

Chapter 3:

Bailouts and Perverse Incentives in the Brazilian States

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Brazil is the most decentralized country in the developing world. It has a long history of federalism and decentralization, and has become considerably more decentralized over the last two decades. By 1995, state and local governments together accounted for nearly 60 percent of public consumption (Ter-Minassian, 1997: 438). In comparison with other developing countries, the Brazilian states also raise a good deal of revenue themselves. In 1995, tax revenues collected by the subnational governments accounted for nearly 38 percent of total tax revenues (ibid.). Unfortunately Brazil has experienced few of the benefits of decentralization in recent years, and has been overwhelmed by some of its costs. Brazil's recent experience with fiscal and political decentralization has posed serious challenges for macroeconomic management. Above all, Brazil has been forced to deal with one of the most serious and persistent subnational debt problems in the world.

Brazil has experienced three major state-level debt crises between the late 1980s and the present, and unresolved debt problems in several key states threaten to precipitate further crises. In each of the crisis episodes thus far, the states-- already facing precarious fiscal situations with high levels of spending on personnel and dangerous levels of borrowing-- were pushed into debt servicing crises by unexpected exogenous shocks. In each case their first

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reaction was to demand bailouts from the central government, and in each case the federal government responded by taking measures to federalize state debts.

The task of this case study is to examine the political and economic underpinnings of soft subnational budget constraints in Brazil, particularly in the states in the 1980s and 90s. It shows that the Constitution and the basic structure of intergovernmental relations undermine the most important mechanisms that enforce subnational fiscal discipline. Voters are not provided with the incentives or the information they need to use the electoral mechanism effectively. The credit market does not adequately discipline state administrations because creditors are allowed to believe that state debt is backed up by the central government. Perhaps the most important problem underlies the others-- the central government cannot credibly commit to refrain from bailing out the troubled states during times of crisis. This commitment is undermined above all by the fact that the states are veto players over all relevant central government decisions regarding subnational finance because of their strong representation in the legislature. Moreover, efforts to improve hierarchical oversight of subnational spending and borrowing in the wake of debt crises fall flat for the same reason.

These arguments are developed as follows: the first section examines the structure of the Brazilian intergovernmental system and assesses the central government's ability to impose hierarchical control over subnational spending and borrowing decisions. The second and third sections examine the electoral and credit market discipline mechanisms. Section four analyzes further the breakdown of these mechanisms by examining the crisis episodes in greater detail. The final section concludes and discusses the prospects for reform.

I. Hierarchical Structure

The hierarchical structure of Brazil's system of federalism is laid out in the 1988 Constitution-- it includes the Union, 26 states plus the Federal District (Brasilia), and about 5,000 municipalities. Brazil is a presidential democracy. The lower house of Congress (Chamber of Deputies) consists of 513 members, with the number of delegates per state determined on the bases of population. The Senate is comprised of three senators from each state, elected for eight-year terms with no limits. Party discipline is extremely weak in Brazil, and both the Chamber of Deputies and especially the Senate are responsive to strong regional groups. The state governors exert a great deal of influence over the deputies and senators from their states. Thus the states have de facto veto authority over most decisions made at the central level, and any major reform requires extensive negotiation with, and ultimately concessions to the governors and regional interest groups.

Not only are the states well represented in the Senate, but the political autonomy of the states and municipal governments is protected by tight constitutional restrictions. The central government is only permitted to use federal troops to intervene in the affairs of the states in the event of a foreign invasion. Moreover, the states preside over large, powerful militias that counterbalance the threat of federal intervention. The states and municipalities are responsible for a wide and expanding range of activities, and the states raise significant amounts of revenue themselves. The states have wide-ranging budgetary autonomy, and despite numerous federal attempts to restrict their borrowing activities, they have access to credit through a wide range of sources and instruments.

This section lays out the most important Constitutional and informal institutional characteristics of the Brazilian intergovernmental system. It describes the distribution of expenditure and revenue authority, the system of revenue sharing and intergovernmental grants, and the regulation of borrowing. The final subsection assesses the ability of the central government to use hierarchical mechanisms to impose hard budget constraints on the states, arguing that the Constitution presents significant roadblocks that prevent or undermine hierarchical central control over state spending and especially borrowing. More importantly, even when the central government seems to have clear authority to constrain the states, it has few political incentives to do so.

Expenditure

Surely no federal constitution is a perfect guide to the distribution of spending and governmental authority between levels of government, but Brazil's 1988 Constitution is even less helpful than most. The Constitution does carefully lay out some exclusive areas of competence of the federal government. These include most of the responsibilities that are generally allocated to the central government in normative fiscal federalism theory: defense, common currency, interstate commerce, and national highways. The constitution also explicitly lays out some spending activities for the municipalities: intra-city public transportation, pre-school and elementary education, preventive health care, land use, and historical and culture preservation. However, the Constitution does not itemize any exclusive responsibilities for the states. Rather, it lists a variety of concurrent, or "joint" responsibilities of the federal and state governments. This list includes a variety of important spending areas, including health, education, environmental protection, agriculture, housing, welfare, and police. In these

concurrent policy areas, the Constitution stipulates that the federal government is to set standards and the state governments are to deliver services. The Constitution also stipulates that the states are free to legislate in all non-enumerated policy areas.

In practice, most policy areas are jointly occupied by two and sometimes three levels of government. In the areas of education, health, urban transportation, recreation and culture, child and old age care and social assistance, all three levels act in an uncoordinated fashion which leads to “confusion and chaos in service delivery” (Shah, 1991: 5). For example, in the area of education the Constitution envisions the role of the Federal government to be limited to setting norms and guidelines, leaving actual provision to the state and municipal levels. In reality, the Federal Government continues to be involved in direct delivery of education services at the secondary, college, and university levels, and in some cases even the elementary level (Shah, 1991: 7).

The constitution does little to place specific restrictions on the spending activities of the states, and they are involved in a wide variety of policy areas. The states prioritize their spending according to their own agendas, and even try to induce the central government to provide funds for their preferred programs through negotiated transfers in the areas of shared responsibility. The Constitution does significantly restrict state autonomy, however, in the area of public sector personnel management. According to the Constitution, states cannot dismiss redundant civil servants, nor are they allowed to reduce salaries in nominal terms. Retiring state employees have the right to a pension equal to their exit salary plus any subsequent increases granted to their previous position. These Constitutional provisions seriously restrict states’ ability to control personnel costs, and given the importance of these costs in state revenue, it is very difficult for the states to make adjustments when fiscal conditions require spending cuts.

These restrictions played an important part in bringing about the debt crises described in greater detail below.

Revenue

One of the most distinctive characteristics of Brazil's federal system is the important role of the states in raising revenue. The states are assigned a dynamic, broad-based value-added tax called the ICMS. Additionally, they have access to motor vehicle, estate and gift taxes, and the federal government allows the states to levy supplementary rates up to 5 percent on the federal bases for personal and corporate incomes. The federal government assumes exclusive responsibility for the taxes on personal income (IRPF), corporate income (IRPJ), payroll, wealth, foreign trade, banking, finance and insurance, rural properties, hydroelectricity and mineral products. The federal government also administers a type of value-added tax—the IPI. The federal government's revenue from income taxes, rural properties, and IPI must all be shared with the state and local governments. The nature of these tax sharing arrangements are spelled out in greater detail below. Finally, the municipalities levy taxes on services (the ISS), urban properties, retail sales of fuels, property transfers, and “special assessments.”

The states' value-added tax—the ICMS—is a particularly important and unusual source of revenue. The Brazilian states, along with the Canadian provinces, are the only known subnational units that administer their own value-added tax. In 1995, the Brazilian states obtained 93% of their own-source revenue from this tax (Ter-Minassian, 1997: 447). While collection of the ICMS is in the hands of the individual states, the tax base and rates are

determined by the Federal Senate.² Individual states are allowed to grant exemptions and other preferential treatments to favored sectors. These preferences must be approved unanimously by a committee of the Secretaries of Finance of the states (CONFAZ), chaired by the Deputy Minister of Finance. Despite the unanimity decision rule, log-rolling among the committee members allows for a proliferation of exemptions that greatly complicate tax administration and burden interstate commerce.

As is the case with spending authority, overlap in the distribution of taxing authority contradicts the basic principles of fiscal federalism and leads to confusion and inefficiency. In particular, the bases for the federal government's IPI, the states' ICMS, and the local governments' ISS overlap, and they are administered in an uncoordinated fashion.

Intergovernmental Transfers

Although the Brazilian states do have access to an important, broad-based tax, and some of the wealthier states fund a large portion of their spending activities through locally-raised revenue, intergovernmental transfers are still an extremely important facet of the Brazilian federal system. Although overall levels of vertical fiscal imbalance are low for the state sector as a whole, dependence on transfers from the federal government varies dramatically from one state to another. Though some states, like Minas Gerais, depend on transfers for less than 10% of their spending, other states, like Rondonia, rely on federal transfers for close to 80% of their funding (Shah, 1991: 20). Unlike most of the states, the municipalities are all extremely transfer-dependent—over 75% of municipal expenditures are funded by transfers from the central

² The rate is presently 12 percent, except for exports from the states in the South and Southeast to states in the other regions, which are taxed at 7 percent.

government and the states (Oliveira, 1998: 3), and some municipalities raise as little as 2% of revenue from their own sources (Shah, 1991: 75). Revenue is transferred to the states and municipalities by (1) constitutionally-mandated tax transfers or revenue sharing arrangements, and (2) non-constitutional, specific-purpose transfers. Each is discussed in turn below.

Revenue sharing arrangements are specified in great detail in the Brazilian Constitution. The Constitution provides strict criteria for the allocation of revenue to the states and municipalities, but does little to stipulate the final use of the funds, other than the requirement that states and municipalities must spend at least 25% of all tax revenues on education. The most important fund for the states is the State Participation Fund (FPE: Fundo de Participacao dos Estados). The FPE is funded with 21.5% of the net revenues of the three main federal taxes: the personal (IRPF) and corporate (IRPJ) income taxes and the VAT (IPI). The distribution of funds among the states is fixed by Act 104-A of 1989, which determines a participation coefficient for each state that is based mainly on redistributive criteria. The coefficients range between 9.4 percent for the state of Bahia, to 1 percent for São Paulo (Ter-Minassian, 1997: 449). The fund sets aside 85% of the total for poorer regions—the North, Northeast, and Center-West.

The Constitution establishes a similar fund for the municipalities—the Municipal Participation Fund (FPM: Fundo de Participacao dos Municipios). The FPM is funded with 22.5% of the net revenues of the income taxes and the IPI. The distribution of funds is determined by a formula that is less redistributive and more population-based than that of the FPE. It also favors state capitals and large metropolitan governments. Municipalities also receive a variety of other general-purpose transfers. First, they receive 50% of the net revenue of the rural property tax collected by the federal government (ITR) in proportion to the value of

real estate properties located in their jurisdictions. Second, they receive 100% of payroll deductions of income taxes of municipal employees. In addition, they accrue 70% of taxes levied on gold, distributed by origin, and 2.3% of revenues from crude oil based on the value of production, and 50% of hydroelectricity and mineral taxes based on the sales value of the mineral by origin. Finally, the states are required to transfer 25 percent of their revenue from the ICMS to the municipalities, and the Constitution stipulates that 75 percent of these transfers should be distributed among the municipalities on a pure derivation basis. The remaining 25% is distributed according to criteria determined by the individual states.

In addition to these general-purpose revenue-sharing arrangements, the federal government makes grants to the states and municipalities for a variety of specific purposes. First of all, a variety of grants have been instituted to comply with laws other than the Constitution. States and local governments also undertake investment projects on behalf of the federal government, which funds them through the General Revenue Fund as well as the Social Investment Fund. In addition, a variety of transfers are made to state and local governments through specific central government agencies.³

A large portion of the funds transferred to the states outside of the revenue-sharing arrangement have traditionally been made through negotiated transfers known as *convenios*. These are not regulated by law and are based solely on negotiations between the federal and state (or municipal) governments individually. These provide support for a variety of activities including regional development, agriculture, education, health and housing. In most cases, funds are transferred to the state and local governments to undertake spending in areas that are

³ Investment transfers and grants made through agencies are not recorded in official statistics as intergovernmental. Thus in comparative perspective, the Brazilian states may be considerably more dependent on transfers than is suggested by official data.

constitutionally assigned to the federal government. The *convenios* made up 22% of total intergovernmental transfers and 8% of total federal revenue in 1987. The states received 90% of the funds distributed in this way, and the municipalities 10% (Shah, 1991: 41).

The most interesting aspect of the *convenios* is the fact that, according to a government report, they have been based on “ad hoc decisions and devoid of any formal criteria.”⁴ Until recent reforms under the Cardoso administration, few observers would argue that *convenios* were based on much beyond pure pork-barrel politics. For example, in 1988 the state of Maranhau, President Sarney’s home state, received more money through negotiated transfers than all of the other state governments in the northern region as a whole (Shah, 1991: 41). These transfers often accrue disproportionate to the most politically powerful, and hence often the most wealthy states. The relatively wealthy southeastern states have received the lion’s share of these transfers, and the wealthy state of São Paulo has been one of the largest single recipients. The *convenios* clearly work at cross-purposes with the redistributive goals of the tax sharing mechanism.

Borrowing

The Brazilian states borrow from a variety of sources, including the domestic private sector, the external private sector, federal financial institutions, and a variety of informal mechanisms. First of all, the states borrow from private domestic banks, primarily for short-term cash management purposes and for medium term financing. An important form of short-term borrowing is the revenue anticipation loan (ARO), which is used as a means of managing cash flow. States also float bonds on the domestic capital market. Twenty of the 26 states and

the Federal District own and borrow from at least one state bank. States also borrow from international private sector institutions. This kind of borrowing usually takes the form of medium term contractual debt. More recently, some states and their enterprises have successfully floated Eurobonds (Dillinger, 1997: 3).

Second, states borrow from federal financial institutions. Since the 1960s, long-term financing has been provided to the states by the Federal Housing and Savings Bank (CEF) and the Federal Economic and Social Development Bank (BNDES). In addition, the Federal Government mobilizes savings through its deposit taking commercial banks—above all the Banco do Brasil—which are lent to the states (Dillinger, 1997: 3). As I will discuss in greater detail below, the Federal Treasury and the Central Bank have also become important creditors to the states as a result of recent bailout agreements.

Finally, states borrow through a variety of informal mechanisms. Short-term state deficits are frequently financed with arrears on payments to suppliers and state employees. In addition, states sometimes use time lags in the judicial process to facilitate a unique form of borrowing: they take cost-cutting measures, like land expropriation, that are likely to be overturned by the courts; but until a judgment is reached, states can avoid payment. Even when an unfavorable judgment is issued, the states can sometimes finance payment through special bonds called *precatórios* (Dillinger, 1997: 3).

The federal government has taken a variety of measures to control state borrowing, and at first glance it would appear to have access to an impressive array of hierarchical control mechanisms through the Constitution, additional federal legislation, and the Central Bank. Most of these mechanisms are undermined, however, by loopholes or bad incentives that discourage

⁴ Ministry of Finance survey cited in Shah (1991: 41).

adequate enforcement. First of all, the Constitution stipulates that the Senate has the authority to regulate all state borrowing. The Senate places numerical restrictions on new borrowing on the basis of two factors: debt service coverage, and growth of the total stock of debt.⁵ These resolutions are merely guidelines, however, and the Senate is free to grant exceptions, which it does frequently. Given that the Senate is dominated by the interests of the states, it is a very poor overseer of state borrowing. As Section IV below describes in greater detail, the recent history of state debt crises shows that placing the Brazilian Senators in the position of overseeing state-level borrowing and enforcing hard budget constraints is akin to asking the fox to guard the hen-house.

In addition to the Senate, additional Constitutional provisions and federal regulations also restrict domestic borrowing in theory. Federal laws stipulate that revenue anticipation loans (AROs) must be repaid within 30 days after the end of the budget year in which they are contracted. The issuance of domestic bonds is controlled by the Constitution, which since 1993 prohibited new bond issues until the year 2000. The states are nevertheless allowed to issue precatorios to finance court judgments and roll over the principal and capitalized interest on their existing bonds. State external borrowing is exempt from these federal regulations, although most international lenders (including the World Bank) require a federal guarantee, which may be granted or denied by the Ministry of Finance. State borrowing from donor agencies is controlled by a multi-ministerial council (COFIEX). An office in the Federal Ministry of Finance also monitors the finances of the subnational entities and makes recommendations to the Senate and the Central Bank, but both are free to ignore this advice.

⁵ The most recent stipulation by the Senate states that (a) total debt service may not exceed the state's current account surplus in the previous 12 months; or 15% of its revenues, whichever is less; and (b) new

The Central Bank is also involved in the oversight of state borrowing in its capacity as overseer of borrowing in the domestic banking sector. Under several recent central bank resolutions, private banks are prohibited from increasing their holdings of state debt other than bonds, but “the complexity of these regulations and their subsequent adjustments has not enhanced their credibility” (Dillinger and Webb, 1998: 12). Central Bank regulations also prohibit states from borrowing from their own commercial banks. This regulation has been evaded with great success, sometimes subtly and sometimes blatantly. The most common trick is to allow a contractor on a state project to borrow from a state bank with a letter of comfort and then default, by prior agreement, leaving the bank with a bad loan that is then assumed by the state government.

Implications for Soft Budget Constraints

Now that the basic architecture of the Brazilian intergovernmental system has been laid out, it is possible to assess the functioning of the hierarchical mechanism. To what extent can the central government use its authority to impose hard budget constraints on the states? The system described above makes this difficult for two interlocking reasons: (1) the Constitution seriously restricts the ability of the central government to influence the fiscal decisions of the states and (2) the central government fails to take advantage of the authority it does have because it is itself at times little more than a loose coalition of regional interests. Each of these arguments is discussed in turn.

borrowing, within any 12 months period, cannot exceed the level of existing debt service or 27% of revenue, whichever is greater (Dillinger, 1997: 4).

First of all, the hierarchical control mechanisms available in the Constitution only restrict the spending activities of the states in counterproductive ways. Above all, the states have until very recently been able to interpret the constitution as preventing them from changing levels of public employment in response to fiscal emergencies. The states are also prevented from setting their own tax rates, which reduces accountability. In some intergovernmental systems, conditions and matching provisions attached to intergovernmental transfers may give central governments some leverage in trying to force fiscal discipline on transfer-dependent units. Indeed, the Brazilian federal government has recently been able to use threats of reduced general-purpose transfers to force the most transfer-dependent states into compliance with some recent reforms, but it has no such leverage over the largest, most fiscally autonomous states which receive most of their revenue from the value-added tax. Conditions attached to specific-purpose transfers—the *convenios*—have traditionally done very little to encourage fiscal discipline. On the contrary, these grants have been ad hoc windfalls negotiated according to a political logic.

Perhaps the most useful mechanism available to central governments in hierarchical intergovernmental systems is the ability to put effective restrictions on subnational borrowing. The Brazilian federal government has had weak or inadequate tools with which to curb the borrowing activities of the states. Perhaps the most serious stumbling block has been the central government's inability, until very recently, to regulate the state-owned commercial banks.

The most important reason for the central government's inability to gain control over state borrowing, however, has not been the lack of constitutional authority. Rather, it is the fact that both the Chamber of Deputies and the Senate are easily captured by the governors and the interests of the state governments. Given the absence of party loyalty and the frequency with

which legislators change parties in both the Chamber of Deputies and the Senate, representatives cannot advance their careers by concentrating on national or even state-wide issues, but rather on maximizing pork-barrel public works projects and other benefits for selected municipalities within their state (Ames, 1995). In order to build a winning coalition on any policy issue, it is necessary to make a large, complicated set of regional pay-offs (Oliviera, 1998). In many federal systems, like the United States and Germany, national party labels play an important role in state elections, and state-level candidates coalesce around the party dynamics of federal-level presidential or parliamentary elections. The evidence in Brazil, however, suggests the opposite pattern; Brazilian congressional candidates tend to coalesce around gubernatorial candidates, and organize their campaigns around state-based rather than national issues and candidates (Samuels, 2000). As a result, the central government—often little more than a loose collection of log-rolling regional interests—is poorly suited to regulate state borrowing.

The Senate has the formal authority to restrict borrowing in a number of ways, and it has been the primary overseer of recent debt renegotiations. It is difficult to expect the Senate to hold the line against the states, however, when it is by all accounts captured by the interests of the governors. On average, three quarters of the senators are former or future governors (Dillinger & Webb, 1998). The Senate appears to operate according to a norm of deference-- quite common to legislatures without party discipline-- whereby the representatives of the various states agree to a system of mutual assistance.⁶ The Brazilian Senate is perhaps the closest public-sector equivalent to the ill-fated Holding Company, or H-form enterprise

⁶ On federalism and the norm of deference in “universalistic” legislatures, see Inman and Rubinfeld (1998: 90).

structure described by Alfred Chandler and Oliver Williamson, in which the central administrative apparatus is made up of representatives of the divisional units, each of whom agrees to vote for each others' projects (Rodden, 1998). A similar kind of institutionalized log-rolling in the Brazilian Senate seems to allow the states to grant exemptions from borrowing restrictions and ICMS rules to one another.

II. The Political Mechanism

The previous section argued that the hierarchical mechanisms embedded in the structure of the Brazilian intergovernmental system do not create strong incentives for fiscal discipline in the states. This section looks at some of the same institutions from a more explicitly political angle and asks whether fiscal discipline might be enforced from below by voters. Above all, it examines whether voters have the requisite information and incentives to oversee state-level fiscal decisions and use elections to punish and reward their representatives for fiscal and other outcomes. First, it suggests that the intergovernmental institutions described above obfuscate information about state government performance and distort local incentives for oversight. Second, it argues that the electoral incentives faced by state-level leaders present them with few incentives for fiscal discipline.

First of all, voters in the Brazilian states receive very few cues to suggest that state governments should be held responsible for their own fiscal health. Voters have a perception—one that is at least partially correct—that state-level deficits and debt are not the fault of governors or other state-level officials. This perception is often reinforced by the media and even members of Congress (Souza, 1996: 340). After all, the states have had little control over

personnel decisions, even though payroll accounts for well over 60% of expenditures in most states. Moreover, the overlap of expenditure responsibilities between all three levels of government makes electoral accountability for service provision extremely difficult. On the revenue side, the vast majority of state-level funding comes from the value added tax; while the ICMS may appear to give the states more autonomy in collecting revenue, in reality it distorts the link between state governments and their voters because tax rates are set through a collaborative intergovernmental process rather than by individual governments. Since the only flexibility in administration of the ICMS available to state administrations is to issue exemptions to selected constituents, the tax does not provide incentives for large, encompassing coalitions of voters to lobby for preferred levels of taxes and public services or overall efficiency in the state public sector; rather, it encourages small, sector-specific groups of constituents with high stakes to lobby for special favors.⁷

In some of the poorest states, and in all of the municipalities, most revenue comes from general-purpose transfers. In the case of the transfer-dependent states, the fact that most local expenditures are being funded by other jurisdictions may discourage careful oversight. Even in the large, relatively wealthy and fiscally “autonomous” states, voters might not face incentives to punish officials for rising expenditures and deficits and unsustainable debt levels. These politically powerful states have been particularly adept at attracting massive subsidies from the central government through the *convenios*. Voters in these states have come to reward their governors primarily for their ability to attract spending projects that are in effect subsidized by the rest of the federation.

⁷ For a more general discussion of this problem, see Rodden & Rose-Ackerman (1997).

The most important disincentive to electoral oversight awaits more careful analysis in section five below-- as Brazil's state fiscal crises have unfolded, the federal government has repeatedly confirmed the public's suspicion that the federal government implicitly backs up the debt of the states. Most of the states' foreign debt has always been explicitly backed up by the central government, and during the first major fiscal crisis in 1989, the federal treasury assumed these obligations. The perception of implicit federal responsibility has been reaffirmed throughout the 1990s as the federal government has assumed other forms of debt—even temporarily taking over some of the state commercial banks. Given the likelihood of federal bailouts, voters face very limited incentives to punish local officials for deficits. On the contrary, they may wish to reward local officials for externalizing the costs of current local expenditures on future generations in other jurisdictions.

It is also useful to examine more carefully the electoral and career incentives faced by public officials. As discussed above, one of the most common assessments of the Brazilian political system is that at every level of government, the most reliable route to career advancement is not through parties, but through the provision of particularistic goods to specific groups of constituents (Ames, 1995; Mainwaring, 1991, 1992). Brazil's open-list proportional representation electoral system perpetuates extreme political individualism, and guarantees that parties play a limited role in mobilizing electoral and legislative coalitions at either level of government.⁸ Between two and four candidates run for governor in each state, and these candidates attempt to attract as many politicians as possible to their camp, regardless of party.

⁸ Voters can vote directly for an individual candidate or for a party's entire label. From the candidate's perspective, this creates a strong incentive to make individual appeals to voters through patronage and pork. The party's total list vote equals the sum of the party's candidates' votes plus its party-label votes. The candidates with the most individual votes get the highest priority in distributing the party's seats, so each candidate prefers a vote for himself or herself over a party-label vote (Samuels, 1999: 495).

Each of these coalitions makes agreements about divisions of cabinet spoils and electoral lists for state and federal deputy elections (Samuels, 2000). Thus even gubernatorial candidates face few incentives to make state-wide appeals to large groups of voters. “In each state, these processes involve personalistic negotiations, and downplay partisan or policy differences” (Samuels, 2000: 5).

Term limits have also provided elected officials with short time horizons. Without reelection incentives, most politicians are striving to build support networks that will allow them to move to a different level of government-- city councilmen aspire to be state deputies, state deputies to be federal deputies, federal deputies to be state governors, and governors to be senators. Executive jobs are preferred to legislative positions, because they provide power over money and patronage (Dillinger & Webb, 1998: 10). This constant shifting of individuals without party labels makes electoral accountability, especially for fiscal outcomes, extremely difficult. Moreover, outgoing administrations frequently run up large deficits that must be dealt with by the next coalition. For example, in order to bolster their campaigns for new offices, outgoing governors frequently grant large salary increases to public employees.

III. The Credit Market Mechanism

The sources of subnational credit and the available mechanisms of central government oversight were described above in the section on hierarchy. That section suggested that the Brazilian Constitution provides the central government with a wide array of tools with which to oversee, restrict, and even deny subnational access to credit, but then pointed out that most of these have been unsuccessful in curbing deficits and excessive borrowing in the states. Precisely

because the central government is so heavily involved in financing, lending to, and (unsuccessfully) regulating the states, it creates expectations among voters and creditors alike that state debt is implicitly backed up by the central government. This expectation not only weakens voters' incentives and undermines the electoral oversight mechanism, but it destroys the discipline of the credit market as well. Even though the Brazilian states have undertaken significant borrowing from private banks, their spending and borrowing activities are not adequately disciplined by the need to attract investment capital on the private market. While most international investors require an explicit federal guarantee, domestic lenders appear to have assumed an implicit guarantee. This assumption proved to be correct time and again in the 1980s and 1990s.

Fifteen states and two municipalities issue bonds, while all of the states borrow through revenue anticipation loans (AROs). Bonds have traditionally been underwritten by the states' commercial banks and sold to private banks and investors. Although they bore five-year maturities, the bonds were generally rolled over at maturity (Dillinger, 1997: 6). As state finances became precarious in the late 1980s, the credit market did begin to put pressure on the states-- interest rates demanded by private banks rose and maturities shortened. Eventually, private investors refused to hold state debt at any price. As the next section describes in greater detail, this pressure placed by the credit market on the states was transformed into political pressure on the federal government, which ultimately was forced to take on the debt of the states when they defaulted. In 1989 the Federal Government agreed with the states to transform the outstanding stock of federally guaranteed external debt into a long-term debt to the federal treasury. This move confirmed the implicit assumption of ultimate federal responsibility for state debts, which was subsequently reaffirmed several times. One of the

important lessons of the Brazilian case is that even when subnational governments do a substantial amount of borrowing in the private market, the capital market will not discipline local governments if creditors believe that local government debt is backed up by the federal government.

IV. State-Level Fiscal Crises and Bailouts

The Brazilian states have been through three distinct debt crises in the last decade. This section discusses the first two crises, and then provides a more in-depth analytic chronology of the most recent crisis.⁹ In the mid 1960s, the debt of all subnational governments accounted for nearly one percent of GDP, while in 1997 the debt of the states accounted for 18-20 percent of GDP (Oliviera, 1998: 3). The following historical account demonstrates that this rapid growth in state-level debt came about through a series of crises, each of which was precipitated by events somewhat beyond the control of the states. Each incident ultimately accelerated and transformed into a systemic crisis, however, because of the moral hazard problems that are inherent in the Brazilian system of intergovernmental relations. In each case, when faced with growing, unsustainable debt levels, the states refused to bear the costs of adjustment and demanded that the federal government assume their debts in some way. In each case the credibility of the states' demands for bailouts was enhanced by their professed (and in many cases real) inability to respond adequately to the crisis alone. Moreover, in each case the credibility of the federal government's commitment not to assume subnational debt was

⁹ Most of the historical information presented in this section has been adapted from three previous World Bank studies: Dillinger (1997), Dillinger and Webb (1998), and Oliviera (1998).

undermined by its history of bailouts and the strong representation of the states in Congress and the executive.

Background

The first crisis arose during the international debt crisis of the 1980s. This crisis originated in loans made by the private sector. State bonds and revenue anticipation loans (AROs) were held by private banks. Unable to rollover external debt and faced with foreign exchange constraints, states ceased servicing their foreign debt. Throughout most of the 1980s, the federal government honored the states' federally guaranteed obligations to their respective creditors on an ad hoc basis. In 1989, after lengthy negotiations the Federal Government agreed to transform the accumulated state arrears and remaining principal into a single debt to the Federal Treasury.

The second crisis involved debt owed by the states to the federal financial intermediaries—principally the Federal Housing and Savings Bank (CEF). In 1993 this debt was also transferred to the Federal Treasury. In both of these deals, the refinanced debt was rescheduled for twenty years at interest rates based on those specified in the original contracts, with a grace period for payment of principal. The federal government had a difficult time securing the agreement of the states to the second deal, and in order to close on the arrangement, the Federal Government conceded an escape clause-- if the ratio of state debt service obligations to revenue rose above a threshold fixed by the Senate, the excess could be deferred. The states would be allowed to capitalize deferred debt service into the stock of debt, which would only have to be repaid when debt service fell below the threshold, or in the ten-year period after the original twenty year payment period.

This capitulation by the Federal Government to the interests of the states created a new set of perverse incentives. The agreements drastically reduced states' immediate debt service obligations in cash terms, but prompted considerable expansion in the stock of state debt. With the new debt service ceiling, states were able to capitalize existing debt service into the stock of debt, which would then expand at a rate that would accelerate whenever real interest rates increased. For the most indebted states, the debt service ceilings drastically reduced the expected future cost of current borrowing and interest capitalization. Moreover, the new incentive structure made it possible for current administrations to reduce debt service burdens, continue to borrow, and leave the fiscal consequences to future administrations. Finally, the agreements reinforced the perception that state debt was in the end backed up by the Federal Government.

The Most Recent Crisis

These new perverse incentives, combined with those inherent in the Brazilian intergovernmental system, precipitated another debt crisis in the mid-1990s. Debt burdens continued to grow during the 1990s, not primarily because of new borrowing, but because of the capitalization of interest on existing debt. Despite the previous crises and bailouts-- or perhaps partially because of them-- the states continued to increase spending, particularly on personnel, and especially during and immediately after election campaigns (Dillinger, 1997: 5). This was sustainable as long as inflation remained high. With high inflation rates, states could reduce payroll costs in real terms by simply holding nominal salaries constant. With the success of the Plano Real in the mid-1990s, however, dramatically falling inflation rates reduced the states' ability to hold the line on real salary and pension increases via inflation. Recall that the

states' hands have been tied to an extent by the Constitution and they could claim that they were unable to fire workers or reduce wages. As a result, real state salary outlays skyrocketed. The states also faced exogenous challenges because of interest rates. Much of their debt was vulnerable to fluctuations in short-term interest rates. The tight monetary policy of the Plano Real resulted in continued high interest rates. Faced with growing personnel costs and overwhelming debt service obligations, the states' response was to default. The states defaulted in a variety of ways: (1) the further capitalization of interest on bonds, (2) the collapse of state banks, and (3) defaults on revenue anticipation loans and arrears.

The most severe problem was with state bonds, particularly in four of the states: São Paulo, Rio de Janeiro, Minas Gerais, and Rio Grande do Sul. As described earlier, the states began to have difficulty marketing bonds in the late 1980s. Unable to liquidate the bond debt, the states sought relief from the Federal Government. The Federal Government could have refused to act, but the states would have been forced to default. The Federal Government was concerned that such defaults would undermine the stability of the entire domestic capital market. Thus it responded by offering them the so-called troca arrangement, under which the Federal Government authorized the states to exchange their bonds for federal bonds. Under the terms of the agreement, state bonds would be held in the portfolio of the Central Bank, which would float a corresponding amount of Central Bank bonds, transferring them to the states. The Senate was authorized to determine the proportion of the bonds that would have to be liquidated at maturity. Not surprisingly, the most indebted states were able to achieve their desired outcome in the Senate in the initial years-- 100% rollovers.¹⁰ In addition, the Senate allowed the states to capitalize the accumulated interest due on the bonds into the outstanding stock of bond debt at

each rollover. Thus the Senate allowed the states to technically avoid defaults, even while they avoided any cash obligations to service their bonds. Interest charges on the exchanged bonds were based on the rate for federal bonds, which remained high. As the interest was capitalized, the total stock of state debt grew at an explosive rate.

Some states also defaulted on debt to their state-owned banks. By far the largest problem was São Paulo and its debt to BANESPA. Throughout the 1980s, the government of São Paulo was able to skirt central regulations and run up massive debts to BANESPA. It did this with loans contracted directly by BANESPA from foreign banks, and with short-term revenue anticipation bonds that were transformed into long term debt. São Paulo began to default on this debt during the early 1990s, and by 1994 had ceased servicing the debt altogether. By the end of 1996, the state's debt to BANESPA had reached US\$ 21 billion, and was the bank's principal "asset" (Dillinger, 1997: 8). By the middle of the 1990s, BANESPA had to meet its cash obligations by borrowing from the Central Bank. Several other state banks suffered heavy operating losses and stayed in business by borrowing from the central bank during this period as well. Because of the importance of BANESPA and São Paulo to the national economy, they were viewed by the central government as "too big to fail." The Ministry of Finance feared that the failure of BANESPA would prompt a liquidity crisis and a run on deposits, which would undermine confidence in the banking system as a whole. In 1995 the Central Bank assumed control of BANESPA and the state-owned bank of Rio de Janeiro, but it returned them a year later with their underlying problems unaddressed. By briefly assuming control of these two state banks and continuing to give liquidity support to them and other state-owned banks, the Central Bank not only permitted them to remain in operation and

¹⁰ This has now been reduced to 98%.

continue to capitalize the unpaid interest owed by borrowers, but it also bolstered the perception that the banks' liabilities carry an implicit federal guarantee.

States also defaulted on short-term cash management debt in the 1990s. As the state fiscal crisis deepened, states lacked the funds to liquidate their short-term debt and appealed to their creditors to roll it over. The states also began to run up arrears to suppliers and personnel. The state administrations blamed the central government as they failed to make payments to contractors and employees, and the political pressure on the central government increased. In November of 1995, the Federal Government responded by establishing the Program for State Restructuring and Fiscal Adjustment. This program provided two lines of credit to the states: one to pay off arrears to employees and contractors, and the other to refinance their revenue anticipation loans. Under the terms of the loans, the states agreed in theory to a series of reform measures dealing with personnel management, state enterprises, tax administration, debt reduction, and overall expenditure control. The Federal Government, however, had very little power to enforce these conditions, and funds were disbursed before any of the conditions could actually be imposed (Dillinger, 1997: 7).

The actions of the federal government with respect to each of these forms of de facto state default effectively federalized the state debt. Bonds that had previously been held by private banks are now held by the Central Bank. While the debt to BANESPA had previously been the concern of its shareholders and depositors, it has now been implicitly assumed by the Central Bank. While the revenue anticipation loans and arrears had been owed to private banks and individuals, the restructured debt is now owed to the Federal Treasury. In December of 1996, the total stock of such debt taken over by the Federal Government amounted to US\$ 123 billion.

Intergovernmental Debt Negotiations

The central government and the states now face a monumental economic and political challenge as they attempt to work out arrangements for the reduction of this debt. State debt is now primarily a matter between the states and the central government, rather than the states and their private-sector creditors. Thus the reduction of state debt and the improvement of state fiscal health is now a matter of political bargaining between the representatives of the central government—Congress and the executive—and the representatives of the states—the governors. The structure of the Brazilian federal system introduces important roadblocks to successful reform. Executive agencies like the Ministry of Finance-- the only actors with any claim to a national constituency-- are reluctant to grant explicit debt reductions, fearing the exacerbation of the moral hazard dilemma. The major debtor states—Rio de Janeiro, Rio Grande do Sul, Minas Gerais and São Paulo— have few incentives to make concessions in negotiations. As a result of the deals described above, their debt service burdens are quite low, and the governors have no incentive to sign any agreement that would increase those burdens—particularly while they are still in office. The major debtor states are the most fiscally autonomous states—they are financed primarily through VAT revenue, over which the federal government has no control. Thus federal threats to withhold intergovernmental transfers are not a major concern for the most important states.

Perhaps the most important roadblock is, once again, the Senate. Under the Constitution, the Senate must approve any debt agreement. Each state has three Senate seats, which means that the major debtor states control only twelve of the 81 seats. Instead of coalescing against the minority debtor states, the senators from the other states took advantage

of the situation and demanded proportionate benefits for their own states in exchange for their votes to protect the interests of the largest debtors. Given the weakness of party discipline in Brazil, the president was unable to use national partisan ties to convince representatives to favor a national agenda over their narrow regional interests. All of the senators face incentives to prolong the debt repayment process (Gomez, 2000). Deadlines for agreements came and went while the stock of debt has continued to grow from 1995 to 1997

In December of 1997 the Federal Government signed its first agreement with a major debtor state—São Paulo. Under this agreement, the federal government agreed to assume all of São Paulo's bond debt and debt to BANESPA. A large chunk (around 80% of the total) was refinanced as a loan to the state government with 30 years to maturity and a real interest rate of six percent—well below the prevailing domestic rate. Another chunk (12.5%) was to be amortized through the transfer of stock in state enterprises. The remainder was forgiven by the federal government. The agreement created a debt service ceiling of 8.86% of net current revenues before 2000, increasing to 13% thereafter (Dillinger, 1998). This ceiling covered not only the newly refinanced debt, but also the debt refinanced under the two previous reschedulings. For São Paulo this amounted to virtually no increase in actual cash debt service, and it allowed the majority of debt service to be deferred indefinitely. The World Bank had advocated that any such debt agreements include requirements that the states agree to expenditure cuts, revenue increases, and other reforms. The São Paulo deal required no such reforms of the state government. Moreover, the agreement may not have provided enough debt relief to permit the state to service the remaining amount. According to World Bank projections, debt service is likely to exceed the ceilings by a substantial margin, which may set in motion once again the well-known pattern of deferred debt service and eventual crisis.

After São Paulo, Minas Gerais and Rio Grande do Sul signed similar agreements. In the course of the legislative debate, Congress chose to offer the refinancing terms to all the remaining states in Brazil. Although these agreements will lower the interest rates paid by the states, the federal government will continue to be the states' creditor and continue to pay the overnight rate as the marginal cost of borrowing funds. Moreover, the states will not be prevented from continuing to capitalize interest on debt owed to the federal government, and state debt will continue to grow. As a result, the aggregate interest costs for the public sector will not decline. The costs have merely been shifted explicitly to the federal treasury, and many of the state-level incentive problems have not been resolved.

Furthermore, obtaining favorable debt workouts continues to be a high priority for most senators, and demands for further delays in repayment are likely to only grow stronger. In fact the governors and senators stand on reasonably firm ground when making their case. As part of the so-called Kandir law, the central government reduced the states' revenue from the ICMS, and facing high real interest rates and social security expenditures, states have successfully argued that they are simply unable to adhere to debt repayment agreements.

V. Reform Efforts

The primary goal of this chapter is to provide an explanation of the rather serious problems that have hampered the efficiency of fiscal federalism in Brazil in the 1980s and most of the 1990s. Nevertheless, as in Argentina, there may be reasons for optimism. While many important reforms have been undermined, others have achieved partial success. Other nascent reform efforts are simply too recent to adequately assess in this chapter.

An evaluation of the Cardoso administration must cast considerable doubt on the popular characterization of the Brazilian presidency as a weak, ineffective victim of constantly-shifting coalition politics (Figueiredo and Limongi 2000). Since 1994, Cardoso's government has been committed to stabilization, and has put together a legislative coalition that has been able to guide reforms through the legislature (Melo, 2000). Some of these efforts seek to assuage the underlying moral hazard problem of Brazilian fiscal federalism. The banking sector has been an important target: Since 1994, a variety of new banking regulations have been implemented, and some moves have been made towards increasing the autonomy of the National Monetary Council and Central Bank (Faria, 1996; Sola, Garman, and Marques 2000,). Above all, many of the state banks have been privatized. Significant steps have also been taken to decrease the discretionality of the intergovernmental transfer system, and as in Argentina, the central government has been able to use threats of reduced transfers in negotiations with states.

The central government has recently implemented an array of new hierarchical mechanisms aimed at limiting the states' access to credit in the future. Senate Resolution 78 (September 1998) resolves to put further restrictions on borrowing from state banks, imposes new borrowing ceilings, restricts new bond issues, and forbids the issuance of promissory notes to contractors (Dillinger, 2000). Additionally, new discretion and autonomy have been given to the National Monetary Council to prohibit lending to states that are in violation of the resolution.

Finally, it is useful to mention a very recent legislative package that may be the single most important fiscal reform in recent Brazilian history—the Fiscal Responsibility Law (Supplementary Law 101, approved in May of 2000) and the Penal Law for Fiscal Crimes

(approved in October 2000).¹¹ First of all, the legislation attempts to dramatically improve the transparency of the central bank's operations. Moreover, the central bank is now prohibited from exchanging the debt securities of the states for federal public debt securities—one of the key bailout mechanisms discussed above. The legislation also tries to resolve a key problem mentioned above—excessive state borrowing aimed at maintaining extremely high personnel expenditures. The new legislation not only places limits on personnel expenditures as a percent of current revenue, but perhaps even more importantly, it establishes a set of measures aimed at increasing the ability of all levels of government to control such expenditures, including prohibitions on wage increases and new hires. The legislation stipulates that failure to meet expenditure targets will result in decreased transfers.

Moreover, the law gives the president a new obligation to set yearly debt limits for all levels of the public sector, and stipulates that violating subnational governments will be prohibited from all internal and external credit operations and placed on a list of violators. The law also attempts to enhance credit market oversight by seriously penalizing any financial institutions that attempt to lend to violators. Additionally, it clarifies the legal authority of the federal government to withhold constitutional transfers from states that fail to repay debts to the federal treasury. Furthermore, all future “revenue anticipation” loans will be made through an electronic bidding process overseen by the central bank.

Borrowing from fiscal responsibility laws in other countries, the legislation imposes new uniform accounting, planning, and transparency requirements on all levels of government. Governments will be required to publish explicit justifications for revenue targets and detailed information about revenue sources and tax breaks. Each level of government will be required to

¹¹ For descriptions of the legislation, see Almeida (2000).

make bimonthly comparisons of expected and actual revenues and adjust within 30 days to revenue shortfalls. The law also creates a fiscal management council with the mandate of adopting procedures for the dissemination of information about fiscal accounts. Though such provisions seem to increase the central government's hierarchical control over the local budget process, they also attempt to enhance market discipline by giving voters and creditors better information about subnational fiscal affairs.

One of the most striking aspects of the new legislation is the increased role given to the judiciary and the penal system in the enforcement of certain of its provisions. The law includes prison sentences for illegal efforts to issue public bonds. It also stipulates that the executive mandate of a mayor or governor may be stripped if debt limits or personnel expenditure ratios are exceeded. Even the omission of an expenditure item in a budget or a misrepresentation in a revenue forecast are subject to penal prosecution (Almeida, 2000).

Finally, Article 35 of the Fiscal Responsibility Law simply prohibits the central government from bailing out any member of the federation. This provision attempts to make a clean break with the past by announcing that the central government will no longer be in the business of financing or refinancing subnational debts in the future. As a whole, the legislation seems to be a rather serious attempt to convince subnational voters, officials, and creditors that the rules of the game have changed and the central government will be resolute in the future if pressed for bailouts. Unfortunately it may not be possible to change expectations with the stroke of a pen. After all, the legislation may be viewed as simply the most recent in a long line of legislative pronouncements and debt limits that ultimately proved to be cheap talk.

It remains to be seen whether the recent reforms amount to cheap talk, or whether they will be accompanied by costly action. These reforms clearly make an effort to address the

commitment problem by delegating new enforcement activities to the National Monetary Council, the Central Bank, and the judiciary. While the delegation of authority from the senate to independent agencies is a step in the right direction, it is doubtful that the enforcement of these new restrictions has truly been placed out of the reach of ambitious Senators (Gomez, 2000). Governors have developed expectations that such restrictions can always be undone or circumvented in the Senate. Moreover, the Senate continues to endorse the financing of social projects while governors receive credits from commercial banks when failing to cover their debts. Rather than distancing itself from state government finances, the central government has only implicated itself more heavily in state-level fiscal affairs, and in spite of legislative pronouncements, debt repayment is clearly a purely political bargaining game. As a result, the central government's basic commitment problem remains serious: state governments and their voters still believe that the central government can ultimately be held responsible-- politically and morally-- for state-level outcomes.

VI. Conclusions

Each debt crisis described above had a proximate exogenous cause: an unexpected drop in inflation, high interest rates, or foreign exchange constraints. But the states were able to claim to their voters and their creditors that they were not responsible for dealing with the fiscal consequences, even though they had placed themselves at risk by overborrowing. The episodes only taught the governors that a pattern of over-borrowing and demanding bailouts is an effective way to maximize outlays from the central government. The experiences of the Brazilian states over the last two decades demonstrate how hierarchical and market-based

oversight mechanisms can fail. The Brazilian constitution and the structure of intergovernmental relations provide voters with neither the information nor the incentives they need to effectively hold state governments accountable for their fiscal activities. Creditors are led to believe that state debt is backed up by the federal government. Thus when faced with an unexpected external shock, state governments face no incentives to adjust; rather, the logical course of action is to demand a bailout.

It is important to understand *why* voters, creditors, and state governments expect bailouts to be forthcoming. What undermines the credibility of the central government's commitment not to bail out the states? Part of the problem in Brazil is that it is common knowledge for all of these actors that states like São Paulo are too big to fail. In addition, the structure of the intergovernmental system provides a number of cues to suggest that the center is ultimately responsible for the fiscal health of the states. The most important reason for the center's inability to commit, however, is that it is captured by the interests of the states. Any commitment not to bail out subnational governments during a debt crisis cannot be motivationally credible in Brazil as long as the relevant decisions are made by vote-trading coalitions of politicians who are only accountable to state and district-based interest groups. Above all, it is impossible to expect the Senate to hold the line against state demands when it reflects so directly the interests of the governors. Unless far-reaching institutional reforms are able to create party discipline and reduce the power of regional distributive coalitions in the Brazilian Congress, the best hope for a credible commitment not to issue bailouts might be the delegation of key decisions to autonomous agencies with no direct political links to the states. Some very recent steps have been made in this direction, but these new commitment mechanisms have not yet been put to the test.

An important avenue for reform is the improvement of the electoral mechanism. In fact, there is already evidence that the electoral mechanism can work in Brazil. A World Bank report suggests that the electoral mechanism played an important role in recent reforms in the state of Ceará (World Bank, 1995). After 25 years of chaotic, clientilistic government, fiscal irresponsibility, and a budget dominated by service on high-cost debt, in 1986 a new coalition of business leaders was able to come to power by promising sweeping reform of the state administration. The coalition followed through on many of its promises, finding new ways to reduce personnel costs, reduce the debt burden, and increase tax collection. The state's budget—which had an average deficit amounting to 30% of revenues between 1983 and 1987—has on average been balanced in all subsequent years (World Bank, 1995: 42). Moreover, candidates of the reform group have been successful in the two subsequent gubernatorial elections.

Despite the challenges to the proper functioning of the electoral mechanism at the state level that have been outlined above, voters nevertheless have the power to punish fiscally irresponsible representatives. Voters would be able to fulfill this function more effectively, however, if federal and state spending responsibilities were more clearly separated, and if the link between taxing and spending decisions were clearer. Perhaps the most valuable benefit of the new fiscal responsibility legislation is its promotion of increased transparency, information access, and accountability at all levels of government. Above all, state voters are most likely to impose hard budget constraints on their representatives if they know that they must bear the costs of local spending decisions—not future generations residing in other jurisdictions.

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