DEBATES

State Effectiveness in Contemporary Brazil[1]

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Brazil is world-renowned for its emerging economy, which successfully reduced social inequality in a stable democratic context. Although poverty and inequality are far from being solved, incremental gains in state capacity to improve citizens' well-being were achieved in the last two decades. Contemporary Brazil is therefore a good case to better understand state capacities in the developing world.

This article examines a critical dimension of state effectiveness, namely the spending capacity of local governments. Primary health care, primary school, urban and housing policies, and garbage collection, among others, are delivered by local governments in Brazil. Hence, both state effectiveness and its territorial reach highly depend on municipal-level capacity to fund the delivery of public services. Additionally, the capacity to frame and execute policies is critical for state autonomy. If state elites lack economic resources or bureaucratic structures, it could imply a weak state (Migdal, 1988).

It is argued here that the capacity of local governments to provide services in Brazil is strongly dependent on the federal government's role in reducing inequality. The literature on decentralized governance stresses the risks posed by transfers on macroeconomic performance (Rodden, 2002; Wibbels, 2000), the revelation of citizen's policy preferences (Tiebout, 1956), economic growth (Weingast, 1995), and free local-level electoral competition (Weingast, 2009). These are indeed relevant aspects to consider when analyzing the role of upper-level transfers. However, this article suggests that reducing horizontal revenue-inequality is critical for state effectiveness. Transfers, by their turn, can play a crucial role in achieving such a goal.

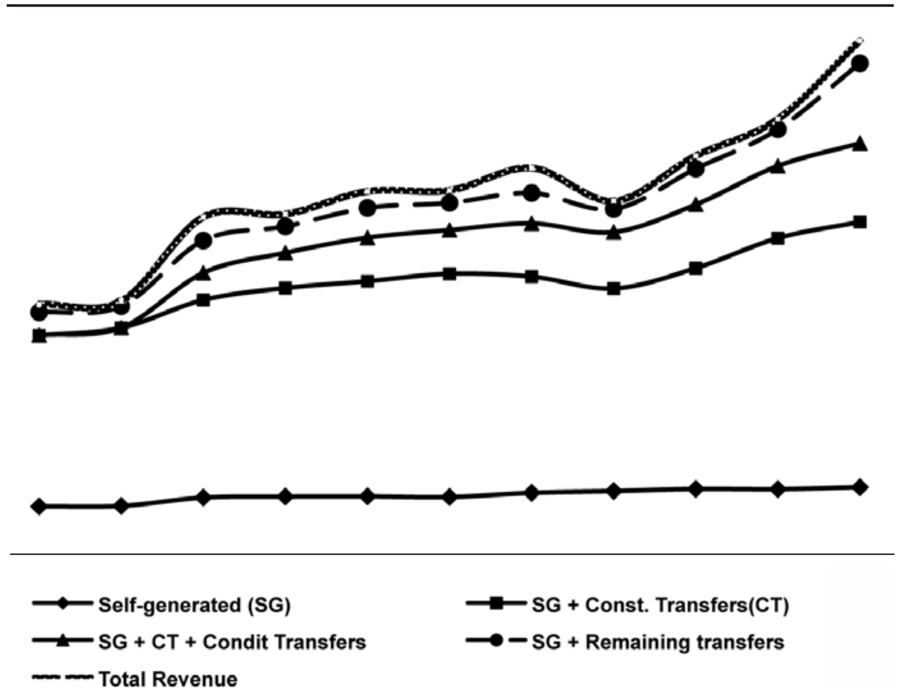
Transfers and horizontal revenue inequality in Brazil

Constitutional transfers are the most important source of municipal revenues in Brazil. The most important of those is composed by 23.5 percent of federal revenues, originating from two taxes: income tax, and the Tax on Industrialized Products. As for its distribution, ten percent is directed to capital cities whereas 90 percent go to the remaining ones. Among these, each individual disbursement is calculated by a formula that is inversely proportional to the population and revenues per capita of each respective state (Afonso and Araújo, 2006).

At the state level, constitutionally mandated transfers operate as tax rebates. States are required to award their municipalities 25 percent of the total revenue collected from IVA tax (the ICMS). They must also distribute 50 percent of the Tax on Motor Vehicle Ownership (IPVA) to their municipalities. Among state-level constitutional transfers, seventy-five per cent of the distribution must be calculated according to revenues collected in each jurisdiction.

Finally, a third transfer type is conditional transfers, which became universal in the early 1990s. They are compulsorily earmarked to specific policies. In health care, they became universal in 1998 upon

Figure 1 - Muncipality Revenue by source (average) 1996 - 2006



the conclusion of the process which linked subnational governments to the Unified Health System. These earmarked transfers cover services ranging from basic health care to hospitalization. All municipalities which fulfill the rules set by the Ministry of Health are entitled to receive them.

As for education, earmarked transfers are universal because all subnational governments are obliged, by the Federal Constitution, to invest 20 percent of their own tax revenues and federal transfers in an audited account, whose redistribution occurs across each state. Revenues are redistributed according to the number of slots offered.

Figure 1 demonstrates the impact of each revenue source on municipal budgets. Surprisingly, if Brazilian municipalities were to rely only upon their self-generated taxes, their average budget would be around R$ 100 per capita. Therefore, constitutional transfers–federal and state–are paramount for municipal revenues. These amounts increased to close to R$ 800 per capita in 2006, but as early as 1996 these transfers were by far the main source of municipal revenue. Conditional transfers have had an additional positive impact. They have grown significantly since their introduction in 1998, and elevated average revenues to circa R$ 1000 by 2006.

Figure 1 shows that the impact of negotiated transfers on municipal revenues is marginal, contradicting a widespread idea that negotiated transfers play a central role in Brazilian politics.

It is evident that a significant proportion of municipal revenues lies outside the realm of political bargaining. Their distribution is constitutionally mandated. Mayors receive upper-level resources regardless of their political affiliation. Thus, the supply of local public services does not depend on political relations, whether they be partisan or individual.

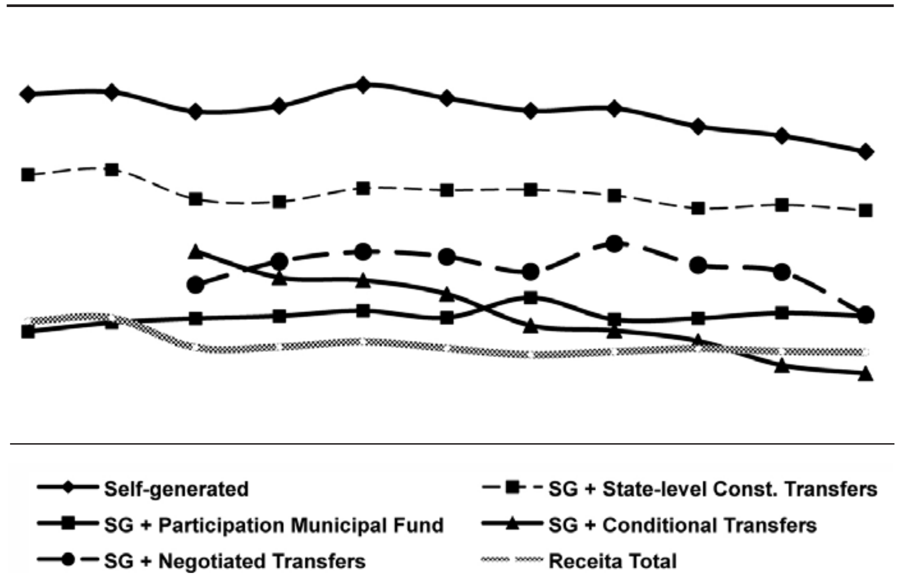
Figure 2 disaggregates the different revenue streams and presents their respective Gini coefficients, which are calculated for self-generated tax collection itself and each transfer type. Therefore, the indicators measure the impact of each on horizontal revenue inequality in relation to self-generated tax collection.

If Brazil's municipalities were to count only on their own tax collection, their spending capacity would be highly unequal (close to 0.550 in 2006, and, although declining throughout the data series, still showing the highest Gini coefficient values). Furthermore, if Brazil's municipalities were to count only on state-level transfers, in addition to their own self-generated tax revenues, horizontal inequality would be slightly lower, since this revenue source reduces the Gini coefficient to approximately 0.450.

Federal transfers reduce, to a great extent, self-generated revenue inequality. Their entry into municipal coffers reduces the Gini coefficient by close to 0.300. That is, if Brazilian municipalities could count only on their own tax revenues and federal constitutional transfers, revenue inequality would be cut by half.

Conditional transfers–intended to give support to the provision of basic health care and fundamental education–were actually implemented in 1998, which explains why they were introduced into the series in this year. Their redistributive impact has been significant. If they were

Figure 2 - Revenue Inequality by source
Brazilian Muncipalities – 1996-2006



the only transfers municipalities had access to, besides self-generated taxes, their effect on revenue inequality would be similar to federal constitutional transfers. Beginning in 2003, these policies have had a more significant impact than all other revenue sources. In isolation, they are the most redistributive; in 2006, transfers earmarked to health and education reduced the Gini coefficient to 0.220.

Negotiated transfers have had an important effect on reducing revenue inequality too.

In sum, transfers reduce the Gini coefficient to 0.280. Brazil's fiscal rules clearly reduce revenue inequality among municipalities. Whichever federal transfer we take, the data confirms the proposition that the poorest jurisdictions are those that most benefit from upper-level transfers. Moreover, revenue inequality reduction is not associated with political negotiations to form coalitions in support of presidential legislative initiatives. Instead, distributive mechanisms work in highly predictable ways; after all, they are governed by constitutional and infra-constitutional rules.

Therefore, the Brazilian case demonstrates that tax centralization can provide a mechanism to reduce horizontal revenue inequality. In the absence of transfers, the capacity of Brazil's municipalities to provide public services would be highly unequal.

However, transfers are not a sufficient guarantee that local expenditures will be directed to public services. In fact, transfers were adopted together with constitutional rules earmarking subnational revenues to spending on health and education. Hence, far from allowing local governments to freely allocate revenues gleaned from other jurisdictions, the logic of this arrangement is aimed at binding local governments' spending decisions to health and education. Transfers were accompanied by limiting the authority of local governments, since central legislation constrains how mayors use the revenues they get from other jurisdictions.

Concluding Remarks

The capacity of states to guarantee an equal provision of public goods to all citizens seems to be critical to achieve state effectiveness. However, when public service provision is decentralized and when the jurisdictions are marked by high levels of revenue inequality, equal provision of public goods is endangered. Intergovernmental transfers, as these paper has shown, can play a fundamental role to diminish this unequal provision of public goods and thus to maximize state effectiveness. Instead of empowering backward regional elites, as the literature on fiscal federalism assumes, they can contribute to reduce local inequality, enabling the state to dissociate public service provision from income inequality.

The case of Brazil, long known as a highly unequal country, nicely illustrates how inequality reduction and improvement of public service provision can be achieved through federal transfers progressively allocated to favor the most needed localities of the country.

Endnote

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