

Federalism and institutions: a comparative perspective

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RESUMO

Este artigo discute, em primeiro lugar, os problemas da estrutura federalista brasileira apontando as conseqüências, em termos de custos de transação, para o desempenho econômico. Em seguida, realiza uma análise comparativa utilizando os casos da Alemanha e dos Estados Unidos como modelos de arranjos federalistas que foram adotados com sucesso por países industrializados, apesar de serem dois modelos completamente diferentes de federalismo. O caso da Alemanha é discutido em maior detalhe porque é um caso menos conhecido dos leitores brasileiros. Finalmente, argumenta-se que o federalismo alemão se apresenta como um modelo que pode inspirar as mudanças no caso brasileiro.

Palavras-chave: federalismo, reforma fiscal.

ABSTRACT

This article first discusses the Brazilian federalist structure problems pointing to the consequences in terms of transactions costs to economic performance. Then it makes a comparative analysis using the cases of Germany and USA as models of federalism arrangements that have been successfully adopted by highly industrialized countries despite being two completely different federalism models. The case of Germany will be discussed in more detail because it is less known to the Brazilian readers. Finally we argue that German federalism stands as a model that could inspire the Brazilian changes.

Key words: federalism, fiscal reform.

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1 Introduction

Nowadays Brazilian society is facing a dual federalism problem. On the one hand there is the need for a new fiscal structure fitted to a stabilized economy and a new model of development. On the other hand there is the challenge of integration with Mercosul. Both questions deal with the problem of building new structures and reshaping the institutional framework of Brazilian economy as well as politics and external relations. In this article we will discuss the possible implications of fiscal change in the federalist structure, in terms of transactions costs, on economic performance. We will do a comparative analysis using the cases of Germany and USA as models of federalism arrangements that have been successfully adopted by highly industrialized countries despite being two completely different federalism models. The case of Germany will be discussed in more detail because the current Brazilian fiscal federalism arrangement is much closer to the American. Thus we argue that German federalism stands as a model that could inspire the Brazilian changes.

In the first part of this study a summary of Brazilian federalism problems is presented. Next, the two chosen federalism models are briefly described and compared so as to highlight the main aspects of each that lead to a more or less cooperative standard of action. In the third section the Brazilian federalist structure is discussed and compared to the German one. Then, the problems of reshaping the Brazilian federalist structure are analyzed.¹ Finally, in the concluding remarks we argue that there is a logic that could have shaped Brazilian fiscal federalism.

Throughout the text it must be clear that we are aware that federalism structure change is not a mere problem of positive economics. As far as it deals with political problems it is much more complex than ordinary economic problems. For this reason we will use an institutionalist perspective that entails the supposition that pure economic rationality may not be enough to explain certain economic phenomena.

2 The Brazilian fiscal federalism problems

The main problem of Brazilian federalism is **the non-existence of a federalism pact fitted to today's needs**. As history tells us, the Brazilian federalist structure of today was

1 It is important to emphasize that Brazilian economy has a wide range of fiscal problems but that in this article we are going to discuss only those associated to federalism problems.

built in the mid 60s immediately after the 1964 military coup. During the first years of the so-called “1964 Revolution” the country experienced a political centralization, which included, as one of its principal consequences, a tremendous fiscal centralization. This process of centralization lasted until 1975 when it was possible to observe the first steps towards a less centralized fiscal structure. The centralization process was extremely convenient to the changes that were occurring in the Brazilian economy at that time, as it enabled the federal government to amass a large amount of resources, both fiscal and financial, that otherwise would not have been attainable. In formal terms Brazil continued to be a federation because the states continued to have their own fiscal revenues. However, the states’ own resources were sharply reduced and as the state governors were no longer directly elected, even the state resources were used according to federal priorities. On the other hand, the federal transfers to the states followed the political logic of cooperation with the federal government and in addition the federal government utilized its power to transfer resources directly to the “municípios”² to diminish state autonomy. The clear division of competencies between Union, states and municípios was never drawn. While the Federal Government was strong and external resources were abundant this federal arrangement worked. During the 70s Brazilian development was known as the “miracle”

Problems began to arise when two processes became reality. The first was the redemocratization process and the second the 80s world crisis. The external indebtedness together with the demand for decentralization provided the environment for change. The problems deepened with the approval of the Constitution of 1988.

The results of the processes indicated above, together with the globalization process, can be observed in the Brazilian economy today. From the federal viewpoint we have a federal government with a **weakened federal fiscal structure**. While the new Constitution determined a new distribution of the fiscal burden that privileged the second and third level of government, it did not establish a clear division of assignments. The consequence was that the federal government continued to be responsible for a series of tasks that could no longer be met. The way out for the federal government was to stop accomplishing the duties it had done before. Health services, social security, public safety, transport, communications, and all the public services that were once provided by the federal government were transformed into chaos. Only a few states such as São Paulo had had the fiscal capacity to provide these kinds of services to the population before. After the change it was supposed that all states would be able to purvey these services. However, experience proved the contrary. So the country today has a **huge vertical fiscal imbalance**.

2 “Municípios” are the third level of government in Brazil.

The problem of vertical fiscal imbalance is aggravated by the federal government's responsibility to sustain stabilization. The mere suspicion that the federal government may not be able to handle its commitments is enough to unchain a series of speculative behaviors that could lead to inflationary pressures. In the last two and a half years the federal government has been imprisoned in a vicious circle that determines the rise of public debt in order to maintain the entrance of external capital. To sustain this process the federal government must keep interest rates high enough to attract foreign investment. The problem is that to control the money supply the federal government accepts a large amount of public debt at high interest rates which puts pressure on the federal budget. As there are no signs that things will change in the near future, one means of handling a situation like this would be to have a sounder fiscal structure.

Another federalist problem that generally is viewed as a financial problem is the indebtedness of the state banks. This is a core problem as it is related to internal debt as well as to state government deficit. For more than eight years, until 1994, several state governments accumulated a huge debt with their state banks. The process by which some "governadores"³ managed to do this was the so-called "endogenous money supply" which has had obvious consequences on the management of the money supply. Every time state banks were in trouble the Central Bank helped them. While inflation was high the inflationary tax collected by the financial sector was enough to perpetuate the process. After the second semester of 1994, when inflation began to slow down, the problems with the financial system became apparent. When the new President took office, the Central Bank intervened in many state banks. The situation is still unsolved. Some economists have suggested that the solution is the privatization of these banks. The question is who is interested in buying banks with such a high indebtedness problem, especially considering that the main borrower was the state - the principal owner of the bank.

The decentralization process promoted by the Constitution of 1988⁴ was expected to solve the states' financial problems by giving them greater autonomy with respect to the federal government. Once more, as the process of decentralization emphasized only the receipts, the other elements for sound interstate relationships were totally unconsidered.

3 Governadores are the chief executives of the second level of government.

Table 1
Brazilian Fiscal Federalism Structure: 1967 And 1988 Constitutions

Taxes	1967	1988
Import tax	U	U
Export tax	U	U
Income tax	U	U
Territory tax	U	
Big fortunes tax		U
On electric energy and fuel	U	
Automobile property	E	E
Minor sales of fuel		M
Improvement contribution	UEM	UEM
Rural property	U	U
Urban property	M	M
Industrialized products	U	U
Exchange, assurance and credit operations	U	U
Transport and communications services	U	U
Extraordinary	U	U
Compulsory loan	U	U
Property transfer (donation)	E	M
Property transfer "causa-mortis"	E	E
Goods circulation	E	E
State services tax	E	
Services tax	M	M
County services	M	
Finsocial	U	U
Social security contribution - IAPAS/INPS	U	U
PIS/PASEP	U	U
Net profit contribution corporate contribution	U	U
Firms contribution to social security – INSS	U	U
Firms contribution to retirement – FGTS	U	U
Education wage	U	U
Other revenue sources (residual)	UEM	UEM

U = Union; E = states; M = counties.

In the last three or four years the problem of financing the federation deficit was alleviated through reducing expenses such as those for social security and health and finding new sources of financing. Among those new sources are the profit contribution (Cofins), the provisory contribution over financial transactions (CPMF), as well as the emergency fund

4 The changes in Brazilian fiscal structure and its current form are shown in Table 1.

(FEF) created for one year at the end of 1993 to guarantee the success of the “Plano Real”, and recreated in 1996, again to last only one year. There are some people who say that the vertical fiscal imbalance was solved with the introduction of these new taxes. However, there are some problems associated to these taxes. First of all they were created under the logic of providing the federal government with resources that would not be distributed among the other levels of the federation. As a result, the taxes that are to be distributed become much less important to the federal government than those that are not to be distributed. The consequence is that important taxes like income tax and IPI (industrialized products tax) are badly administrated. Second, they are not taxes created by the Constitution and therefore they need to be approved by the Congress every year, which imposes a high level of uncertainty on federal government planning and a recurrent need for negotiations to get this money every year. The need for negotiations would not be a problem if there were some major orienting norms for finding a solution. Obviously in a circumstance like this the main issue is the process of negotiation.⁵

Another problem that arises from the Brazilian fiscal federal structure is the so-called “fiscal war”. This problem has two dimensions. The first one is the problem of tax evasion. As in Brazil the IVA (ICMS) is divided between the producer and the consumer states, the incentive to declare the export of a product that will in fact be consumed in the producer state is high. In doing so the share that would go to the consumer state is not collected by any of the states. The second problem arising from this structure is a conflict between more developed and less developed states. Some states in Brazil are reducing the aliquot of the tax in order to attract new firms into its territory. This behavior generates protests from the states that are losing firms and causes a regional conflict that creates barriers to an understanding between states. The conflicts between states are supposed to be solved by the Conselho Fazendário (CONFAZ), which is a commission assigned to solve the issues concerning conflicts of interests among states and to establish the rules for state fiscal relations not determined by the Constitution nor the complementary law. This commission is made up of all the state finance secretaries and unanimity is required to approve any new determination. This unanimity rule has been responsible for a lack of decision and a paralysis of the agreement process. It is needless to say that it contributes to the absence of negotiations between states as long as any single state may stop discussion by using its right to veto.

5 We will return to this point later.

There is a proposal, presented by the federal government, that suggests the need to unity the two aggregated value taxes that exist today in Brazil, the IPI and the ICMS. According to this proposal those two taxes will be united into one IVA tax to be collected by the federal government and distributed according to the law. If this proposal is accepted by the Congress it will probably end the problems indicated above. However, it is most unlikely to be approved without further costs to the federal government, because for each ally the federal government gets, another expense is created.

As is well known Brazil is an extremely unbalanced country with an enormous share of its population living below the international standards of poverty. Setting aside the problems discussed above, it is possible to say that the main challenge for a new fiscal federalism structure is the building of a keystone to diminish regional disparities. As was suggested above, from 1930 to 1975 the country followed a centralization trail that augmented the regional disparities. From the beginning of the decentralization process until the present there have been no clear signs of change concerning these regional differences. So one must argue that the federalist arrangement in Brazil has been of no use to diminish regional inequalities.

3 German federalism

It is not the purpose of this text to present an exhaustive analysis of American and German federalism. The aim is to unveil the main characteristics of these two federalism models that are associated to the Brazilian federalism structure. When Brazil first adopted a federal structure, in 1891, the inspiration came from the American Constitution. As is well known the American federalism model is characterized by a radical division of competencies. It is a model that may be called competitive federalism, in which the states have the power to legislate about subjects that are not under the exclusive or private sphere of the Union. In the American Constitution one reads that the powers not delegated to the United States by the Constitution, nor denied by it to the States, are reserved for the States or the people. According to this principle the states may also establish their own fiscal structure and there is no limit on state power to determine the basis, kind of tax, aliquots and so on. Due to the principle of autonomy and power equality between levels of government the same argument that holds for external trade is applicable to interstate trade. In others words taxes cannot be exported.

Until 1930 Brazilian federalism followed the model mentioned above quite closely. Afterwards Brazilian federalism experienced a series of changes in its federal structure. The main tendency observed was a departure from the classical competitive federalism that

characterizes the American model to the cooperative federalism present in the German model. There is no point in describing every Constitution Brazil had during these periods.⁶ Therefore we will focus only on the last Constitution to compare it to the German model.

It is reasonable to say that the main distinctive feature of German federalism compared to American federalism is the mutual commitment of coordination and cooperation existing between federal entities. This commitment is based on an interdependence existent among levels of the government. The interdependence can be observed on various grounds such as the administrative, partisan politics, governmental, institutional and planning. Regarding the fiscal structure it is also possible to observe a consistent pattern of cooperation. As is well described by Biehl (1994), the intergovernmental fiscal relations in Germany also show the characteristics of a cooperative federalism.

The main element of German fiscal structure that characterizes cooperative federalism is, on one hand, the subdivision of an assignment into parts and distributing these parts among different levels of governments, and on the other, existence of concurrent responsibilities. According to Biehl (1994), an example of authority subdivision is the power to tax, which can be divided into the power to legislate on a tax, the right to collect revenues and spend them, and the power to administer a tax. As long as these tasks must be performed, dividing them among distinct levels of government encourages cooperation. Moreover, the adoption of concurrent instead of exclusive responsibilities also points to the path of cooperation. German fiscal structure is complex, compared to American or even to Brazilian standards, and it is totally directed towards achieving cooperation. The Constitution establishes (a) the assignment of tasks and their execution, which means that the duty to spend is a result of the assignment of tasks, (b) the right to collect at each level, (c) the revenue sharing, (d) the power of each federal entity to legislate, (e) the right of concurrent responsibilities and (f) the financial compensation between Union and states and within states.⁷

There are a few features that best characterize the cooperative pattern of German federalism. First of all, there are tasks that are executed by states through the delegation of

6 There were five Constitutions in Brazil from 1934 to 1988, along with a lot of constitutional amendments.

7 Laufer (1995).

the Union, in which case the responsibility to afford the expenses belongs to the Union who transfers resources to the states. These are the **delegated tasks**. In other words states receive resources that are to be used for a specific purpose. In this case both levels of government are responsible for the accomplishment of the tasks and so there is a strong incentive for partnership. In addition, the check and balance mechanism put to work for the federal government must supervise the execution of the work.

Beyond the delegated tasks there are the **federal aids for investments** to be executed by the states. This is foreseen in the Constitution whenever there is the need for investments that will improve macroeconomic conditions of growth. Once more it is a case of the Union transferring resources to the states that are directly assigned to a specific work.

Third, there is the question of the **power to legislate**. In this case it is possible to observe a predominance of the right of the federation to legislate on the taxes that are of its exclusive responsibility and also on the taxes that are under the concurrent responsibility of states and federation. This is determined by the principle of equality presented in the Constitution that determines that no citizen will be treated unequally in fiscal terms. However, in the case of the taxes divided between Union and states the approval of the Bundesrat is needed to establish terms of taxing. As the Bundesrat is formed by representatives of the state governments,⁸ the states' right of joint power to legislate is insured. As Laufer (1995) points out, negotiations on changes in the value aggregated tax (VAT) and income tax (IT) could last for quite a long period of time. Until an agreement is reached the situation remains as it was. Nevertheless, there are strong incentives for every level to negotiate because a coalition of a sufficient number of state representatives can change the legislation. So when there is the suggestion for a change everyone involved in the negotiation becomes engaged. As we will discuss later the incentive to negotiate is one of the most powerful instruments of the collaboration.

The principle of autonomy guarantees the right of each level to collect, notwithstanding that the **revenue sharing** practice accentuates the interdependency between levels of government. Here there is another example of division of tasks because the two most powerful taxes in terms of power of collection are divided between Union and states.

8 Vogel (1995).

Probably the most distinctive feature of German fiscal structure is **the financial compensation** between Union and states and within states. This is a unique example of commitment between states that can be observed in the fiscal structures. The logic of this rule is anchored on the principle of guaranteeing the same living conditions to the inhabitants of all the states, especially regarding basic living conditions such as education, health, food, and housing.

Finally, it is important to mention the **Constitutional Federal Court** that holds central importance in structuring German federalism. According to Laufer (1995) this court is responsible for interpretation of the Constitution whenever there are divergences about rights and duties between the parts of the federal government such as the Republic Presidency, the Bundesrat and the Bundestag. It is also responsible for solving conflicts arising from differences of opinion or doubts on the formal compatibility of federal versus state legislation. Further, it is liable for divergences about rights and duties of the Union respecting the states. In doing so it stands as the federation guardian because it is particularly important in guaranteeing states' rights in a situation of growing federation power.

4 German and Brazilian federalism compared

It was suggested above that Brazilian federalism begun in 1889 and inspired on the American federalism little by little has migrated towards the German pattern. The comparison between German and Brazilian federalism will be done in three parts. First it will contrast the tax structure, second the assignment structure and finally the institutional arrangement. In Table 2 there is a summary of the elements of each type of fiscal federalism in discussion here.

With respect to tax structure it is necessary to mention that in Germany as well as in Brazil the taxes responsible for the highest amount of collection are income tax (IT) and value aggregated tax (VAT). In Brazil there is another important federal tax that is quite similar to VAT but is related only to industrialized products and in some sense represents double taxation as VAT is also collected over these products. The main difference concerning income tax is that in Brazil only federal authority is allowed to legislate. The story concerning VAT is a bit different. In both countries there is concurrent legislation, however in Brazil the power to collect is a right of the state and the power to spend is a right of both the state and county.

Table 2
German and Brazilian Fiscal Federal Structure: Institutional Elements

		Germany	Brazil
main taxes			
income tax	power to legislate	B & B	C & RF
	power to collect	FE	FE
	power to spend	FE & SE	FE, SE and CE
	distribution rules		53% U, 21,5% S, 22,5% M and 3% P
value aggregated tax	power to legislate	B, B & AS	C, CF & AS
	power to collect	FE	SE
	power to spend	FE & SE	SE
	distribution rules		75% S and 25% M
industrialized products tax	power to legislate		C & RF
	power to collect		FE
	power to spend		FE, SE & CE
	distribution rules		43% U, 31,5% S, 22,5% M and 3% P
Total revenue distribution		66% U and 44% S&C	30% U and 70% S&C
Assignments			
Defense		U	U
Communication		U	U
Social security		U	U
Science and research		U	U & S
Interstate transportation		U	U, S & C
Social assistance		U & S	U, S & C
Education		S	U, S & C
Urban and regional planing		S	U, S & C
Public health		S	U, S & C
Inter-city and urban transportation		S&C	U, S & C
Housing		S	U, S & C
Other elements			
Federal Assembly	party representation, proportional state representation		the same as in Germany
State representation (Bundesrat or Senate)	state government representation, proportional to state population, absence of freedom to vote		direct popular voting, freedom to vote even in respect to the party
Conflicts conciliation	Federal Constitutional Court, Bundesrat, Conciliation Committee of the Bundesrat and of the Bundestag		CON FAZ
State indebtedness policy			currently negotiation case by case with the Central Bank
Rules of negotiation	approval by the Bundesrat and the Bundestag		clause of unanimity in the CONFAZ

B & B = Bundesrat and Bundestag.

C & RF = Congresso e Receita Federal.

FE = Federal Executive.

FE & SE = Federal Executive and State Executive.

FE, SE & CE = Federal Executive, State Executive and County Executive.

P = special development programs for the North and the North-east regions.

B, B & AS = Bundesrat, Bundestag and State Assembly.

C, CF & AS = Congresso, CONFAZ and State Assembly.

SE = State Executive.

Summing up all the sources of tax revenue in Germany, the federal level holds 66% while in Brazil the Union only receives approximately 40%. That it is why some analysts argue that Brazil has one of the most decentralized fiscal structures. Nonetheless, the assignment of tasks is totally different in these countries. To begin with, there is a clear cut separation of tasks between levels of government in Germany, exception made for social assistance. In the Brazilian case only defense, communications and social security are of the exclusive responsibility of the federal government. All other tasks are to be accomplished by all three levels of government with no clear distinction about who does what. In recent times, some initiatives to develop agreements between state levels have been observed. An example is the attempt of the São Paulo Mayor to make a deal with the São Paulo Governor to define distinct responsibilities concerning the supply of public health services. It is easy to perceive that any long lasting solution would have to arise from a joint and formally institutionalized action of the three government spheres.

Finally, taking into consideration the organizational elements it is possible to notice a series of features that distinguish the two countries. The main characteristics that differ between the two countries are related to the potential for negotiations embodied in each organizational structure. While in Germany it is extremely high, in Brazil it is unusually low. To begin with, in Brazil there is no commitment from the Senate representative to be a defender of the state's executive interest and thus he has no ties and no incentive to try to cooperate with the Union or the other states. What is commonly observed is that Senate as well as Assembly representatives are always trying to extract resources from the federal government but not necessarily to solve state fiscal imbalances. On the contrary, these resources are in general a means of promoting representatives among their electoral bases. As representatives are free to vote according to their beliefs or personal interests the results generally are not those favoring cooperation between levels of governments.

Another element that is worth noting is the process of negotiation. Again, while in Germany there are at least three loci of negotiation, in Brazil any conflict of interest between states must be solved in the sphere of CONFAZ. This commission is a federal council composed of the state finance secretaries of all the states of the federation. Moreover while in all three loci of negotiation in Germany the rule for approval or rejection is the majority rule, in the CONFAZ unanimity is needed to approve or reject any new proposal.

As it is possible to see, Brazilian fiscal federalism has a high potential for becoming competitive despite its revenue sharing rule. Currently, it seems that Brazilian fiscal federalism has moved towards developing the cooperative institutional environment that had never been built. This brings us to the central point of this article, which is: how are institutions built and more importantly how do they change?

5 Brazilian federalism and institutional building

Taking into account that the principal aim of federalism is to “generate and maintain both unity and diversity”,⁹ which is determined by the existence of opposite forces of integration and disintegration in the same territory, it is necessary to admit that federalism is a question of degree. In doing so a perspective could be adopted to analyze a specific form of federalism that seeks to apprehend its peculiarities and compare them with other forms of federalism in a search for clues that could help us understand the reasons that determine the occurrence of that particular form.

From an institutional viewpoint it is possible to translate federalism into a set of rules that shape the relationship between federal entities. That is to say a code of behavior that orients resolution of conflicts between these partners. What is possible to observe in Brazilian economy nowadays is the absence of institutional rules that lead to the conciliation of the conflicts of interests and this void brings about undesirable results. The worst is the deadlock in the attempt to promote the structural reforms needed, especially fiscal and administrative reform, which includes social security reform. Brazil is at a crossroads and needs to redefine its federalism model. It will be necessary to decide whether a competitive or a cooperative model will be followed. The choice between competitive or cooperative federalism depends on which are the more praiseworthy values to a society.

As Biehl has shown, there is no single solution when evaluating a fiscal federalism structure. According to this author the process of building a fiscal structure is influenced by two costs: the resource cost and the frustration cost. The first is associated to the allocation of resources necessary to make a decision and the second to the attributed value of the participation in a decision. As these two costs are inversely related to one another it is reasonable to suppose that there is a combination of these two costs that minimizes the total cost of decision-making for each preference structure depending on the number of participants. So to ascertain which would be the best combination for a particular situation it is important to know the value structure of a society. In other words, it society prefers more or less democracy. Measuring democracy is a hard task to perform even if we know exactly which is the right democracy concept. However, that would not be a theoretical constraint for utilizing this methodology because even the uses obtained from consumption of goods are not possible to measure.

9 Bothe (1995).

Nevertheless, as the New Institutional Economics (NIE) argues, there is a series of other elements that prevents the attainment of an optimal solution. Among them it is desirable to specify asymmetric information and bounded rationality among agents, interdependence between institutions and organization and the possibility that organization entails the design of informational structure as well as incentive design.¹⁰ It is the presence of the elements cited above that explains the appearance of transactions costs. On the other hand: *“The existing allocation of property rights defines transactions costs and thus players’ incentives to exchange, acquire knowledge and innovate, and ultimately promote institutional change. Institutional change, the essence of which is changes in property-right definition and allocations, can be brought about endogenously through the equilibrating process of political markets.”* (Aoki, 1996, p. 8-9) North goes further: *“The success stories of economic history describe the institutional innovations that have lowered the costs of transacting and permitted capturing more of the gains from trade and hence permitted the expansion of markets. But such innovations, for the most part, have not created the conditions necessary for the efficient markets of the neo-classical model. The polity specifies and enforces the property rights of the economic marketplace, and the characteristics of the political market that are the essential key to understanding the imperfections of markets.”* (North, 1990, p. 109) North emphasizes that what would make political markets approach zero transaction cost model is the following condition: *“Legislation would be enacted which increased aggregated income and in which the gainers compensated the losers at a transactions cost that is low enough to make it jointly worthwhile.”* (North, 1996, p. 109) For North the institutional structure that will more approximately enable this condition is modern democratic society with universal suffrage. Looking over the actual cases of democracy it is possible to notice again that there are a multitude of variations what would make it quite difficult to evaluate North’s assertion. Nonetheless, it is clear that the majority of the democracies that emerged from the transition processes that occurred during the 80s and the 90s are missing some fundamental features of the democratic practice.

Let us exemplify the point above by returning to our main interest, Brazilian fiscal federalism. The problems arise because of the way negotiations are carried out, or in other words because of the absence of rules favoring agreements. First of all there is no determination that the negotiations must take place. Second, since there are no principles to conduct the negotiations, the logic of the actions is oriented solely by the competitors’ fear

10 Aoki (1996).

of losing what they already have without any compensation. In cases like this the most probable outcome is the paralysis of understandings and the maintenance of the situation. Third, Brazilian political structure has two characteristics that greatly shape the dynamic of the negotiations within and between levels of government. On one hand the Brazilian parties are weak organizations that in most situations depend on some charismatic political chief. The political representatives do not need to vote according to the determinations of the parties and it is common to observe the passage from one party to another. Political practice in Brazil is better qualified as clientele than as democratic politics. On the other hand, the “governadores” detain an enormous amount of power within their states. They hold considerable power over state representatives in both the Senate and the National Assembly. Furthermore they have vast power over both the State Legislative and the State Judiciary.¹¹ They are able to stop a negotiation by provoking a prisoner dilemma with no gains to anyone.

Buchanan and Tullock¹² said elsewhere that sometimes it is easier to agree on norms than on specific interest issues. In the case in discussion here perhaps it would be better to say that the contrary would be easier. Looking at the recent Brazilian experience on promoting reforms it is easy to see that subjects associated to fiscal reform such as the recent agreement on the exclusion of collection of VAT on exported products or the approval in 1994¹³ and the extension in 1996 of the FEF, faced less resistance than any subject that refers to political reform. Notwithstanding, it seems that what would really enhance the potentialities of the fiscal as well as the other reforms is a political reform that favors the development of mechanisms of negotiations.

6 Concluding remarks

If the problem of implementing a fiscal reform is associated to the problem of implementing a political reform we are back to the question of institutional change. According to North, institutional change is better understood in the following sense: “*Long-run economic change is the cumulative consequence of innumerable short-run decision by political and economic entrepreneurs that both directly and indirectly (via external*

11 Abrucio (1994).

12 Buchanan and Tullock (1996).

13 As is well know, this approval has been renewed every year since the first one.

effects) shape performance.” (North, 1996, p. 104) It depends on one hand on the institutional environment, that is to say the enforcement mechanisms, the way enforcement occurs, the norms of behavior, and the subjective models of the actors, and on the other on external factors such as the effects of international trade on the institutional environment.

When there are vested interests against the change it is quite difficult to improve it. This seems to be the case of the recent Brazilian reform experience. Even though it is possible to observe some change in Brazilian economy, this is mainly due to the effects of the external environment and the failure of the old development model in treating the questions posed today. When the reshaping of the institutional environment begins there will probably appear new forces pushing for further reforms. The main reason to expect this result is that at that moment the array of interests will have changed with a larger proportion of agents interested in change.

In a sense this is what is visible in the Brazilian case. The problem is that while there is a reasonable probability that external factors gain a predominance over the process and orient change in the desired direction there is also a considerable probability that internal counteracting forces could restrain changes. The result that will emerge is a event that only history can foretell.

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