exchange regime.

Despite these flexibilities, analysis of the federal system since the passage of the Fiscal Responsibility Law suggests a number of important changes underway. Between 2000 and 2002, 18 states improved their personnel/revenue ratio and only 3 states were above the limits set by the law. Debt ratios also improved in 16 out of the 27 states. By 2002, only seven remained above the debt ceilings set by the Senate. In the same period, 18 states also improved their primary surpluses, 8 went from deficits to surpluses and only 3 presented primary deficits in 2002 (Nunes and Nunes 2003).

2.2.1 Fragility

Although this data implies that subnational governments are obeying the Fiscal Responsibility Law, there is evidence to suggest a continuing effort by states to circumvent its provisions. For example, states are currently trying to renegotiate their monthly payments committed to the federal government under the terms of debt renegotiations and those locked in under the Fiscal Responsibility Law. Governors from these states attempt to mobilise public opinion and exert political pressure through state representatives in the House, and especially the Senate. In some ways, the Senate has protected itself by assigning greater control to the Treasury, though states attempt to exert pressure there also. Overall, state leaders have had little success to date in bringing about change through these political channels.

There are also a number of shortcomings in the law that open up the possibility of retrogression. First, the penalty structure of the law is fragmented and dispersed, and there is not an entirely clear mandate to punish administrators, especially those within the legislative and judicial branches. The oversight functions are shared by the legislature at each level of government, the Attorney General, the Accounts Tribunals, and the judiciary. Few of these could be expected to monitor themselves, and the fragmented nature of accountability will likely vary across states. Though these oversight bodies are largely efficient and effective at the federal level, the states vary significantly in the degree to which oversight is technically capable and politically autonomous from governments. In particular, the Accounts Tribunals are charged with alerting the public and other branches of government to the violation of fiscal terms of the law. In general, these tribunals have built capacity to attack corruption (some better than others), and most lack the capacity to evaluate fiscal targets and performance. In municipalities, one has to be doubly worried. At all levels, the counsellors in these tribunals are not entirely suited to be monitors, as they are chosen in part by indication of the legislative or executive powers (interview, National Accounts Tribunal).

Also, despite the valiant efforts of the Treasury to unify the system of accounting at all levels of government, ambiguities remain. Personnel levels are largely measured in similar ways, but there remain issues with the way in which the concepts of pensions are treated across states, some of whom have largely privatised their state pension funds, while others have not. Some states have stipulated that pensions and medical expenses for public servants should not count towards personnel ceilings (Guimarães 2004: 108–9). Debt ceilings are also slightly complicated to measure. Though all significant state banks have been privatised or handed to the federal government, various mechanisms of debt remain. How these are calculated within debt ceilings is still ambiguous, particularly for those states with access to international capital.

Table 2.1 Consolidated debt and personnel as a percentage of liquid receipts

	Debt				Personnel/Receipts (%)			
	2000	2001	2002	2003	2000	2001	2002	2003
Average % Current Liquid Receipts	1.70	1.73	1.94	1.79	47.85	45.97	45.49	45.32
# States Above the Legal Limits	7	5	8	8	7	2	3	3

Source: National Treasury Secretary

2.3 Final observations

The Fiscal Responsibility Law of 2000 in Brazil can be viewed from several perspectives. To some of those involved, it was the bold move of a group of enlightened Brazilian politicians that had finally put their federal house in order:

The approval of the law reflects the extraordinary change in parliamentary behaviour... Not only did the Congress approve the law, but an overwhelming majority of authorities and legislators from states and municipalities understood that she represented a decisive step for the federal republic, almost one century after its initiation, to achieve its potential... This profound movement of the fiscal pattern in Brazil has been recognized internationally... and the IMF concluded that it was a watershed event.

(Serra and Afonso 2002: 4–5)

To others, the law was simply the next step in a path-dependent trajectory that could potentially be reversed:

The principle conclusion of this project is that the Law does not represent a point of rupture. The more likely scenario is that the law represents only one more link, though an important one, in a chain of events that are frequently ambiguous and not rarely contradictory, in the federal history of Brazil. In this sense, from the point of view of broadly evaluating the paths of stability or change in institutions, it can be said that the Law is no more and no less vulnerable to political conjunctures as past institutional arrangements.

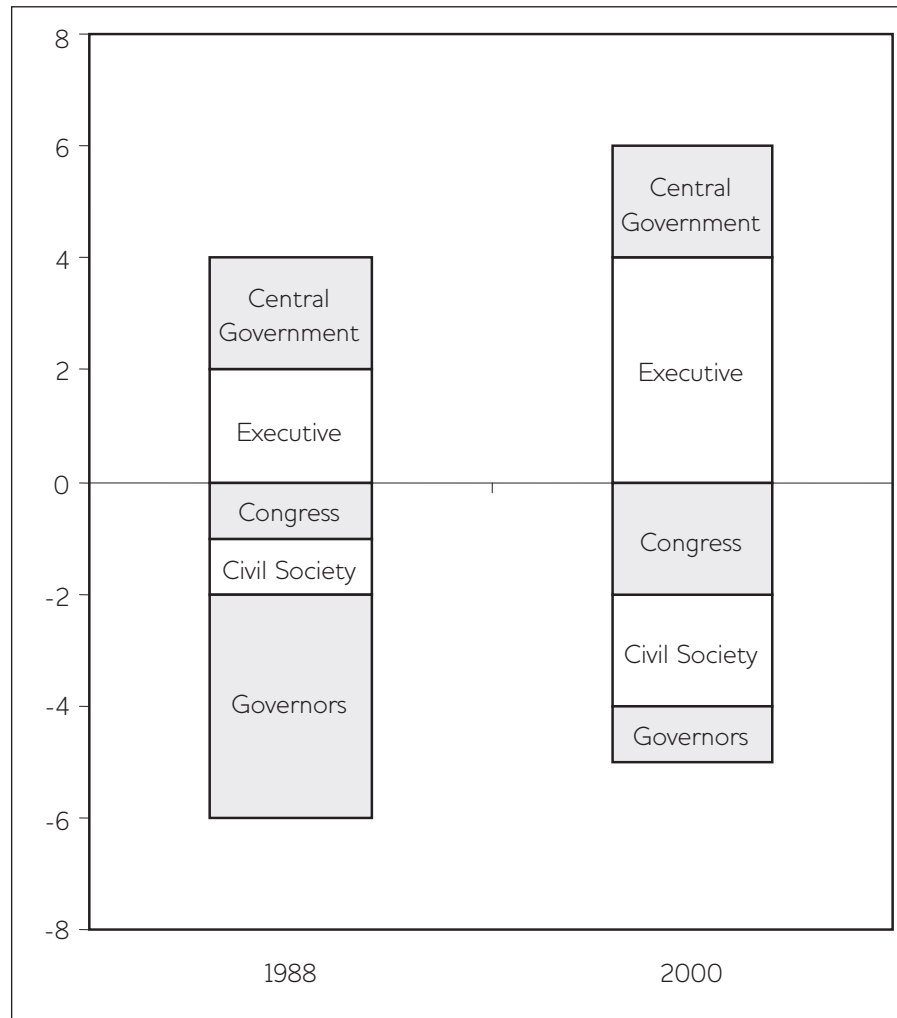
(Guimarães 2004: 138)

The current project takes a middle road. The Fiscal Responsibility Law in Brazil marked the passage of a threshold. Brazilian federalism is indeed different than it was before, most particularly because subnational governments must now obey a relatively hard budget constraint. Still, this threshold was not passed in a sudden leap. Rather, subtle shifts and adjustments in the preferences of different actors, their relative power, and the institutions in which they operated, meant that the federal pact of 1988 had been surpassed. Beginning in 1994, a number of legislative and institutional steps moved towards a new pact, and the Fiscal Responsibility Law represented the culmination of the long process of forming a new federal arrangement.

A potential simplification might be generated, as shown in Figure 2.1. Of course, the numerical representations are meant to be only indicative. Actors who support a new pact get a 'support score' of two, and moderate supporters get a score of one. Opponents score -1 or -2 depending on the intensity of their opposition. Actors also receive a 'power score' that reflects their relative power. Strong actors score a two, and weak actors score a one. The contribution of an actor to a potential new pact, their 'pactability', could be obtained by the product of their support score and their power score. A simple algorithm

takes the sum of these products to give the likelihood that a new pact can be formed. Figure 2.1 offers a heuristic to understand why wholesale change in institutions occurred when it did. From 1988 to 2000, the balance of pactability switched from highly negative to highly positive. More importantly, Figure 2.1 makes it clear that the process of marginally adjusting actors' preferences and powers accumulated to a tipping point. The numbers serve as poor summaries of the contextual details above, but they offer an easy comparison with the case of tax reform, to which we now turn.

Figure 2.1 Wholesale institutional change: a new federal pact around fiscal responsibility



3 Within-institution change: the fiscal pact around tax

3.1 Scope for change in the taxation system

Like the pact supporting federalism after 1988, the pact around tax appeared intractable. A major tax reform had occurred under the military regime in 1967, and the 1988 Constitutional Convention failed to reopen the debate on who should pay what to which level of government. During the 1990s, however, fiscal crisis once again put tax back on the agenda. Two patterns of change were possible: within-institution change or wholesale institutional

change. Unlike the federalism reform marked by the Fiscal Responsibility Law, no wholesale change was to occur in the realm of taxation. Instead, the existing pact that upheld the previous institutional arrangement was modified around the edges, and only limited change occurred. These limited changes were significant in their policy impact, raising tax capacity by over 10 per cent of GDP in that decade alone. There were also notable improvements in the administration and rationality of certain taxes, such as income tax. Still, the changes failed to create a new pact to support more significant change, and the increase in the tax burden came at the cost of economic inefficiency (Werneck 2000; Varsano 2003). The tax reform was an important policy change, but it could have been much more successful in terms of increasing capacity and accountability, had a new pact around tax been possible.

Instead of forging a new pact around tax, all actors manoeuvred within the boundaries of previous tax institutions to face challenges as they emerged. From the earliest days of reform, Deputy Marcos Cintra noted acidly, 'The reform project of the government was a deception. In reality, it has been only a bandaid' (*Folha de São Paulo* 26 November 1995).

3.1.1 Starting positions: the 1967 tax reform

The architecture of Brazilian tax institutions can be traced to the military regime. After several years of discussion, the 1967 Constitution marked a turning point in a tax code (Varsano 1996, 2003). The code gave central government the authority to define subnational tax rates and exemptions, lowered the portion of federal taxes to be shared with states, and reserved the power to establish social contributions to the federal level (Lopreato 2002: 26).

Income tax had been under discussion since even before the military came to power, and it was reformed to shift burdens and expand collection. The system was riddled with fiscal incentives to direct and stimulate capital accumulation, and the result was less equitable than it might have been, especially as the increased tax fell heavily on labour income (Varsano 2003).

Additional reforms included replacing a series of cumulative and cascading sales taxes with a tax on goods and services that made Brazil a pioneer in the use of value added tax (VAT). Unlike later versions of VAT popular around the world, the Brazilian tax was far more complex. It included different rates for different goods and differentiated assignment of revenues across levels of the federation in which both state and national level had their own sales taxes. In addition, the Brazilian version is based on the restricted origin principle, which potentially favours states that are net exporters of taxed goods. In response to pressure from poorer states, a lower tax was applied to cross-border trade. According to the different rates set in each state, importing and exporting states shared the revenues of goods crossing borders.

Unfortunately, while, in the whole world, VAT evolved in the direction of generalization and simplification, in Brazil, especially in the case of the state tax, it followed the path of specificity and complexity. Administration and compliance costs, relatively high with VAT, became excessive; and distortions imposed on the allocation of resources and on competition grew immoderately.

(Varsano 2003)

Despite these shortcomings, the tax take increased from 15.2 per cent of GDP in 1962 to 25 per cent by the end of the 1960s. During the remainder of the military regime and the beginning of the democratic transition, taxes hovered at or around 23–25 per cent of GDP.

3.1.2 Military regime decentralisation and deterioration

At the peak of centralisation under the military regime, constitutional transfers to each

subnational level were just 5 per cent of income tax and the tax on industrial products. As the military began to loosen its hold on power during the 1970s, it increased its transfers to the states and municipalities. By 1988, these transfers reached 14 per cent for states and 17 per cent for municipalities (Medeiros 1986). Over time, these transfers became more and more untied, providing lower levels with block grants to allocate largely as they wished (Serra and Afonso 2002).

During the entire period of the 1960s and 1970s, incentives to production had been an important component of the strategy of capital accumulation and development. Over time, though these incentives slowed, they proliferated enough to eat into fiscal capacity, and by the late 1970s, tax capacity was weakening. For the federal government, this was exacerbated by increased transfers to lower levels. To sustain tax capacity at approximately 25 per cent of GDP and to secure further revenues, the regime used decree powers, legislative majorities and strong presidential powers to pass a number of social contributions. These contributions were collected into various funds and were retained at the federal level.

3.2 Failed wholesale change

3.2.1 The 1988 Constitution

The transition to democracy in 1985 was followed by the Constitutional Convention of 1988, described above. In many ways, the Constitutional Convention was one of the first attempts to open a discussion on a new pact around tax. Ultimately, like the other attempts that would follow, actors shied away from real debate. In this case, they were enveloped in localist and regional pressures, and instead of dealing with basic questions of more equity and efficiency, the debate focused on reorganising the federal dimensions of the tax system (Souza 1997). 'The distribution of tax revenue among units of the three levels of government was the main issue. The backbone of the tax system remained practically intact.' (Varsano 2003) The Brazilian political elite was unable to confront the politically charged questions of who should pay and receive what. Instead, they focused on what level of government should collect taxes, and what level should spend them.

The Constitution fixed high levels of block grant transfers to subnational units (44 per cent of income tax and industrial goods tax) and confirmed the autonomy of states and municipalities to control their own tax bases. The state sales tax on goods was expanded to areas (such as fuel, energy, telecommunications, transport and minerals) that had previously rested with central government, and municipalities were given control over sales taxes on services. Central government retained several exclusive taxes, including social contributions.

The result was that the assignment of revenues exacerbated inequality across units of the federation. The ratio between the states with highest and lowest tax capacity is almost 9.4 (Prado 2001: 50). Though the federal transfer system includes a progressive formula to address some of these inequalities (Rezende and Afonso 2002: 115), there is nothing in place to address inequalities across municipalities in individual states (Prado 2001: 54). In fact, some of the least progressive internal distributions of tax capacity are in the poor north-eastern states that receive most transfers from the federal government.

Although constitutional transfers included a progressive formula for distribution, negotiated transfers worked in the opposite direction. Wealthier states tended to benefit disproportionately from transfers outside the constitutional system, which are negotiated directly between the state and federal government. Negotiated transfers almost doubled from 1995 to 2000, and most were directed towards states that were politically important to coalition-building at the federal level (Rodden and Arretche 2004).

It has to be noted that pressure from civil society, progressive political elites, and the general mood of democratisation turned some attention during the Constitutional

Convention to equity issues. The legislation itself shows an attempt to tackle 'who should pay what' questions. A tax on wealth was created, and the federal government retained a tax on rural property. Unfortunately, the commitment to these measures was never significant, and neither was ever to prove an important source of revenue. In fact, the tax on large fortunes remains unregulated and even its advocates have not found a way to push it through (Varsano 2003; interview, Everardo Maciel).

3.2.2 The Collor era

Attempts to chip away at the edifice of the tax regime left by the 1988 Constitution and its antecedents began almost immediately. A look at the fits, occasional successes, and frequent retreats tells the story of the scope for governance reform within inherited institutions and the difficulty of change.

In 1991, facing fiscal and currency crisis, President Collor pursued a reform labelled the Big Amendment (Emendão). This reform included emergency measures that set top personal income tax rates at 35 per cent and introduced a tax on financial transactions. For a time, it secured an increase in tax capacity that raised taxation levels close to 30 per cent of GDP. Yet Collor had failed to build a real pact around these issues, and had largely made use of autocratic powers left to the executive from the military regime (Castro Santos, Gracas Rua, Massimo Machado and Peixoto Machado 1994). He proved unable to build a parliamentary coalition, and taxes soon dropped to their previous level. In fact, parliament soon tired of his high-handed strategies, and in the midst of a corruption scandal, Collor was eventually impeached. In a prescient analysis, several observers noted, 'The tax and fiscal reform at the heart of structural change will depend on a political solution' (Castro *et al.* 1994: 60).

3.2.3 The Cardoso era

Varsano (2003) lays out the basic elements of what most technical observers consider the important necessary reforms.

It is practically a consensus that the Brazilian domestic taxation hinders both the insertion of the country in the global economy and economic growth, for: it imposes a competitive disadvantage to the Brazilian production sector, in both the international and the domestic markets; it distorts the allocation of resources in detriment of economic efficiency; it increases the cost of investment by taxing capital goods; it is excessively complex and inappropriate for international harmonization; it facilitates or even stimulates evasion, causing inequity and unequal competition; and it is suitable for predatory fiscal competition among states, the so-called fiscal war, that brings about conflicts in the federation.

(Varsano 2003)

Attempts at a global reform were reinitiated in 1997, this time spearheaded by a special committee in Congress. Acting with the support of the industrial and financial sectors, the Special Committee generated a replacement reform proposal that targeted both sales taxes and contributions (interview, President of the National Confederation of Industries). This replacement proposal germinated over the next two years, and it involved tough negotiations among all political parties, state governments, the private sector, and the federal executive, represented at times by the Ministry of Finance and at times by the Secretary of the Tax Administration (interview, Everardo Maciel). In late 1999, the federal government, congressmen, and state secretaries of finance convened a series of meetings to attempt to overcome the impasse.

The heart of the reform addressed the sales tax. This tax currently operates on the basis of the origin principle and in a segmented fashion in which all three levels set rates on one

area or another. The state sales tax (ICMS) is the most important tax in terms of collection, and it accounts for approximately 30 per cent of all taxes collected (Varsano, Pessoa, Costa da Silva, Afonso, Araujo and Ramundo, 1998; Prado 2001). The rates for this tax vary across states and goods, and generally hover around the 18 per cent level. The states complicate the picture further by competing to attract investment with the use of tax holidays and other incentives, and the total number of tax categories has risen to 44 across states (interview, office of Senator Aloisio Mercadante).

To renegotiate this tax would require a pact among various states. A key problem is the issue of uncertainty in the context of fiscal crisis. States may be willing to accept a switch to the origin principle, but no one actor can be sure how much will be gained or lost. As Fernandez and Rodrik (1991) show, uncertainty about future benefits can create a status quo bias. One observer from the Ministry of Finance agrees, 'It is not that the states or some group of states are too powerful, it is that neither the states nor the federal government want to run the risk of losing money.'

An additional problem with a new pact around tax could be found in Congress. The rapporteur in the Special Committee, Mussa Demes, had been a state secretary of finance, and he committed himself to protecting the revenues of the states. His alternative proposal and skilful use of legislative rules meant that negotiations over tax were slowed to a crawl. He accused the executive of 'technocratic terrorism' in trying to overturn his proposal (*Gazeta Mercantil* 26 November 1999), and the executive responded with its own attacks: 'The reform presented by Mussa Demes has a series of loopholes favouring, above all, evangelical legislators with links to radio stations, and industries in the Manaus free trade zone.' (*Correio Braziliense* 27 November 1999).

Additional civil society actors found their way into the negotiations and further complicated a new pact. Somewhat dubiously, the private sector attempted to portray itself as the champion of the poor in its opposition to reform. The head of the São Paulo Industrial Federation commented, 'Business-people are principally worried about the consumer of low income who is excessively burdened with tax when buying basic subsistence goods' (*Gazeta Mercantil* 7 October 1999). Ultimately, the private sector divided, and it returned to its traditional practice of seeking specific incentives for specific businesses.

A wholesale change in tax ultimately floundered because even its staunchest advocates lost interest in seeing it succeed. Fiscal crisis meant that neither central government nor the executive was willing to reform tax in a way that might risk revenues.

An important obstacle for carrying on the reform has been apprehension about its repercussion on fiscal adjustment. Any relevant tax reform entails some risk to the level of tax revenue; not because of technical or administrative troubles, which can be surmounted, but due to judicial disputes about the changes, which may interrupt tax payments for some time.

(Varsano 2003)

3.3 Within-institution change

3.3.1 Recovering central control

This pattern of failed wholesale change does not mean that nothing happened during the 1990s. Important advances were made, and tax capacity increased markedly. These advances began in part with the Real Plan of 1994. The plan depended on a fiscal adjustment, and cutting spending was, and continues to be, exceedingly difficult. Instead, the government sought to increase taxes and reduce the portion of revenues controlled at subnational level.

To generate surpluses at the federal level, central government sought a constitutional amendment to retain 20 per cent of earmarked tax revenues that would be collected into

the distractingly labelled 'Social Emergency Fund' (FSE). To acquire the two-thirds majority needed for the amendment, the president who replaced Collor, Itamar Franco, had to enter into complicated bargaining with the Chamber and the Senate, and had to agree to a time limit on the fund. In ensuing years, each time the limit was set to expire, the central government renewed the fund under different names (Fiscal Stabilisation Fund, Disconnection of Union Revenues). Each time, support in Congress had to be re-established, and the opportune application of patronage to legislator bailiwicks pushed the fund through each time (interview, legislative aide).

This retention and other mechanisms allowed the federal government to recuperate some of the ground it had lost to the states and municipalities. From 1983 to 1995, the federal government had lost progressively more ground through growing constitutional transfers. Central revenues as a percentage of the total were 69.1 per cent in 1983, and fell to 56.2 per cent in 1995. From 1995 to 2000 the trend reversed, however, and central revenue increased to 59.9 per cent (Samuels 2003: 555–6). Still, rolling back some of the decentralisation that had occurred under the military and in the first years after the 1988 Constitution was always treated as a temporary measure. No entirely new pact on relative shares of revenue could be established.

3.3.2 Contributions

Among the most important tools to recover fiscal capacity at the centre were the social contributions the military regime had initiated. During the 1990s, these contributions accounted for approximately half of the growth in tax as a percentage of GDP (Afonso 2001). Contributions were attractive as instruments of revenue collection for several reasons. They came into effect three months after initiation (instead of the following year, as with normal taxes); they were not shared subnationally; and they required only a simple majority to approve (not a supermajority and special congressional committee). In several instances, presidents used decree powers to adjust rates on contributions, and these issues moved immediately to the top of the legislative agenda.

During the 1990s, existing contributions climbed and new contributions were initiated. Among the nine major contributions, five were payroll taxes dedicated to pensions and other benefit systems. Originally, the contribution on financial transactions was passed as a temporary measure by Collor and was subsequently declared unconstitutional. A political bargain to patch up a health crisis in 1996 brought the tax back, but only on a temporary basis (Piola and Biasoto 2001). The contribution was renewed in 1998, unconnected to health, and it has survived as a repeatedly renewed temporary measure. As a proportion of total revenues, contributions climbed from 27.2 per cent to 46.7 per cent between 1990 and 2001 (Samuels 2003: 556; Rezende and Cunha 2002).

The most significant problem with the contributions, of course, is that they tend to be cascading. At each stage of production, contributions of one sort or another end up factored into production costs and eventually pass into the price of goods. A noted tax expert, Professor Rogerio Werneck, commented: 'The biggest problem is that the largest portion of the increase in federal taxes results from low quality taxes, especially as the government seeks the most varied and exotic forms of revenue, capable of generating receipts that are not shared with the states and municipalities.' (*Estado de São Paulo* 7 October 1999)

Still, these contributions have been an important, if not the most important factor in increasing federal share of overall revenues. They have also been an important mechanism of fiscal adjustment. Politically, the contributions were attractive because they were spread over the entire formal sector, and though their economic cost was obvious, the contributions themselves were relatively invisible deductions from payroll and bank accounts (Lledo 2004). In other words, a large fiscal boon required little more than a few discussions in Congress, some exchanges between the executive and legislature, and no significant

pacts with wider interests. Table 3.1 below displays the changes over time in amounts of tax and the distribution of tax across levels of government.

Table 3.1 Tax burden and distribution across levels of government

Year	Tax burden (% of GDP)	Share in total tax collected (%)			Share in disposable revenue (%)		
		Union	States	Local	Union	States	Local
1960	17.41	64.0	31.3	4.7	59.5	34.1	6.4
1970	25.98	66.7	30.6	2.7	60.8	29.2	10.0
1983	26.97	76.5	20.6	2.8	69.8	21.3	8.9
1988	22.43	71.7	25.6	2.7	60.1	26.6	13.3
1995	29.41	66.0	28.6	5.4	56.2	27.2	16.6
2001	34.36	68.7	26.8	4.5	59.3	26.5	14.2

Source: Varsano (2003)

3.3.3 The Kandir Law

In 1995, a new attempt at major reform stalled, and only marginal changes were possible through the artifice of hiding reforms behind other legislation, utilising decree powers, and generally avoiding a wider renegotiation of social and federal pacts.

For various reasons, the most significant result of the 1995 amendment proposal (PEC 175/95) was the Kandir Law. This law exempted international exports from state sales taxes, and thus removed a major obstacle to Brazil's continued liberalisation. It can be considered an important advance. The reform was only possible once the federal government had promised a compensation fund for exporting states so that they could recoup lost revenues. The chief architect of the law, Deputy Antonio Kandir, played an important go-between role for the federal government and the different states. The agricultural exporting states formed a particularly organised lobby, and they secured the most favourable terms of the compensation fund. They continue to point out, however, that the amounts set aside for compensation have been greatly underestimated and are prone to chronic delay (Interview, Chamber of Deputies Office of PFL delegation). In addition, as a result of fiscal pressure on state governments and pressures from individual lobbies, the law was watered down when reissued and is now less technically efficient than the original.

3.3.4 Income tax

Later reforms continued the same trend – the federal government preferred turning the screws on tax handles that were already established, thereby avoiding direct confrontation with powerful interests over taxes.

Brazil followed international trends and dropped its income tax and profit contributions to approximately 25 per cent for the top marginal bracket. This was intended to attract investment, and coincided with additional measures to create a more globalised economy (Ministerio de Fazenda 2001: 108–10). Through temporary measures first in 1997, again in 1999, and a third time in 2003, the top bracket was raised to 27.5 per cent. Each time, the increase was presented and negotiated in Congress as a temporary measure, set to expire within a few years. By presenting them in this form, the increases were more palatable to potential opponents. Even politicians whose electoral bases might oppose any tax increases could pretend they did not know the increase was likely to be renewed. Income tax increased by over 50 per cent, and increased as a portion of total taxes from 13.8 per cent in 1994 to 16.7 per cent in 2000.

In addition to increasing the revenues from income tax, reforms in this area simplified the administration and compliance of the tax regime. Incentives were eliminated, and rates were unified across different patterns of personal, corporate and financial income. For small and medium-sized businesses, new forms of simplified tax (SIMPLES for small business and Presumed Income for medium businesses) replaced a whole series of contributions and taxes that were difficult and costly to administer. The impact was to decrease the attractiveness of informal sector activity for small and medium-sized businesses, and the number of taxpayers rapidly increased. In 1999, firms paying the SIMPLES and Presumed Income taxes accounted for over 16 per cent of corporate income tax and included over 92 per cent of the firms.

Several of the changes were possible through bureaucratic decree, and those that had to be approved by Congress required only a simple majority. The general pattern adopted was to leave the debate over tax until the end of the year. As Congress discussed the budget and tried to find room for the pet projects of each legislator, the tax legislation would simultaneously pass through committee. The result, of course, was that legislators had to approve the tax increases if they were to secure their preferences in spending. To protect themselves, they used artifices such as pretending the tax increase was temporary, attaching a time limit to any increase in rates, or the creation of new bases. When time limits expired, the same game would be played, with congressmen forced to pass the tax increases if they hoped to secure funding for extra spending amendments.

The government paid particular attention to the financial sector. By redefining and equalising the rates for different forms of financial assets and income, government income from this sector increased rapidly. In addition, the prior concepts of profit and employment contributions were extended to the financial sector, netting almost R\$2.4 billion in 2000 alone (Ministerio de Fazenda 2001: 135). Everardo Maciel, Secretary of the Tax Administration at the time, explained the success of the reform in terms of strategies pursued following the Real Plan, when the most powerful banking interests faced outstanding judicial cases as a result of rapid changes in inflation and interest rates. Maciel 'resolved the judicial cases outstanding, and in the process, left the adversary weak. After, I negotiated with FEBRABAM (the Association of Banks) over taxes on the financial sector. The difference was R\$22bi to federal revenues'. What Maciel does not mention is that one of the chief beneficiaries of the high interest rates following the Real Plan was the financial sector. One cannot deny his persuasive leadership in breaking through resistance. Still, the pain of the extra contributions he was demanding surely hurt less in a context in which interest rates rose to a ceiling of 40 per cent, and never fell below about 13 per cent, where the sector could make unprecedented profits, not least on government debt.

3.3.5 Addressing cascades

Moderate reforms passed in 2002 and 2003 eliminated cumulative effects in some of the social contributions. Using presidential decree powers, the executive proposed a change to the contributions that would replace a cascading 3 per cent rate with a non-cascading 7 per cent rate. The new rate was meant to be revenue neutral, though the executive simply delayed presenting the evidence of revenue neutrality until after Congress had to vote on the bill. Issued first as a decree, the proposal moved to the top of the legislative agenda, and governing majorities meant that the bill was passed quickly.

There might have been room for debate on setting the equivalent rate for the non-cascading tax. Outside the public eye, representatives from the private sector estimated a 6 per cent rate would have been sufficient. Publicly, productive sectors and their representatives had little capacity to generate a broad consensus on the issue. Instead, individual interests blocked the legislation, which required three separate laws to pass, and negotiated particularist exemptions from the change. Side-payments were secured by subcategories of the private sector, such as transport and agriculture. They argued that their shorter production chains should be allowed to retain the prior cascading 3 per cent rate (interview, Association of Small Businesses). Still, the government was content to secure a moderate increase in

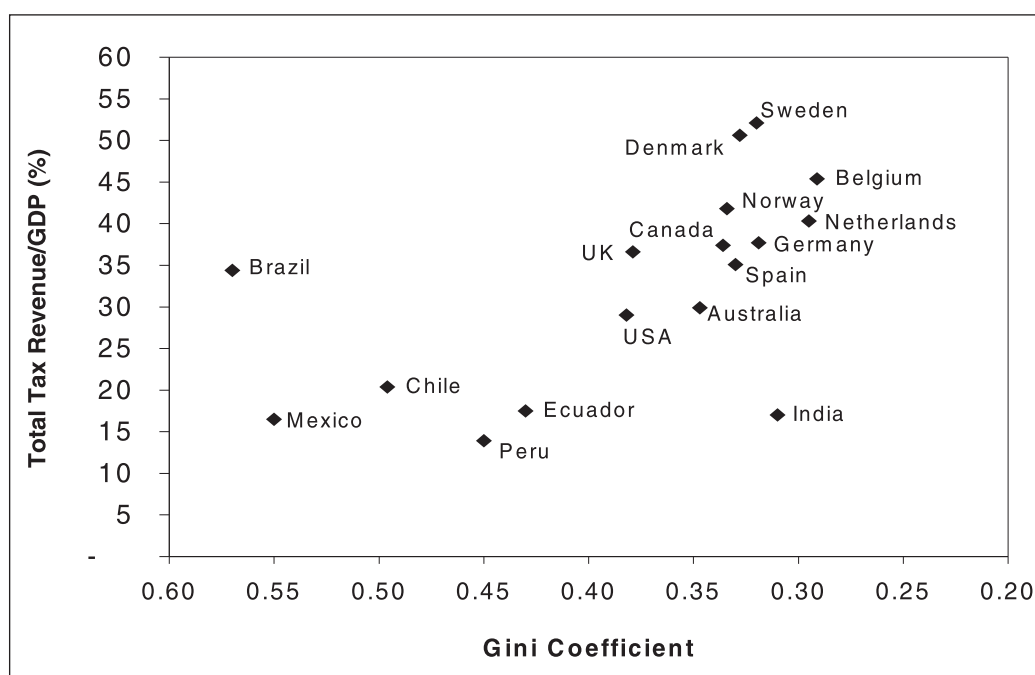
efficiency and a slight increase in revenues without negotiating a broader social pact. To engage in a full reform of the entire system would have been too politically complicated.

There were important triumphs in changing the tax regime during the 1990s and early 2000s: the modernisation of the income tax regime, the exemption of exports from sales tax, the elimination of some elements of cascading contributions, and the extremely impressive increase in tax capacity. Even these reforms were achieved under the radar of important political actors. There was little public discussion of the changes that actually occurred, and no new pact around tax led to their approval.

The reforms passed unnoticed by the population in general and even among specialists because it was done gradually, in the context of a well structured project, that required only ordinary legislation to promote. For that reason, it was not necessary to confront the conflicts and difficulties typical of constitutional tax reform.

(Ministry of Finance, Treasury Secretary: 137)

Graph 3.1 Tax burden and gini coefficient



Source: Bezerra de Siqueira *et al.* (2003: 5)

3.4 The problem of regressivity

The failure to directly engage in a debate around tax has continued to degrade the efficiency of the system. As Varsano (2003) suggests,

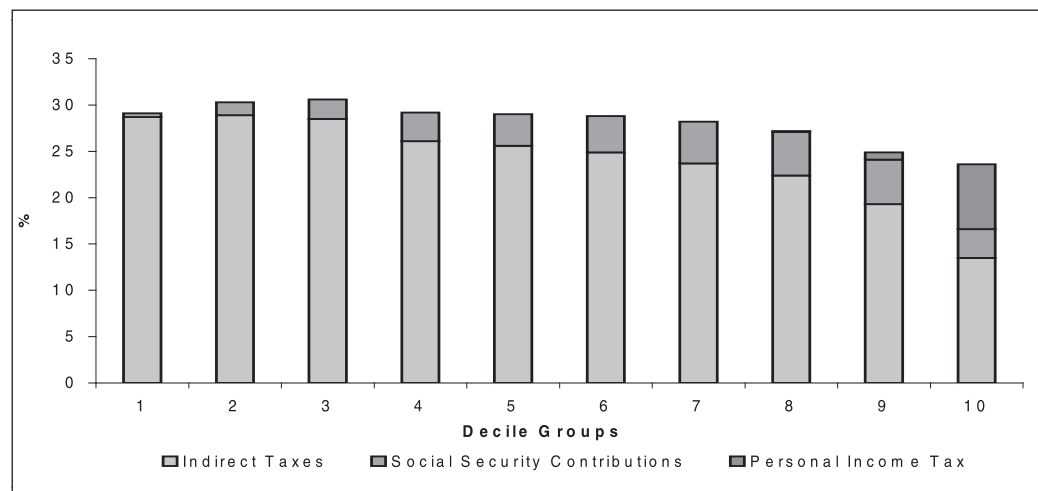
Brazilian experience shows very well that, despite being a discontinuity, tax reform is far from an instantaneous event. Rather, it is a process that involves time-consuming discussions, negotiations and legislative procedures before implementation. Time elapsed from the initial discussions and propositions to completion of the reform is usually very long. Furthermore, resistance to change stemming from economic agents – prominent among them tax administrations of the three levels of government – brings about a tendency to recondition pre-existent taxes instead of replacing them by better quality ones.

(Varsano 2003)

In addition, the aspect of the tax system that has been least addressed is its regressivity. As many have noted, Brazil is the single most unequal country in the world. One might expect a country that mobilises so many resources to combat inequality effectively; yet, Brazilian inequality remains far worse than other countries that tax at similar levels (Bezerra de Siqueira, Nogueira, Levy, Immervoll and O'Donoghue, 2003). In fact, Brazil is an obvious outlier in a graph that plots tax burden and gini coefficient. Most countries with levels of inequality comparable to Brazil tax far less, and most countries that tax heavily do a much better job of redistribution.

When one considers the proportion of household income that Brazilians pay in tax, poor households end up contributing more. Direct taxes practically hit only the highest income brackets, and the poorest households (mainly in the informal sector) largely escape social contributions. Still, if one assumes that producers shift social contributions to consumers, the incidence of taxes almost uniformly decreases with income.

Graph 3.2 Taxes as a proportion of household gross income by decile group



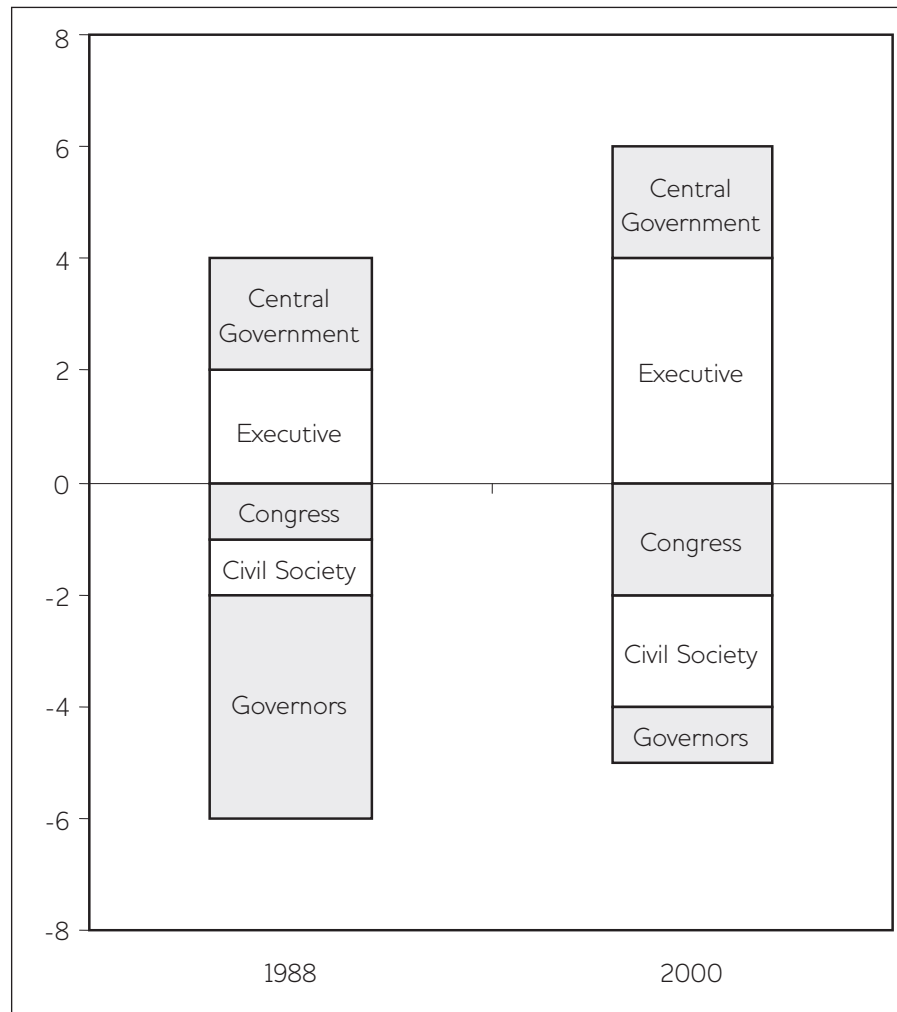
Source: Bezerra de Siqueira *et al.* (2003: 11)

The degree of regressivity in the Brazilian tax code has remained markedly off the tax reform agenda. While in opposition, the Workers' Party attempted to introduce more progressive sliding brackets on income tax when reforms were debated in 1995 and 1999. These proposals were not adopted in the reform, and they have been left off the agenda since the party came to power in 2003.

3.5 Final observations

Changes to the tax regime in Brazil during the 1990s and 2000s have been significant, and they allowed for fiscal adjustment at the federal level. These changes occurred slowly and incrementally, but at virtually no point was the government able to forge a new pact around tax. All of its governance reforms occurred within existing institutions, and there was virtually no ability to engage in wholesale institutional change.

If we take the same algorithm as in Figure 2.1, we can see that the processes of change that occurred during the 1990s were not sufficient to tilt the balance in favour of wholesale change. Once again, the position score ranges from two (strong support) to -2 (strong opposition) and the power ranges from one (weak) to two (strong). Unlike the strong swing that occurred to tip the balance in the form of the Fiscal Responsibility Law, there is only the slightest hint of a swing in the case of tax.

Figure 3.1 Within-institution change: tax reform

4 Conclusion

One cannot help but wonder why a new pact around the Fiscal Responsibility Law was possible, while it was impossible for tax. Both reforms represent governance changes, and in this sense, they shared some similarities. They were both gradual and incremental processes in which interests, power, and inherited institutions mattered. What set the two reform processes apart was whether incremental changes in these variables built towards a new pact or not.

The incremental process leading to the Fiscal Responsibility Law served to weaken opponents, strengthen supporters, and adjust institutions in ways that directed actors' interests towards reform. In particular, the principal opponents of reform found their positions weakened and shifted over the course of the decade. Ultimately, this reached a threshold that the Fiscal Responsibility Law was able to breach. The law was the result of a new pact around public finances and federal relations.

In the case of tax, incremental changes occurred within existing institutions and did not accumulate to create a new pact around tax. Explicit attempts to forge a pact among social, political and federal actors were unsuccessful, and actors remained content to operate within the boundaries of inherited institutions. This meant that certain perversions continued

and were exacerbated. The federal government made use of decree power and institutional rules to raise revenues, but it did so by using cumulative taxes and retaining transfers it was meant to share. States made use of the autonomy they had gained in the 1988 Constitution to engage in fiscal competition over the sales tax. The result was an inefficient tax system that raised significant revenues but carried an economic cost in distortions, disincentives and inequities. The few episodes of reform that occurred were limited to the boundaries of existing institutions, and did not seriously upset or threaten existing pacts.

The role of fiscal crisis is interesting in both cases. In the case of the Fiscal Responsibility Law, the fiscal crisis of 1999 offered the final push to tip the balance in favour of reform. In the case of tax reform, fiscal crisis did not overcome the coordination and uncertainty problems involved in creating a new pact, and may even have complicated matters. In the context of fiscal crisis, all actors were insecure about losing revenues, and the central government in particular wanted to avoid worsening a fragile fiscal situation.

A few other observations are relevant. Much of the preceding discussion has focused on the Machiavellian 'high' politics of manoeuvres and manipulations to disarm opponents and strengthen allies. Indeed, this is the stuff of everyday politics in which contingency and agency are crucially important. This leaves open two related questions.

- First, what conditions make contingency and agency relevant?
- Second, what do these changes mean for the concept of governance?

Machiavellian manoeuvres were sufficient to bring about an entirely new pact which enabled wholesale change in the institutions of fiscal policy in Brazilian federalism. The same kind of politics was only sufficient for within-institution change in the case of tax.

The reason high politics was sufficient in one case and not in another may lie in the nature of social actors that had to be coordinated. In the case of federalism, there were fierce opponents to reform, but these were mostly located among the political elite (senators, governors, bureaucrats). These actors were drawn from a narrow group, and could be co-opted, cajoled, or coerced into cooperation.

By contrast, wholesale change in tax institutions would have required a much more fundamental and structural renegotiation. The same political elite was at the centre of the process, but they operated as representatives of wider social and economic interests. Governors opposing the reforms acted as members of different regions, and they saw tax as a struggle between fundamentally opposed interests. Civil society actors articulated the interests of competing sectors (industrial, agricultural and others). There were fewer possibilities of side-payments and coalitions when the interests in opposition were more deeply rooted. Instead of facing up to the task of a new pact, tax reform focused on the high politics of intra-elite negotiation. This was sufficient to achieve within-institution change, but it could never approach wholesale change.

This observation allows us to address some of the debate between those who focus on Brazil's chaotic political system and those who emphasise countervailing institutions. The current study suggests that countervailing institutions do allow some degree of change, especially at the level of political elites. Yet, the countervailing institutions are insufficient to tackle some of the biggest structural problems in Brazil, most notably those that excite the anger of powerful societal interests. Powerful interests in Brazil block issues like tax reform, land reform, and redistribution. No amount of Machiavellian manoeuvring can sneak such changes through existing institutions. On these issues, the political system shows itself to be feckless, inchoate and chaotic. Far more powerful countervailing institutions would be necessary to tackle such problems, but forming pacts to support such institutions has proved extremely difficult.

Still, the results of federal reform and tax reform are infinite improvements over governance patterns that existed previously. The working definition of governance that has oriented this study has been 'the manner in which the State exercises and acquires authority'

(Campos and Pradhan 2003:1). Both reforms represent shifts that increased the capacity of the state while moving towards more modern patterns of operation. Wholesale change represented by Fiscal Responsibility Law was more significant for two reasons. First, the Fiscal Responsibility Law created new institutions; tax reform only involved adjustment at the margins of existing institutions. Second, the process of achieving wholesale change depended on the construction of a new pact. In relation to tax, this was not possible.

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