

# **Brazil: The Prospects of a Center-Constraining Federation in a Fragmented Polity\***

## **Preliminary Version**

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### Introduction

The wave of redemocratization that spread throughout Latin America and Eastern Europe in the 1980s has taken varying paths, producing different experiences and results. In many countries, redemocratization came hand-in-hand with political and financial decentralization to subnational governments. In others, redemocratization implied coming to terms with the authoritarian past through the drawing up of a new constitution. In certain federal countries, redemocratization and decentralization have changed the features of their federation. These factors came together with a common agenda for the economy, democracy, and its institutions: these countries are struggling to build or re-build their democratic institutions, while at the same time adopting an economic paradigm of tight fiscal control and market-oriented policies.

Brazil is an example of a country in which all these factors have occurred simultaneously. Although there are certainly problems concerning Brazil's democracy, the country has succeeded in creating or re-creating the institutional procedures of political democracy, i.e., it has experienced several free and fair elections at all levels of government. The drawing up a new constitution was of great importance to reconcile all segments of society by allowing them to voice their demands. The new constitution was also of importance to federalism given that the options taken by the 1988 framers at that particular critical historical juncture redefined the federation, as well as its prospects. As regards decentralization to subnational government, there is a consensus that Brazil is the most decentralized country in the so-called developing world.

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In order to analyze the current stage of Brazilian federalism, its prospects and the achievements of the agenda mentioned above, it is necessary to examine both the national and subnational institutions. Furthermore, these factors and this agenda become more complex in countries that are characterized by deep-rooted political, social, economic, and regional disparities as in Brazil.

Federalism is one of the institutions that has been reconstructed in redemocratized and decentralized Brazil. However, recent changes should not be viewed as a radical move from a centralized to a decentralized political regime. The Brazilian case does not present a dichotomy between centralization and decentralization. Rather, Brazilian federalism and the transformations it has undergone since redemocratization are best understood as the latest set of changes on a continuum of center-state-local power relations.

Although there have been deep changes in the federation as a consequence of redemocratization and decentralization, profound imbalances among regions persist. As an illustration, it is worth mentioning that in 1994 56% of GDP was concentrated in the Southeast and 17.5% in the South, whereas the Northeast had 14% and the North and the Center-west regions had 4.8 and 7.1% respectively. Regional GDP per capita also bears out the country's high degree of inequality. Brazil's GDP per capita is US\$ 5,037; in the Southeast it is US\$ 8,843 and the Northeast US\$ 3,085, three times smaller than that of the Southeast. In the case of the participation of individual states in the GDP, economic concentration has worsened in the 1990s. In 1985, seven out of 26 Brazilian states and one federal district produced two-thirds of the national wealth and in 1994 this figure reached 77.3% (Lavinás et al., 1997). In contrast to the 1970s and 1980s when regional economic concentration decreased slightly the 1990s saw this trend reversed. Southeast GDP, which had fallen between 1970 and 1985 from 65.5% to 59.1%, reached 59.6% at the end of 1998. Northeast GDP, which had increased its share from 11.7% to 13.6% between 1970 and 1985, dropped in 1998 to 12.6% (Serra and Afonso, 1999).<sup>1</sup> Therefore, despite the efforts made by the 1988 drafters to decrease economic concentration through the distribution of taxes from better-off to worse-off regions, economic concentration in the Southeast has increased.

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<sup>1</sup> For the impact of regional inequalities on economic and social issues, see Guimarães Neto (1995).

These imbalances have shaped the results of redemocratization and decentralization, creating contradictions and tensions in the nature of Brazilian federalism. On the one hand, political and financial decentralization has favored the prospects of democratic consolidation by making Brazil more "federal". Specifically, the transformed political and institutional environments have prompted the emergence of new political actors. The changes have also led to the emergence of alternative power centers that now compete among themselves and with the federal government. As a result, the federal government is compelled to negotiate with the subnational spheres to find solutions for national issues, thus making Brazil both more "democratic" and more "federal". On the other hand, the Brazilian experience suggests that decentralization restricts the reduction of the country's regional inequalities by financially and politically weakening the federal government. The weakening of the federal government has not meant that it is an absent player rather it is forced to reach compromises with subnational politicians for the solution of national issues.<sup>2</sup>

Literature on decentralization, intergovernmental relations, and fiscal federalism has not yet provided clear answers on how to assess these issues in a theoretically informed manner. This lack of a coherent analytical framework allows excessive space for evaluating how decentralization, intergovernmental relations, and fiscal arrangements affect the way federalism works in practice. The literature is generally too normative or incomplete, such as the attempts made by public choice and new institutionalist theorists to address the impact of decentralization, intergovernmental relations, and fiscal arrangements on federalism. Although they take into account a crucial issue in federalism, i.e., the problem of collective action, therefore, allowing for the view of federalism as a conflict-ridden institution, it remains over influenced by economic assumptions.<sup>3</sup>

Some political-science literature, in contrast, has concentrated much effort on explaining federalism. This literature deals with federalism itself, its definition and characteristics, such as Elazar's (1984; 1987) classical works. Another slant taken relates

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<sup>2</sup> For a well-documented study of the success of the federal government in dealing with Congress, see Figueiredo and Limongi (1999). For how the interests of state governors sometimes coincide and diverge from Cardoso's agenda to reforming the State, see Weyland (2000).

<sup>3</sup> For a critique of fiscal federalism literature and its application to the Brazilian case, see Aguirre and Moraes (1997). For the limitations of decentralization literature, see Souza (1997).

federalism to democracy or interprets federalism as a result of "coming together" purposes, as in the classical works of Dahl (1986; 1989) and Riker (1964; 1975). These contributions are of great importance because they provide theoretical grounds for comparative research and they address the broad questions facing a federation. However, because they are oriented towards answering broader and more general questions, one still needs to narrow the search for other theoretical formulations able to capture differences within each federation. This is the case in a country like Brazil which has throughout its history assumed different federal arrangements and where federalism has also survived under authoritarian regimes. Furthermore, Brazilian federalism was not a response to the division of society along ethnic, linguistic, and religious lines; these have never been important on the political agenda.

Empirical studies on Brazilian federalism offer little to a better understanding of a federation deeply-rooted in regional inequalities. These studies derive from several disciplinary angles: law, fiscal federalism as an aspect of macroeconomics and public administration; history; and political science. However, they present some problems.<sup>4</sup> The great majority are not theoretically informed and many tend to isolate the financial from the political realm. This separation hampers a proper understanding of Brazilian federalism given that the rules of the fiscal system, including the distribution of revenues between levels of government, are a detailed chapter of the constitution. This means that any change in the fiscal rules become not only difficult but highly politicized because they require changes in the constitution. Works on fiscal federalism, for instance, while offering a great contribution in terms of statistical data in this often-neglected area fail to obscure the authors' personal or institutional agenda. They bemoan the fiscal system as inefficient or unfair either to less or to more developed regions or to the federal government.

Brazilian political-science literature has tended to concentrate its efforts on the impact of decentralization to subnational governments rather than on federalism itself.<sup>5</sup> Theoretically oriented analysis of Brazilian federalism that puts together a) the view of

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<sup>4</sup> One exception is the work of historians. They provide the most fertile ground on which to build our knowledge of Brazilian federalism. See, for instance, Camargo (1993), Carvalho (1993; 1996), Fausto (1986), and Love (1993).

<sup>5</sup> FUNDAP (Center for Administrative Development) has made an attempt to relate discussions on Brazilian federalism to its current decentralized features, resulting in several publications (Affonso and Silva, 1995a, b, c; 1996a, b).

federalism as a conflict-driven subject; and b) the relationship between political and fiscal arrangements remains in its infancy.

In the search for a narrower theoretical framework able to overcome the limitations of the empirical literature and the too broad approach of the classical theoretical literature, this work has opted to follow Burgess' (1993) proposition in which federalism is treated as a value concept; the recommendation and the promotion of support for federation. From this perspective, the logic of federations is federalism, an ideological perception of what follows from federalizing. More than a semantic difference, the need to distinguish federation from federalism is important given the variety of practices of federal principles within each federation, as argued by Souza (1997) and Théret (1998). They vary not only according to principles but also according to the particular historical circumstance. They also vary according to the dynamics of the political economy, party politics, and political culture.<sup>6</sup> These features are added to other territorial manifestations of federalism, such as power-sharing within the legislature and between levels of government, the role of the judiciary, the allocation of fiscal revenues and responsibilities, and the constitutional guarantees of the federation's component units. They are not only relevant in the analysis of constitutional design or in operational practice, but also help us to question the interests, values, and pacts which prevailed when changes occurred in the federation.

The view of federalism as a political ideology, as proposed by Burgess, does not imply the inclusion of normative principles such as freedom and democracy, instead values reflect interests. Burgess' contribution opened the way for investigating the motivations and pacts behind the promotion of any federalism. Each federalism, not only each federation, incorporates a range of attributes which intermingle to produce complex patterns of interests, identities, and pacts. Following from this, the driving force of Brazilian federalism has always been the need to cope with great regional inequalities, as argued by Souza (1997). At each historical moment, these inequalities have been accommodated in different ways and these differences are expressed in the constitutional design and in the fiscal arrangements.

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<sup>6</sup> For a discussion on how federalism shapes the Brazilian party system, see Mainwaring (1999).

In examining these and other features of Brazilian federalism, the focus of this article will be directed towards answering two main questions:

- a) What have been the most important features of Brazilian federalism since its introduction? What purpose do they serve with respect to sustaining the territorial pacts constructed throughout different political regimes?
- b) What are the main tensions currently facing Brazilian federalism, and if they are not addressed, how will they influence the prospects of federalism?

This article argues that in Brazil federalism has always been a way of accommodating deep-rooted regional disparities. The current features of Brazilian federalism have made the country a center-constraining federation. As a result of current demands and agendas, subnational governments have become the main providers of social services. However, the country's deep regional inequalities imply that the capabilities of subnational governments to respond to these demands and agendas are highly uneven. The tensions currently surrounding Brazil's federalism express old and unresolved political conflicts in a regionally and socially unequal country rather than being result of federalism itself. Therefore, the prospects for tackling political and financial tensions that have an effect on the way federalism operates depend less on federalism as an institution but rather on addressing broader political conflicts.

The article highlights and examines the critical issues facing Brazil's federal system. In doing so, it aims to provide an overview of the institutional and political context of current federal relations as well as an analysis on which to assess the prospects of the federation in the new millenium. It begins with a brief review of the federation's main historical factors and constitutional designs, with respect to finance in particular. Section 2 analyses the decision taken by the drafters of the 1988 Constitution to strengthen federalism as a result of redemocratization and how these decisions have changed the federation. Section 3 presents the federation's current social, regional, and political features. The last section discusses the prospects of the federation.

### **An overview of the trajectory of Brazilian federalism<sup>7</sup>**

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<sup>7</sup> For a more detailed analysis of the trajectory of Brazilian federalism regarding constitutional design and fiscal arrangements, see Souza (1997).

Following the theoretical orientation mentioned above, a better understanding of the current stage of Brazilian federalism is achieved by briefly accessing its trajectory. This is because federalism was shaped by political and territorial pacts constructed throughout the country's history. These pacts were have been witnessed in each of the country's six constitutions. They show how and why Brazil has moved along a continuum of federalist relations, from an "isolated" federalism in the early republican days to centralization during the military years and finally to political and financial decentralization as a result of redemocratization.

The first republican constitution promulgated in 1891 created an "isolated" federation because there were few constitutional and practical links between the levels of government.<sup>8</sup> The fiscal system accomplished the decentralized promise of the republican slogan: "centralization, secession; decentralization, unity", making the Brazilian federation at that time more decentralized fiscally than their Argentine and Mexican counterparts (Love, 1993: 186). The share of the states and municipalities in the national revenue increased from 34% in 1907 to 49% in 1930 (Mahar, 1976) although financial and economic resources were channeled to a few states. Therefore, the Brazilian federation was born under the aegis of regional inequality.

This isolation ceased in the 1930s when Brazil launched its plan to build an urban-industrial society in which the State was the leading actor. This plan was led by Vargas under a dictatorship. One of Vargas' main struggles was to achieve federal hegemony against the states. However, concessions were made to the states, such as the writing off the states' debt to the federal government, including São Paulo's enormous debt to subsidize the price of coffee, therefore pacifying regional discontentment (Love, 1993). In 1932 Vargas sponsored a electoral reform in which, among other measures, the political representation of smaller and economically weaker regions in Congress was increased. Initially conceived to counteract the power of few states over the country, this principle remains as one of the bases of Brazilian federalism. Subnational governments lost their fiscal power to the federal level through the extinction of several taxes and the expansion of the bases of federal

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<sup>8</sup> Heated debates about the territorial division of power started in Brazil long before the end of colonial rule. These debates focused on the relationship between federalism and centralization, on the one hand, and freedom and tyranny, on the other (Carvalho, 1993). Carvalho showed that the major aim of the republican movement was that of federalism and not that of freedom, although, together with decentralization, they were presented synonymously. We owe the rescuing of the debates that free Brazil from the accusation that its federalism was a mere copy of the North-American one without regards to local circumstances to historians.

resources. The most important measure adopted by the constitution was, however, to grant the federal government jurisdiction to regulate external and inter-state exchange regulations. By denying the regional oligarchies the right to decide on the most important aspect of their economic life, namely the definition of their trade regulations, Vargas paved the way for industrialization through, among other measures, fiscal unification.

The 1934 Constitution was short-lived. Popular elections were reintroduced and the 1946 Constitution was approved. Liberal ideals, especially the rejection of the federal government's intervention in the economy, were the main concern of the constitution-makers. However, liberal intentions did not last long due to the increasing demands for rapid economic growth under the aegis of the State. The 1946 Constitution ended up repeating most of the measures adopted in 1934, with some adaptation. Because democracy and decentralization have traditionally been associated with each other in Brazil, local government revenues were increased, with the aim of decreasing its dependence upon the states. The constitution was both centralized in favor of the federal government and "localist" because it increased local finances by transferring several state taxes to the municipalities and by making the states share their revenue with the municipalities. The scheme of revenue sharing from higher to lower territorial units of government was the first attempt to address the issue of vertical fiscal balance. Horizontal balance was also partially introduced through the earmarking of federal revenues to be applied in the North and Northeast. Despite efforts to overcome vertical and horizontal imbalances, Mahar (1976) showed that they were of limited effect, because of the disproportional growth in the federal activities, the increase in the number of new municipalities, inflation, and the non-payment of federal quotas to subnational units.

In 1964, with the military regime, the federation underwent profound transformation, with repercussions on the roles played by the three levels of government. The military did not immediately draw up a new constitution, despite changing several provisions by amendments to the 1946 Constitution. Only in 1967 was the military constitution promulgated, and in 1969 it was again changed through a constitutional amendment. The 1967/69 Constitution, together with the 1966 fiscal reform law, boosted the centralization of public finance and political power. Nevertheless, subnational governments, and their politicians, continued to play an important role under centralized



rule. As noted by Ames (1987) and Medeiros (1986), subnational governments were used by the military to legitimize the regime and to build up coalitions for the regime's survival. Although revenues were centralized in the federal sphere they were redistributed through participation funds which took into account regional disparities, thus furthering horizontal balance. Furthermore, the use of negotiated grants increased considerably.

Much effort has been spent evaluating the effects of fiscal centralization on federalism. Such studies can be divided into two groups. On the one hand, those which concentrate on the analysis of the fiscal accounts, and showing that the financial position of the municipalities improved over the period, as opposed to that of the states (Graham, 1987; Serra and Afonso, 1991). On the other hand, some viewed the political and financial dependence of subnational governments as a breakdown of the federation and of federalism (Lordello de Mello, 1976) or as an example of formalistic federation, masking the reality of a unitary state (Selcher, 1989).

Redemocratization started in 1985. Democracy was then understood as implying political, fiscal, and administrative decentralization, along with better public services and income redistribution. All these demands received special treatment in the 1988 Constitution.

### **Redemocratization and the strength of federalism**

The drawing up of the 1988 Constitution was coupled with enthusiasm and optimism regarding the country's future. For twenty months Congress and Brasilia were the center of Brazilian life, a visible exercise in democracy and political participation. Among the most powerful lobbies, were the ones led by mayors and state governors demanding financial decentralization.

The framers' responses to subnational pressures were very positive. As shown by Rezende (1990), before the 1988 Constitution the federal government had a share of 44.6% of all public revenue, but after the constitution this dropped to 36.5%, representing 5.7% of GDP. The states share increased from 37.2% to 40.7% (6.3% of GDP) and the municipalities from 18.2% to 22.8% (3.5% of GDP).<sup>9</sup> The increase in subnational revenues was achieved in several ways and two are of particular importance. First, by transferring

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<sup>9</sup> The financial income of municipalities fell with the creation of 1,405 new municipalities between 1984 and 1997, therefore reducing the positive impact of federal and state transfers.

five federal taxes to the states, thus increasing their tax bases, especially value-added tax, the *ICMS*, which, unlike in other federations, is a state tax. Furthermore, the constitution gave the states more freedom to determine *ICMS* rates and total freedom on its use, the only limit being the transfer of 25% to the municipalities. By doing so, the 1988 framers avoided adverse reactions from the economically powerful states, given that the *ICMS* is also the largest tax in absolute terms. Second, by increasing the percentages transferred from two federal taxes to subnational units through participation funds. These funds adopt a formula to distribute resources according to population size and per capita income, therefore addressing the problem of horizontal fiscal balance by distributing more resources from better-off areas to worse-off ones. This scheme satisfied the demands of less developed subnational governments.

Subnational governments collect today 32% of all taxes collected in the country. With transfers from federal taxes, they are now responsible for 43% of tax revenue, including those accruing from the social security system. In terms of expenditure, subnational governments are responsible for 62% of payroll expenditure and for 78% of public investment. The federal government is the main agent for the payment of pensions and debt interest, which account for 80% and 90% respectively of all public sector expenditure on these two functions (Serra and Afonso, 1999).

The constitution adopted other measures that further empowered subnational governments: a) the municipalities became part of the federation together with the states, unique among federal countries; b) the municipalities were given the right to have their own constitutional law known as *Lei Orgânica*; and c) the creation of metropolitan regions no longer became a federal but a state issue. However, the constitution kept a tradition of maintaining uniform nationwide legislation. Therefore, subnational governments have little room to adopt their own legislation on many matters.<sup>10</sup>

The 1988 Constitution has not only kept but also expanded certain political and financial mechanisms designed to accommodate regional disparity. The political mechanism is related to the fact that smaller and economically weaker states hold

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<sup>10</sup> Article 22, for instance, states that only the federal government can legislate on the following functions considered under the scheme of concurrent power: hydro-electricity; traffic and transport; mines and mineral activities; and guidelines for education.

proportionally more seats in the Chamber of Deputies than larger constituencies.<sup>11</sup> This over-representation was first introduced in 1932 to counterbalance the power of the states of São Paulo and Minas Gerais in the federation. It has been maintained ever since. However, there are current political reasons which favor this over-representation: weaker economic units of the federation force the political system, the federal government, and Congress to include the problems of Brazil's regional inequalities on the political agenda.<sup>12</sup>

The second mechanism used to counterbalance the country's regional inequality is a fiscal one: since 1946 Brazil has adopted a fiscal system aiming at a better vertical and horizontal balance through the distribution of national revenue from the well-off to the worst-off regions. Because of the system of horizontal balance the fiscal system is highly intertwined and whenever the economy of well-off states slows, less developed regions are also affected.

The decision to decentralize and to strength the federation was an exercise of constitutional and political engineering which is summarized below. First, there were no doubts about the decision to weaken the federal government financially. The struggle was how to divide resources in a regionally uneven country. Conflicts concerning the division of financial resources were less politicized and more regionalized. Second, there was a consensus on rejecting whatever had been done by the military regarding centralization of resources, thus confronting the federal executive. Paradoxically, the federal government did not react at that moment against its financial losses; it was too worried about short-term issues related to the then President's political survival. Furthermore, the credibility of the

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<sup>11</sup> The most significant difference is between the North and the Southeast. The latter, with 46% of the electorate, holds 33.6% of the seats in Congress, while the North, with 4.8% of the electorate, holds 11.3% (Nicolau, 1997).

<sup>12</sup> Many scholars (Stepan, 1999; Samuels and Snyder, 2000, among others) do not share this view. Stepan (1999), for instance, goes as far as to construct a Gini-index to classify federal countries according to their proximity to pure proportional representation. According to this index, Argentina, Brazil, and the USA in that order, stand out as those that bloc the democratic majority at the center most given the over-representation of smaller units. Although Stepan has certainly built up a range of sophisticated formulae to come up with a classification of what he labeled as "demos constraining" versus "demos enabling" federations, the reality of some countries may make them take "demos constraining" decisions to compensate for other unresolved problems, such as Brazil's regional imbalances. It is interesting to note that during the drawing up of the 1988 Constitution, an agreement was made between the state delegation of São Paulo and the other delegations to increase the number of federal deputies to be elected by the state by ten. However, this agreement was skewed by the creation of three new states, two in the North and one in the Center-west. Paradoxically, the roll-call voting in favor of the creation of these new states had the unanimous approval of all delegates from São Paulo. See Souza (1995).

federal bureaucracy was in question and it was also busy lobbying for its own demands. Third, regional cleavages, especially between weak and powerful economic states coupled with weak party discipline meant that each parliamentarian was an individual player and a solitary negotiator. Fourth, economic issues such as public deficit and inflation control were not on the drafters' agenda due to the enthusiasm at the prospect of the restoration of democracy in the country over economic realities. All this helped to create a federation in which power has been decentralized and where several unequal but competing power centers have the strength to play a part in the decision-making process. Nevertheless, as argued by Souza (1997), decentralization was not followed by a consensus on what was to be achieved by it.<sup>13</sup>

However, when the constitution was promulgated, the country's economic predicament ran deeper than at the beginning of the decade. The failure of several stabilization plans had been followed by a reduction in public resources, recession, and by uncontrollable inflation, constraining fiscal policy and deficit control. In addition, the proportion of net fiscal resources decreased during the late 1980s when compared to GDP. These trends worsened the distributive cleavages between levels of government because there were fewer resources to share and to transfer.

Only after the promulgation of the constitution, did the federal government start to react against its financial losses and has continued to do so to this day. However, the federal government's reaction has always been ambiguous. The Presidents had tried to put the blame on subnational levels for public sector problems. Yet, because of the increase in the power of the legislature granted by the constitution and also that of state governors and mayors of large cities, the civilian Presidents need their support to obtain congressional approval for their policies. This is so because every President since redemocratization has had difficulties guaranteeing a stable parliamentary base. In a milieu of fragmentation and fragility of most political parties and of an electoral system of open-list proportional representation, the governors have become one of the main players in assuring the federal

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<sup>13</sup> As argued elsewhere (Souza, 1997) the 1988 Constitution did not mark the beginning of political and financial decentralization. Several other measures and events prior to 1988 were signals that decentralization would be one of the likely outcomes of the constitution. The importance of the 1988 rests on the fact that a) federalism was subjected to heated debates that went beyond the quest for financial decentralization; and b) the decision to decentralize was not taken by the government but by parliamentarians.

government of its capacity to govern. This picture shows that the federal government alone is not in a position to overcome the constraints of Brazil's public finance.

Another ambiguity is the way in which the federal government deals with subnational debts.<sup>14</sup> The states' debts were further troubled by the *Real Plan*, when interest rates rose to unprecedented levels, putting subnational governments in a position of financial disarray. Most of them did not contract new debts, but because of the increase in interest rates their financial capacity was blocked by inherited debt. Four states (São Paulo, Rio de Janeiro, Minas Gerais, and Rio Grande do Sul), the most powerful economically, are accountable for 90% of the debt. Per capita state debt is estimated at US\$ 808, as opposed to US\$ 492 in Argentina, another great debtor at subnational level (Freire et al., 1999). Furthermore, states' debts also influence the performance of public accounts. As a result, the federal government has been making agreements with the states to try to overcome, once again, their negative financial situation. These agreements imply the federalization of part of the states' debt and represent more than R\$ 50 billion in transfers from the national taxpayers to 17 states, mainly the four better-off ones. Federalization of the states' debt means that they now owe around R\$ 103.4 billion or 10.3% of GDP to the federal government (Serra and Afonso, 1999). The debt is to be paid in 30 years time and with interest rates lower than that of the market.

The municipalities owe mainly to the social security system and negotiations with the federal government are making slow progress because they are made on a case-by-case basis between the federal government and each of the 5,507 municipalities.

If economically better-off states present high debt figures in absolute terms, the situation of less developed states is not less worrying. As discussed by Souza (1998), the share of long-term debt in the states of the Northeast vis-à-vis the region's GDP is extremely high when compared to other regions.

Although the federal government has been ambiguous in dealing with subnational debt, the same cannot be said about its reactions against subnational financial strength. Examples are abundant. First, it has adopted a policy of constant increase in rates of taxes which are not shared with subnational levels, as shown by Afonso (1994). Second, it is

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<sup>14</sup> On the debt of the states and their commercial banks, see, among others, Dillinger (1997), Sola (1995), and Souza (1996).

decreasing its efforts to collect federal taxes that are shared with the subnational levels, as discussed by Pessoa and Malheiros (1994). Third, the federal government is cutting expenditure dramatically, putting pressures on subnational governments to fill the gap in social services and investment. Since the Collor administration the federal government has adopted tough control over its expenditure, mainly through the freezing of investment and salaries. In the 1999 fiscal year, for instance, only 40.7% of the resources allocated in the budget for investment has been spent (Vianna Jr. *et al*, 2000). The bulk of federal resources are being used to pay interest in order to sustain the *Real* Plan, as Table 1 shows.

Table 1 Federal Expenditure by Type of Expenditure, 1999

Type of Expenditure	Percentage Spent
Payroll	96.97
Interest and Debt Services	80.39
Other current expenditure	87.27
Investments	40.67
Financial investments	15.42
Debt payment	76.19
Total	74.43

Source: SIAFI/SPF/STN *apud* Vianna et al. (2000)

A fourth way used to constrain subnational expenditure has been the creation of new taxes, such as CPMF, a tax on financial movements, and the FEF (Fiscal Stabilization Fund), a fund created to constrain federal transfers. Along the same lines, a law, known as Lei Kandir, was promulgated, exempting several export products from *ICMS*, with the promise of compensation paid by the federal government. However, agreements on the amount to be paid have been the subject of heated disputes. Finally, the last attempt by the federal government to force subnational politicians to exercise fiscal control is still under analysis in Congress. This law imposes limits to public sector debt and expenditure on payroll, prohibits the bailing out by the federal government of new debts contracted by subnational governments, and imposes penalties on public sector financial managers. These reactions show that the federal government has not relinquished its importance as a political institution, which has meant that competition for power is stronger than ever.

Other measures to control subnational debt and expenditure which do not depend upon Congress approval have also be taken by the federal government. Among these is the sale of state companies, such as electricity and telecommunications, with subsidies and

grants from the federal government. Since 1996 29 state companies have been privatized (Serra and Afonso, 1999). Privatization of federal companies has occurred at the same pace.

For a better understanding of Brazilian federalism after redemocratization two trends should be considered. First, there are new responsibilities distributed between levels of government that have changed the previous political and financial frameworks within which policies and politics were carried out. These new responsibilities are basically a) the role of subnational debts in the fiscal adjustment program; and b) the increased role of subnational governments in social services. Second, political and financial decentralization has transferred considerable power from federal to subnational governments. In turn, decentralization has upgraded the role of subnational political elites. As a result, the federal government alone has limited scope to set up the necessary adjustments in the political, social, financial, and economic frameworks. Furthermore, it is the first time in Brazil's republican history that both the states and municipalities have gained financial strength themselves. State and local governments, on the one hand, and Congress, on the other, have become important political actors with whom national policies have to be negotiated. A new balance of power has been established in which diffused power and a fragmented polity have become the main elements of Brazil's political system, with a direct effect on the federation. The balance of power between federal and subnational governments is more delicate than ever. The expanded powers of Congress, in which governors and mayors of the main states and their capitals have strong influence, and the lack of political support for civilian Presidents mean that the President has to negotiate with subnational governments each time a bill is submitted to Congress.

The historical review of Brazilian federalism and its current developments show the limits of some theoretical formulations that play down the importance of conflict-ridden relationships as elements which sustain territorial political pacts. The discussion above also suggests that centralization-decentralization movements are more usefully interpreted as a continuum rather than a dichotomy.

### **The current features of Brazilian federalism**

From the beginning of its republican history Brazil has been marked by the persistence of deep-rooted regional and social inequalities within both the federation and social classes. The persistence of these inequalities have posed new challenges to the federal equilibrium

on which a consensus was reached during the drafting of the 1988 Constitution. Federalism, in the current Brazilian setting has also made it more difficult to address complex social problems, especially income and regional concentration given that the political system is now highly fragmented. While its role in inter-regional income transfer is decreasing, the federal government's adoption of market-oriented policies has led to a reduced role in the provision of basic social services. However, states and municipalities have been making an enormous effort to strengthen their role in and resources they devote to social services, therefore accommodating social tensions and filling the vacuum left by the diminished presence of the federal government.

Three sources of tension are being exerted on Brazilian federalism and an analysis of each is necessary when considering its prospects. First, policies addressing social and regional problems were adopted by the 1988 Constitution and, as a result, a host of social rights coupled with measures to tackle Brazil's regional inequalities became part of the constitutional framework. Consequently the 1988 framers broadened the role played by the State with respect to social and regional affairs. On the other hand, this was followed by the political decision to diminish the role of the State. A new economic paradigm was adopted aiming at tackling Brazil's hitherto uncontrollable inflation but, more importantly, at attempting to make Brazil a global player. The demands of this new paradigm are proving to be irreconcilable with the demands of a broader role for the State in addressing the country's social and regional inequities. Second, because Brazil has high levels of inter and intra-heterogeneity, the results of decentralization and the capacity of subnational governments to provide social services are highly uneven, especially because decentralization was adopted without a social consensus on what was to be achieved.

As a result of these two tensions, more than ten years after the promulgation of the 1988 Constitution, the implementation of social and regional policies remain on the agenda as unresolved but, more than this, they are now seen as incompatible with current economic policy. These tensions make it difficult to find solutions to social and regional inequality, bringing to the fore the question of how to reconcile the needs for a more equitable country, both socially and regionally, with the adoption of economic policies aiming at reducing the role of the State in social and regional affairs.



At this point it is important to describe the federal government's fiscal and economic agendas, especially after the election of Fernando Henrique Cardoso. Cardoso was elected in 1994 following the success of the *Real* and re-elected in 1998. His presidency represents a center-right coalition that has an agenda focused mainly on implementing a market-oriented program, meaning privatization, deregulation, and the opening of the country's economy. One of the anchors of this policy was the adoption, in 1994, of a stabilization program, the *Real* Plan, based on the use of high interest rates. This policy is changing the federal arrangements that had been agreed in the 1988 Constitution and it is having a great impact on two aspects of Brazilian federalism.<sup>15</sup> The first of these impacts is the influence of the policy of high interest rates to sustain the value of the *Real* at the three levels of government, as discussed. Subnational governments have become highly indebted and the federal government is playing all its cards and resources to sustain interest rates and debt services. The second impact is that this policy has affected the state of São Paulo and its capital in particular, not only because they were Brazil's major debtors, but also because the opening up the economy and deregulation have led to the decline of São Paulo's industrial production. Although industrial deconcentration started in the late 1970s and the current economic problems of São Paulo are a result of policies adopted long before the *Real* Plan, the state has been severely affected by it. However, industrial deconcentration does not mean a) that São Paulo has lost its leadership in the economy; and b) that industries are moving to less developed regions. As argued by Marques and Torres (2000), the state continues to host the headquarters of large companies, including multinationals. All empirical evidence shows that despite the reduction in relative terms of its industrial production, São Paulo has kept its leadership and command of the Brazilian economy, including the concentration of productive and financial services, keeping its position as the main metropolis and the main center connecting the Brazilian economy to the rest of the continent and the world. Despite this, the restructuring of the economic role of São Paulo has important social and political consequences which affect the prospects of Brazilian federalism. Unemployment is higher than the average for region's and other states and public finance has decreased, making it more difficult to invest in social programs. On

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<sup>15</sup> Kugelmas and Sola (1999) correctly associate the federal government's success in re-centralizing resources to the *Real* Plan because it restored the traditional notion of strong Presidencies by keeping inflation under

the political front, the decrease in industrial production has brought reactions from powerful elites, deepening disputes among states and regions, even within the President's party, the PSDB. Reactions from these elites are also deepening the popular feeling that São Paulo is, once again, subsidizing the development of other regions.<sup>16</sup> These reactions could have an impact on the future of the federation, a point to be further developed.

Nevertheless, São Paulo's industrial decline has not affected the hegemony of the Southeast in economic terms. As mentioned above, economic concentration in the Southeast increased in the 1990s. Furthermore, industries are moving away from São Paulo but not away from Brazil's economically and socially better-off regions: the Southeast and the South. In the case of car manufacturing, for instance, of the US\$ 4.3 billion recently invested, 3.5% was invested in the city of São Paulo and 16.6% in the state. However, Paraná, in the South, received 47.7%, and Minas Gerais, in the Southeast, 24.5% (Marques and Torres, 2000). A survey quoted in Marques and Torres (2000) shows that future investment in the chemical industry is planned for the states of Bahia, Rio de Janeiro, and São Paulo (Paulínia); for the steel industry for Minas Gerais, Rio de Janeiro, Ceará, Paraná, and Rio Grande do Sul; and paper and cellulose industry for Bahia, Minas Gerais, São Paulo, and Paraná. With the exceptions of Bahia and Ceará, all the other states are located in the Southeast and in the South.

The third tension affecting Brazil's social and regional inequalities is related to the results of decentralization. Many studies show that decentralization has been implemented without a thorough understanding of the various issues such as the level and timing of such decentralization. Health and education, for instance, have been decentralized at local level without evaluating the administrative capacity of individual municipalities, which varies greatly. Furthermore, there has been no appreciation for the fact that decentralization does not occur in a vacuum, but instead requires a complex politico-institutional engineering (Souza, 1997). In some states and municipalities, policies have thus deteriorated instead of

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control.

<sup>16</sup> Many interpret São Paulo's industrial decline as merely the result of what became known as the fiscal war among states. Because *ICMS* has had its base expanded, states have been using it to grant fiscal incentives to attract new and large investors away from other states, especially São Paulo. As argued by Montero (2000), the outcries of the *paulistas*, their politicians, and the media against the fiscal war have been greatly exaggerated.

improved as a result of decentralization, as some works show (Arretche, 1998; Melo, 1996).

Empirical studies also show that there are no guarantees that the virtuous cycle of decentralized policies will be distributed equitably. Bremaeker (1994), for instance, indicates that over 200 municipalities in the Northeast have no chance of expanding their tax bases nor pay for anything other than their civil servants, most earning below the minimum wage. These municipalities lack economic activity and are bound by the extreme poverty of their population. Samuels (2000) shows that almost 75% of Brazil's municipalities generate less than 10% of their total revenue from taxes and that almost 90% of the municipalities with 10,000 or fewer inhabitants depend on transfers for 90% or more of their revenue. As for the states, seven of them collect less than 0.5% of the total *ICMS* levied in the country (IPEA and IBAM, 1994). Therefore, Brazil's regional inequalities act against the ultimate goal of decentralization because decentralization itself limits the opportunities for the federal government to transfer resources from better-off regions to worse-off ones. Even in countries like Brazil where there are schemes aimed at fiscal horizontal balance, these schemes are of little effect in redressing the balance. This shows the limits of decentralization in countries characterized by extreme regional inequalities (Souza, 1997; 1998).

However, despite their constraints and indebtedness, subnational governments are now the main providers of social services. As shown by several studies subnational governments are slowly and inconstantly replacing the federal government in certain spheres while others lack governmental support because of the withdrawn of the federal government (Afonso, 1994; Rezende, 1997; Almeida, 1996, among others). This unplanned and uncoordinated transfer of responsibilities contradicts the view that one of the main financial constraints faced by the federal government is the lack of responsibility transference to the subnational levels.

The increased role of subnational governments on the provision of social services is shown in Table 2.

Table 2 Social Expenditure by Level of Government

	1980	1985	1992
Social Expenditure	100	100	100
Federal	65.8	62.0	57.0
States	23.6	24.6	26.5

Local	10.6	13.4	16.5
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Source: Médici and Maciel, *apud* Draibe (1999)

Although the federal government remains the largest investor, 65% of its resources on social programs are spent on pensions, 17% on health care and 8.5% on education. At state level, 50% of resources are allocated to education. The municipalities focus their efforts on urban development programs (80%), followed by urban transportation and sewerage (Draibe, 1999).<sup>17</sup>

Expenditure by region shows that less developed regions present per capita values of expenditure sometimes twice as low as those in better-off regions and states. However, the shared effort of the three levels of government in the Northeast is striking: per capita social expenditure reaches 30% of the region's GDP, against 19.5% in the North, 18.1% in the Southeast, 17.8% in the South and 22% in the Center-west (IPEA, 1998 *apud* Draibe, 1999).

Database on subnational governments' accounts between 1986 and 1995 (Ministério da Fazenda/ STN/DIVAM, 1997) show the commitments of the states and their capitals to prioritize social services. They also show that a) investment in social services have always been their priority, but the importance of their role has increased because of the withdrawal of the federal government; b) the state capitals are making a greater effort than the states to maintain their investment in social services; and c) there is a great tension between expenditure on social services and the payment of debt services.

The few current programs targeting poverty have been led by the states and municipalities. The main program is the payment of a minimum wage (R\$ 151,00) to poor families, mostly conditioned by their children attending school. In early 1999 three states and 20 municipalities adopted this program, reaching around 140,000 families and 700,000 people.<sup>18</sup>

Many large cities have also embarked on a policy of increasing their own revenue, contradicting the assumption that when subnational governments have a large share in federal transfers they make little effort to increase their own revenue. As shown by Jayme,

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<sup>17</sup> For detailed information on expenditure on social programs between 1980 and 1996 according to function, level of government, and individual states, see Oliveira (1999).

Jr. and Marquetti (1998), eleven state capitals have increased the growth rate of their own revenue by more than 10% per year between 1989 and 1994, therefore decreasing their dependence upon state and federal transfers and allowing them more resources to invest in social services. However, Jayme Jr. and Marquetti (1998) also show that not all state capitals have adopted this policy, illustrating that decentralization has brought different results and set different agendas in large Brazilian cities.

To sum up, Brazilian local and state governments vary greatly in their capacity to take advantage of decentralization and to deliver social services. However, the literature on subnational government performance after redemocratization and decentralization has tended to treat all Brazil's subnational governments as enjoying the same capacity to play an expanded role in social services and investment. This literature fails to take into consideration Brazil's enormous heterogeneity, ignoring the fact that decentralized policies under subnational discretion can vary greatly.<sup>19</sup>

This section has shown that on the whole, subnational governments are struggling to maintain and to increase their investments in social services, therefore counterbalancing the federal government's policy of economic stabilization.<sup>20</sup> It has also shown that the capacity of subnational governments to play an increased role in providing social services is not equal and that there are hundreds of municipalities and some states that cannot survive without federal help. It has also shown that Brazil's regional imbalance, both economically and socially, is not improving. However, Brazil's social dilemmas, especially inequality among social classes and regions, remain a national issue. Although subnational spheres are becoming more involved in tackling social problems, there are no guarantees that this trend

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<sup>18</sup> Although in absolute terms these figures may be of significance, in relative terms they are not given that according to IBGE 10.3 million families had a per capita monthly income lower than R\$ 65.

<sup>19</sup> Recent literature on local governments in Brazil is vast. As reminded by Samuels (2000), municipal life is important in Brazil because the country is not dominated by one "metropole", as is the case in Argentina and Mexico. However, if local governments have received great attention from scholars and practitioners, the same cannot be said about state governments after redemocratization. Exceptions are studies by Ames (1996), Hagopian (1996), Abrucio (1998), Souza (1997); and Tendler (1997). Nevertheless, few studies focus on the connections between federal-state-local power relationships that are crucial for a better understanding of federalism today.

<sup>20</sup> This is not to say that the federal government has become totally absent from social programs. It continues to transfer federal resources to subnational governments for health care and in 1998 created a fund for education. In both schemes, subnational governments can only receive these federal resources if they also contribute.

will continue given a) the size of their inherited debts and their weight in public deficit; and b) the attempts to re-centralize resources at federal level given the policy of fiscal control.

### **The prospects of federalism in a fragmented polity and in a center-constraining federation**

Brazilian federalism is characterized by the existence of multiple power centers, by a complex system of political and financial dependence among governmental units, by varying routes for influencing and delivering policies, and by great economic and political disparities among its regions. The trajectory of federalism in Brazil confirms the vision that federalism, as a mechanism of territorial power sharing, is a way to accommodate deep regional conflicts rather than to promote harmony. It also confirms the view that federalism is more an ideology based on values and interests rather than a commitment based on juridical and territorial arrangements or on democratic purposes. Experience also shows that federal relations are more likely to be based on conflicting interests which are in turn an expression of other political conflicts in society.

Since 1988, several competing, although unequal, power centers have had access to decision making and to policy implementation, especially in the delivering of social services. In a politically democratic system, subnational politicians have become a source of support both for the national governing coalition and for providing social services. The strength of subnational politicians and governments does not mean, however, that the federal government has taken a back seat. However, their strength has created extra-constitutional and extra-parliamentary structures and processes that may be as important as normal ones.

This article has highlighted certain tensions surrounding the issue of regional and social inequalities that affect the way federalism is operating. These tensions will now be used to form the basis on which the prospects of the federation are analyzed.

Redemocratization has brought with it a broader role for the State in social and regional affairs. This commitment has been reduced by economic policies. Although subnational governments are now playing a greater role in social affairs, the tackling of regional disparities remains in a vacuum. The tensions mentioned above raise some issues that may have an impact on federalism in the near future.

First, for how long can subnational governments sustain their level of social investment? This question is important given that states and municipalities entered the 1990s with large debts and because the federal government is successfully re-centralizing financial resources. While subnational governments are playing an important role in enabling social services, they also constrain the stabilization program. Furthermore, with the strength of the state governors in the national political coalition, the President need their approval to pass the constitutional reforms drawn up by the economic team. Subnational governments, therefore, have a double role to play: they enable the demands for social services but they constrain the economic objectives of the governing coalition. By doing so they also constrain the chances of nationally addressing Brazil's social and regional problems.

The second issue here relates to the fact that current power-sharing relationship does not mean that every state or every municipality enjoys the same amount of political power and financial resources. Instead there are several unequal but competing power centers which have a voice in deciding on or in vetoing national policies. However, there are also a great number of subnational governments that are taking little advantage of Brazil's decentralized federalism and that are unable to play any role in delivering social services. This is probably the most complex problem facing federalism today and there is little indication so far that these subnational governments will be able to improve their lot. The question for how long will migration to other states, municipalities and even to foreign countries be able to buffer the lack of provision of the basic needs for these citizens is not a question that can be answered by federalism as an institution.

The third issue concerns the services themselves. If states and municipalities are increasing their role in social services, we need to know how these services are being provided and how individuals are selected to have access to them. There has been little research on this, calling for investigation of subnational institutions. The majority of social services provided by subnational governments function now within a different institutional framework from the past. Stimulated either by national policies or by foreign grants, that require the constitution of community councils for releasing funds, especially for health care and basic education, subnational governments have created several community councils. The idea behind this is to encourage citizens' participation to improve

accountability and transparency. However, many local councils are a formal reproduction of what the rules say, undermining fundamental assumptions of participation. Although there is still no body of research analyzing these community councils in depth and in comparative terms, there have been several accusations about the control subnational leaders exert over them, together with suspicions of corruption now apparent in the media. This leaves open the issue of what is happening in the subnational political realm and how decisions regarding the provision of social services are being taken. Furthermore, as shown by a few studies, if power is now highly fragmented at the national level, the control state governors and mayors exert over subnational institutions is extraordinary, preventing these institutions from exerting checks-and-balances (Abrucio, 1998; Souza, 1997). Therefore, it is necessary to examine the role played by subnational political institutions in constraining or enabling access to social services. This is so because institutions are shaped by history, culture, incentives, and constraints that vary greatly and are transformed when they move from the national to the subnational sphere, especially in a heterogeneous country like Brazil.

The fourth issue is related to the results of the federal government's political decision to adopt market-oriented policies. These policies may affect federalism in two ways. First, the opening up of the economy tends to make federal relations even more complex as it increases the differences between more and less developed states, therefore contributing to the deepening of the current trend of reversing previous movements of economic deconcentration. Second, the policy has affected, although indirectly, the state which is the center of the Brazilian economy, bringing reactions from powerful elites. These reactions will certainly be echoed in the 2002 presidential race. This election will juxtapose the interests of São Paulo with those of other states of the region and of the country. However, different from the past, when conflicting interests also played an important role, Brazil is no longer a federation dominated by a few economically powerful states. Redemocratization has upgraded the importance of regional politicians and Brazil is now an urbanized society with an industrial economy. Furthermore, the political and electoral systems have become very competitive and because of the two factors mentioned above discussions on federalism will certainly be at the heart of the 2002 candidates' campaign.



This article has shown that despite some changes in the way federalism was constitutionally designed in 1988, the tensions of Brazilian federalism center around problems which were not addressed by previous political regimes, the country's historical social and regional disparities, for instance, rather than on the decision taken by the 1988 drafters to strength the federation. Solutions to the political and financial tensions discussed above are not easy to find and they depend less on federalism itself than on addressing broader political conflicts. There are certainly powerful forces being exerted to change the current fragmentation of Brazil's polity. However, there are also forces, albeit fragmented, requiring Brazil to carry on with its current mode of federalism. These forces might prevail, not only because of interests but also, as reminded by Stepan (1999), all democratic federations are inherently center-constraining.

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