The Fiscal Institutions of Brazilian Municipalities

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Introduction

Despite the possibilities of decentralized autonomy, the Brazilian municipality is bound to a number of institutions that affect its fiscal actions regarding credit market access, accountability, and fiscal control. Beyond the constitution, which mandates revenue and expenditure assignments among the levels of the federation, the national Law of Fiscal Responsibility, which imposes expenditure and debt limitations on all levels and branches of government, strives to keep public spending within its means to avoid macroeconomic consequences of inflation and costly interest rates. The credit system, evidencing signs of an administered market, affects fiscal management. And strategies used by municipal government officials affect municipal governments' accountability. At the forefront of the decentralized funding debate is the question of how developing country governments in the process of fiscal decentralization can design intergovernmental and municipal finance systems so that municipalities can responsibly fund investments without destabilizing the national economy.

In developing countries with restricted credit systems, many factors may affect a municipality's creditworthiness, including intergovernmental relations and transfer structures, the history of default rates, legal issues, economic conditions, municipal debt burden and debt structure, pledged security, national legislation, and constitutions. Based on empirical research, de Mello (2001) identifies a number of policy implications related to fiscal decentralization and subnational borrowing costs. This paper presents the institutional arrangements that affect municipal borrowing in Brazil against the backdrop of de Mello's policy implications. By examining the institutional arrangements against the prescription, this paper discusses the ways in which the institutional arrangements serve and fail to serve the Brazilian municipalities.

Literature Background

There are substantial reasons to care about the design of decentralized financing arrangements, as investment and financing arrangements affect a variety of fields and concerns. From a financial health perspective, investors and central bank officials care that municipal borrowers will offer timely, in-full repayments. With fiscal federalist policies the relationship between national and subnational debt becomes more interconnected and the importance of municipal creditworthiness intensifies. The repercussions of municipal default for the central bank could be disastrous, resulting in costly emergency bailouts or political discontent. Investors facing default could withdraw other investments, triggering widespread financial upheaval. From an economic development perspective, investment decisions at the local level may spawn or deter growth and investment opportunities. From a social development perspective, local investment and financing opportunities are important for the distribution of public goods and services in a cost-effective and efficient manner. From a governance perspective, a municipality's investment and financing choices have implications for the government's accountability to the citizenry.

Based on the benefit model of local finance, decentralization is believed to lead to economic efficiency gains and better government performance in terms of implementing projects that are aligned with public demands (Slater 1997, Oates 1993, Oates 1999, Bahl 1999, Bahl and Linn 1992, Bird 1993). Decentralized arrangements can provide stronger incentives for service provision and sustained development efforts (Schroeder 1999). Also, decentralization improves resource mobilization as local governments can tax their growing economic base more quickly than the central government. Thus, strengthening the local public sector also strengthens governments' responsiveness to local demands, varying tastes, consumer mobility, and innovative service provision.

Decentralization is also inextricably linked to developing local government institutional capacity. While some degree of local government capacity is necessary for successful decentralization (Stein 1998), decentralized structures can also enhance local government capacity. Yet, critics acknowledge that decentralized arrangements are subject to free riding, capture by special interest groups, loss of economic efficiency achieved by economies of scale, institutional weakness, long-term intergenerational inequity, interregional inequity, and danger of national macroeconomic instability (Bahl 1999, Stein 1998, Prud'homme 1995, Ter-Minassian 1997a, Ter-Minassian and Craig 1997). These potential weaknesses of decentralization highlight the importance of subnational government institutional development and fiscal discipline, justifying exploration of municipal government accountability.

Research of municipal credit markets in developing countries where decentralized arrangements are extant shows the importance of emphasizing a municipal borrowing framework that encourages municipal investment (Martell and Guess 2006). The framework should not restrict use of assets for collateral or bias one investment type over another, but should strengthen the banking sector. As well, framework should enhance local government capacity to manage cash and debt and to plan and finance capital projects. Finally, the framework should encourage modern financial institutions such as primary and secondary markets, municipal credit analysis, and commitment to allocation and pricing by risk.

Evaluation Framework

The results of de Mello's (2001) empirical analysis guide a number of policy recommendations. First of these is that spending and revenues should be aligned at the local level, whereby local governments directly raise their own revenues, as opposed to relying on discretionary transfers from the federal government. Local governments that rely on discretionary grants and transfers from higher levels of government face higher borrowing costs; a 1 percent increase in fiscal dependency results in a 0.34 to 0.53 percent increase in borrowing costs.

The second policy implication is that local government fiscal management should be encouraged through the use of stringent constraints on local government indebtedness via fiscal institutions or markets. For example, fiscal rules might restrict local governments from using credit to deficit finance and allow debt issuance to finance capital outlays only. Alternatively, fiscal constraints could be imposed by markets, or market-like mechanisms, should the subnational securities be traded. It is expected that market discipline will yield fiscal transparency and information disclosure.

Finally, de Mello's third policy implication is that the form of decentralized arrangements may affect the sovereign's borrowing costs, which in turn would affect the subnational governments' borrowing costs. Efforts to reduce subnational borrowing costs should emphasize three points. First, revenue sharing arrangements should encourage local revenue mobilization rather than local government dependency on the central government for grants and transfers. Second, the arrangements should foster local government fiscal discipline and governance, such as sustainable budgetary and investment policies. Third, automatic, earmarked transfers to local governments should be avoided so that local governments do not capitalize on windfalls at the expense of local tax effort.

Brazil Background

While Brazil has a longstanding history of waxing and waning federalist arrangements, constitutional change of 1988 reinforced the role of subnational governments in the nation's revenue raising and expenditure responsibilities. Writers of the 1988 Constitution saw weak federal power and strong subnational governments as key to a successful democracy, leading to a highly decentralist document (Dillinger and Webb 1998). Brazil's federalist government has three dimensions: a union, twenty-six states plus one federal district, and over five thousand municipalities. Much of the decentralization detail emerged from the assignment of revenue streams and expenditure responsibilities.

The Brazilian municipal credit market is marked by borrowing from a variety of lenders, mostly public, and by oversight of the federal government. Subnational governments attain credit from state-owned state banks, federal banks, private banks, the central bank, multilateral credit institutions, the national treasury, state-owned enterprises, and private lenders.[1] Borrowing from banks occurs mostly on a short-term basis while the municipalities await expected transfers (Rigolon and Giambiagi 1999).

The federal constitution governs the issuance of domestic bonds. Until 1993, subnational governments had an active bonded debt market. At that time, new bond issuance was prohibited until the year 2000. The moratorium was extended later to 2010 (Resolution 78 1998). In cases where subnational government external loans require a federal guarantee, the requesting government submits a request to the Ministry of Finance. The Ministry of Finance reviews the fiscal and financial performance of the subnational government and passes its judgement to the Banco Central (Portaria 89 1997), which then determines whether the borrower is in compliance with all the legal limits. Ultimately, the Senate approves or denies the loan request. Internal loans

[1] "Short-term borrowing" also has occurred in the form of arrears to suppliers, contractors, and employees.

do not require a federal guarantee, but often the borrower will use its transferred revenue streams as collateral.

Methodology

Based on the policy implications identified by de Mello (2001), this research examines the main institutional structures in Brazil that affect local government borrowing. In addition to the adoption of the 1988 Constitution, Brazilian local governments have been exposed to a number of institutional changes ranging from federal law to locally-designed administrative strategies. The most prominent legal change is the Law of Fiscal Responsibility (LRF), promulgated in 2000. The municipal governments, especially those that have made efforts to borrow in the capital markets, have been increasingly exposed to market, and market-like, practices. Finally, in response to those institutions as well as to demand by local citizens, Brazilian governments have undertaken a series of financial management reforms.

The claims in this review are drawn from a series of studies of Brazilian municipal credit systems and legislation conducted by Martell (2000; 2003; 2004; and forthcoming). Two of the studies are empirical assessments of the relationship between loan data (amount, price) and explanatory factors (political alliance, financial management, debt management, and economic environment). One study explores, via case analysis, what financial management measures local governments have undertaken and the effects of those measures on accountability. The final study reviews Brazil's Law of Fiscal Responsibility and examines its impact on the municipal credit system. The institutional changes of each of these studies are reviewed in the context of de Mello's recommendations.

Institutions

#1: 1988 Constitution

As embodied in the 1988 Constitution and subsequent amendments, the Brazilian government realigned revenues and expenditure assignments and better defined the roles, rights, and responsibilities of subnational governments. The 1988 restructuring reduced the federal revenue share from 45 to 36 percent and increased the state and local shares from 37 to 45 percent and 18 to 21 percent respectively. From 1988 to 1997, the local share of all disposable revenues increased and most growth is attributed to an increase in local own-source revenues (Alfonso and Ramundo 1998, Villela 1998).

The constitution defines both the various tax bases, indicates the level of government responsible for collecting each tax, and establishes a system of tax sharing among the three levels of government. The shared taxes were set up so that one level of government collects the tax, holds them in a fund, and then passes on a share to another government via a transfer. Some funds are distributed on the bases of generation, others on the bases of redistribution.[2]

The tax sharing arrangements leave a discrepancy between a unit's collection and final apportionment of receipts. Whereas the collection among the union, states, and municipalities is approximately 19.63, 8.26, and 1.46 percent of GDP in 1997, the respective post-transfer receipts are 16.54, 8.07, and 4.73 percent of GDP (Afonso and Ramundo 1998). Clearly, the municipalities gain the most after redistribution.

Municipalities, in addition to sharing the value-added, automobile, income, and industrialized products tax bases, collect and have full rights to three taxes: urban property (IPTU), service (ISS), and estate (ITBI). While municipalities have some latitude in setting local

[2] For a more detailed treatment of tax revenue collections and allocations, see Martell (2000).

tax rates, each rate of the three main municipal taxes must fall within a range and is subject to a ceiling set by federal law (Constitutição 1988, Art. 156).

In contrast to the constitutional clarity of the post-1988 tax assignments, expenditure assignments were left implicit. President Collor's proposed program to decentralize expenditures to match tax assignments was poorly received by Congress and the public (Dillinger and Webb 1998). An unexpected consequence of transferring the expenditure responsibilities occurred was that governors and mayors embraced the opportunity to take over assets and demonstrate their management ability. In 1996, municipal governments accounted for 50 percent of expenditures in fixed investments (Afonso and Ramundo 1998) and increasingly municipalities provide health and primary education.

Expenditure assignments face some federal restrictions. A municipality cannot spend more than 60 percent of its current revenue on salaries. Also, the federal government establishes minimum parameters for some decentralized public policies, especially concerning education and health. The central government transfers funds to municipalities that cannot meet the minimum standards.

#2: Federal Law

The Law of Fiscal Responsibility was intended to create a new pattern of medium- and long-term fiscal management and to change fundamentally the fiscal regime. A unique feature of the law is its scope, applying to three levels of government (federal, state, and local) as well as to the three powers (executive, legislative, and judicial). Similar constraints, although tailored to the relative authorities of each level, are imposed to each party. Early observers of the process noted the importance of the comprehensive extent of debt limits. To be effective, debt limits had to apply to all debt, at all levels, and be monitored (Ter-Minassian 1998).

The law is far-reaching.[3] It applies to budget processes, governs certain expenditures such as personnel, limits debt, facilitates transparency, and controls contracting in the final six months before an election. Penalties for noncompliance take the form of administration, fiscal, or personal sanctions. Combined with the Law of Fiscal Crimes, an administrator can be held personally accountable for noncompliance.

Another feature of the law's design connects the use of fiscal resources with goals and plans. At the local level, these are laid out in increasing detail through the Multiyear Plan (PPA), the Law of Budget Directives (LDO), and the Annual Budget Law (LOA). Expenditure choices have to be consistent with the policy direction indicated by the current municipal administration. As the law is complex, broad, and very detail oriented, it requires a fair amount of institutional infrastructure to see to its implementation. For example, how the law applies to municipalities is elaborated in 89 principal aspects (de Oliveira 2000).

Finally, the law was designed to advance the principles of responsible fiscal management and transparency by providing ample access to society of information about public accounts, tax policy, and budget allocations.

A number of critiques of the law have surfaced. First, the penalty structure is fragmented and dispersed. The law does not articulate a punitive body, especially for legislative and judicial branches (Schneider 2004). Second, making the first critique more difficult to overcome, oversight is confusing and fragmented as functions are shared by legislature for each level of government, the Attorney General, the Tribunal of Accounts, and the Judiciary. A third critique is that the system of accounting is not unified, which makes accounting for concepts such as pensions, medical expenses, and debt ceilings ambiguous and open for debate. A fourth critique

[3] Extensive details of the Law of Fiscal Responsibility (Lei Complementar 101/2000) can be found at a number of Brazilian sources, including www.federativo.bndes.gov.br/f_lrfiscal_dicasmp.htm, "Lei de Responsabilidade Fiscal: Acompanhamento da Execução Orçamentária" (Garson 2001), and de Oliveira (2000).

is that the law advances the hand of the federal government vis-à-vis the state and municipal governments. In the period after the 1988 constitutional convention and prior to implementation of the LRF, the balance of power shifted from the states to the federal government, largely as a response to state bailouts.

#3: Municipal Markets

Despite municipal need for long-term financing, the Brazilian municipal credit market is limited. Theoretically subnational governments attain credit from a variety of sources: state-owned state banks, federal banks, private banks, the Banco Central, multilateral credit institutions, the national treasury, state-owned enterprises, and private lenders. In practice their options are limited. Subnational governments borrow mostly from private banks on a short-term basis and from national or international development banks for long-term loans (Rigolon and Giambiagi 1999).

Historically, municipalities lacking accountability and creditworthiness have seen a clear precedent that the federal government will refinance their debts. In the past, municipal governments were not encouraged to share the borrowing risk. At the same time, the municipal system was characterized as having weak municipal capacity and unresolved discrepancy between revenue streams and expenditure assignments.[4] The municipal credit system exhibited characteristics of being relationship-based.

Presently, municipal governments face fairly tight municipal credit system restrictions. Legal limits and conditions control both the demand and supply of credit. Brazilian national laws, including the Law of Fiscal Responsibility, on subnational government debt issuance have become increasingly restrictive over the years in order to reduce, or at least control, the level of

[4] Prior to the 1994 *Plano Real* macroeconomic stabilization reform, inflation was rampant. Municipal governments experienced inflationary revenues that abruptly ended when inflation rates fell and stabilized. Consequently, real budgetary structural deficits became painfully obvious.

subnational government debt (Ter-Minassian 1997b).[5] The 1996 subnational debt was estimated to be 17 percent of GDP (Ter-Minassian 1997b, Ter-Minassian and Craig 1997). In 1998, state debt amounted to R$ 140 billion and municipal debt amounted to R$ 17.8 billion (Villela 1998). Resolution 78 imposes strict and clear limits on local debt issuance.[6]

The supply of credit is restricted in a number of ways. First, public banks, subsidized by federal funds, are the main suppliers of credit. While bond issuance was allowed in the past, the federal government imposed a moratorium on bond issuance, initially until the year 2000, later extended to 2010 (Resolução N.78 1998).[7]

Second, central bank Resolutions 2461 and 2521 govern the supply of credit made available by domestic bank lenders (Resolução N.2461 1997, Resolução N.2521 1998).[8] Resolution 2461 limits the debt between the financial system and public entities. The calculation of the limit is done by the central bank and is not transparent to the individual financial institutions, which often do not know when they are approaching the limit.

Third, development banks also face restrictions on their use of funds. Laws require that a portion of funds be used to finance policy goals such as housing, education, or small business development. Most lines of credit offered by the development banks are to attain federally promoted policy goals. The two dominant development banks dedicate lines of credit to municipal development projects.

Despite demand and supply restrictions, there is a movement among the actors to address

[5] The most recent Senate resolutions include Resolutions 11 of 1994, 69 of 1995, and 78 of 1998.
[6] Among the requirements are limitations to the total amount of debt operations, the annual disbursement of credit operation payments, and the total debt stock.
[7] Exceptions were granted for subnational governments to roll over the principal and capitalized interest on existing bonds or to finance court judgments (*precatórios*).
[8] Resolution 2521 redefines rules and limits for possibility of credit to the public sector. One part of the resolution states that it is forbidden for official federal financial institutions to realize credit operations with the states or federal district, except for refinancing debt with the union (Art. 8). This effectively limits the long-term supply of funds to states.

some of the system's underlying weaknesses. Programs sponsored by development banks, Caixa Econômica Federal (CAIXA) and Banco Nacional de Desenvolvimento Econômico e Social (BNDES), aim to strengthen municipal fiscal and administrative capacity. Tributary reform tries to align better revenues and expenditures within the federalist system. The recently approved Law of Fiscal Responsibility targets issues of accountability and ownership of risk within the public sector (Lei Complementar 101/ 4 2000). Recent movements suggest efforts to build municipal institutional capacity and reputation development, elements compatible with a market-based system.

The Brazilian municipal credit market is largely characterized as relationship-based and administered (Martell 2003).[9] Neither the amount of debt borrowed nor the amount invested is responsive to interest rates. Municipalities that rely more heavily on transfers than own-source income have access to higher loan allocations. Likewise, the borrowing rate, while positively related to maturity, is negatively related to the revenue-to-expenditure ratio and loan amount signifying an administered market. Overall, the results suggest that there is a rate discount for large purchases.

However, there is evidence that the municipal credit market in Brazil increasingly has elements of a market (Martell 2000). With respect to allocation, credit is increasingly associated with financial management and debt management variables (revenue-to-expenditure, debt stock-to-revenue). Over time the price of credit has increasing been associated with financial management variables such as own-source revenue and margin of self-finance. These empirical results reinforce de Mello's (2001) results that an increase in own-source revenues is associated

[9] Under a market-based credit system, borrowers will present information to signal their repayment capacity and creditworthiness. The amount financed should depend on the municipality's borrowing need, repayment capacity, and the cost of borrowing (Holtz-Eakin 1991). Alternatively, under a relationship-based credit system in which borrower reputations are undeveloped, borrower creditworthiness and default risk have little bearing on the allocation and cost of credit. In this case, the transaction costs of verifying the borrower's characteristics are high.

with lower subnational borrowing costs.

#4: Municipal Governance

As local institutions increasingly play a role in addressing the needs of local communities through decentralized arrangements, they also need to develop their accountability to the local population. Local governance characterized by devolution is likely to encourage local authorities to be responsible to local concerns (Haque 1997). Economic, administrative, and political accountability is an expected outcome of local institutional capacity. The *economic* significance of local accountability refers to the accountability that local officials carry out the economic activities to which they have been entrusted, including revenue generation and expenditures. The *administrative* significance of local accountability refers to the accountability that services are provided efficiently. The *political* significance of local accountability refers to accountability that services are provided fairly and that allocation is not dominated by any one group, such as rural and urban elites. Accountability is inextricably linked to local institutional capacity.

Based on empirical study (Martell forthcoming), municipal governments in Brazil have made efforts to improve economic, administrative, and political accountability as expected under decentralized arrangements. While some of the efforts to improve accountability are constrained by the environment or legal systems, it is useful to summarize successful efforts.

First, the literature reports that economic accountability is challenged by weak financial infrastructure, low revenue effort, and input control. The municipalities studied demonstrate that there is increased emphasis on using the budget and strategic planning as policy tools. Municipalities are using the budgetary system to improve their daily financial control. Cash management, evidenced by decreasing accounts payable, and prioritized spending are both areas of improvement.

Municipalities are undergoing a series of efforts to improve tax effort and administrative capacity. Some are consistent with the principles of public finance: targeting all evaders, providing agents with incentives that are compatible with bringing taxpayers into compliance, and improving the municipality's capacity and professionalism. Others dubiously contribute to the long-term sustainability of the municipality's tax sources: latching onto tax handles, tax amnesties, lotteries, and offering discounts for timely payments.

Second, the literature reports that administrative accountability is thwarted by inadequate enforcement and lack of skilled employees. The case studies suggest that contract enforcement is seen as a necessary part of administrative and financial control. Municipalities recognize the need to forward cases of financial delinquency to the judiciary, but are being more discriminate in what they send so as not to overburden the system with cases that can be more easily resolved in house. Municipalities realize the necessity of enforcing tax collection policies, even when it comes to taking the land, with judicial approval, of tax evaders.

Third, the literature predicts that decentralized arrangements should yield political accountability, but that political accountability is challenged by lack of public participation and an underdeveloped sense of civic culture. Brazilian municipalities have made concerted efforts to make the workings of the public sector more transparent to the public and to include the public in municipal decisions. Multiple audits provide different information; decentralized mini-city halls open the municipal government to the citizens; and experiments with, albeit on a very limited scale, participative budgets help to develop a civic culture. A sense of citizenship that demands accountability of the municipality is developing.

Effects of Institutions on de Mello's Recommendations and Discussion

Given the overview of some of the institutional arrangements that affect local borrowing capacity, consider how each serves, or fails to serve, Brazilian municipalities in relation to de Mello's (2001) policy recommendations. The application suggests that the Law of Fiscal Responsibility has a positive affect and that the Constitution, borrowing markets, and municipal actions have mixed affects on municipal capacity.

Spending and revenues should be aligned at the local level

Initial assignments of the Constitution had mixed success in aligning local revenues and expenditure responsibilities. Tax assignments were quite clear. Changes to them since the constitution has yielded less money to the subnational governments. Yet, the clarity of division was not altered.

Despite the clarity in tax assignment, expenditure assignments were implicit. Although leaders of subnational governments embraced the opportunity to take over assets and demonstrate managerial capabilities, the non-explicit aspect of expenditure policy is particularly important when local government revenue collection is restricted and/or mandated. In the Brazilian case, some local expenditures are legislatively mandated. For example, the Lei Camata dictates how much local governments should spend on personnel. Additionally, in the face of "vegetative growth" and non-matching transfers, the lack of expenditure clarity leaves municipal governments exposed to increasing costs relative to transferred revenues.

Stringent constraints on local government indebtedness

The institutions, particularly the LRF and the markets, have been very effective at controlling local government indebtedness (Tavares, 2004; Nunes and Nunes, 2003; Nascimento, undated-1). Municipalities in the aggregate showed improved fiscal performance after implementation of the LRF. The primary result (revenues minus expenditures) has increased in amount and as a percent of gross domestic product (GDP). Although debt levels have also increased, they decreased as a percent of gross domestic product.

A unique feature of the LRF is that, by applying to all levels and branches of government, it imposes restrictions at each level. The debt limits are comprehensive and apply to all debt. Under this arrangement, hard budget constraints are imposed to all debt at all levels. The hazards presented by soft budget constraints are that (1) fiscal responsibility is not maintained and (2) an exception to the law in one aspect sets precedence for bending in other aspects, ultimately perpetuating a cycle of poor fiscal management.

Although Ter-Minassian (1998) warned that to be effective the LRF would have to include all debt, at least two states are technically compliant with the LRF, but have been in arrears to vendors and salaries. Despite the golden rule of reserving long-term debt for long-term capital, these entities have exchanged long-term debt for short-term debt, impeding fiscal balance (Nascimento undated 2).

Perhaps equally important as the objective measures of fiscal health, the LRF has resulted in non-incremental structural changes, representing a change in culture. It is believed to be a law, without equal anywhere, which has changed the public's mentality of and support for fiscal control. The efforts are not lost on the international community, which initially watched the process with skepticism and later positively evaluated the changes. International bodies credit the law for increasing transparency (IMF, CEPAL), advancing e-government (IMF), improving fiscal profile (IMF, OECD), facilitating macroeconomic stability (OECD), improving fiscal planning (World Bank), and promoting a process of public debate and consensus (CEPAL).

Consistent with the change in fiscal culture, the LRF has resulted in the conceptualization that fiscal responsibility implies social responsibility.

With respect to the markets, local government debt has been limited, though not necessarily in a wise way. Debt has been limited in a way that does not necessarily promote good financial management practices. The data suggest that in the Brazilian municipal credit system investment and borrowing decisions respect some, but few, boundaries of financial and debt management. The control of borrowing through quantity and not price has left a municipal credit system with no alignment between risk and return. There is evidence of subsidies to poorer municipalities, allocation to the municipalities with outstanding debt, and economy-of-scale pricing. The potential consequence of this arrangement is that the federal government bears the burden of default risk, which does little to discipline municipal borrowers, and ultimately could destabilize macroeconomic goals and undermine local authority.

<u>Revenue sharing arrangements should encourage local revenue mobilization</u>

The hard budget constraints embedded in constitutional and legal arrangements have mixed results on encouraging local revenue mobilization. The tax assignment of the taxes that are transferred is very clear. In addition, the local governments control the collection and use of property, service, and estate taxes. Yet, the ability of local governments to raise revenues through these tax bases relies solely on their ability to improve tax effort. Since the tax rates are controlled by federal law, the local governments cannot use that dimension as a tool of revenue mobilization.

However, in response to the constraints imposed by other institutions, the municipalities studied are enhancing their tax efforts and mobilizing own-source revenue through a number of strategies. They are training fiscal auditors in specific areas, targeting all evaders, providing agents with incentives that are compatible with bringing taxpayers into compliance. It is not clear the extent to which local governments have shifted towards user charges in addition to their local tax bases. The ratio of own-source revenue to total revenue increased from 17 to 28 percent from 1986 to 1997 (Martell 2000).

Foster local government fiscal discipline and governance

Collectively, the institutions of laws and municipalities have fostered local government fiscal discipline and governance. In addition to the expenditure and debt control measures, the LRF contributes to aligning fiscal resources with goals and plans, in some way rationalizing the budgetary process and increasing the transparency of choices, and advancing principles of responsible fiscal management.

Over the last ten years, and even before the LRF was promulgated, municipalities have been making efforts to face the challenges of poor capacity, human resource development, and public participation. These efforts are classified as fiscal and cash management, tax effort, contract enforcement, transparency, and citizen participation. As with many young efforts, some efforts, such as relying on tax handles and amnesties, questionably contribute to the long-term municipal financial sustainability.

In contrast to the LRF and municipal arrangements, the borrowing institutions, controlled largely by the federal government, have had negative effects on fostering local government fiscal discipline and governance. Rather than focusing on building market-like structures, the policy emphasis has been on controlling the supply of credit and allocating it not based on demand, but on policy issue. The system collectively has encouraged borrowing systems that are uncertain and distortionary. However, ever so slowly these systems seem to be changing.

Evidence of a relationship-based municipal credit system suggests that municipal borrowers are not charged at a price that reflects their level of risk. Alternatively stated, the municipality does not assume and is not held accountable for the risk burden, leaving it the responsibility of the development banks and the central government. If control of borrowing is maintained through quantity and not price, borrowers will have little incentive to improve their financial health. Thus, the credit system does not provide incentive for municipal governments to improve their administrative, debt management, and financial management capacities.

These results support a larger framework that promotes increased use of market discipline in municipal credit systems. One policy recommendation is to leverage the financial management and capacity improvements that municipal governments are demonstrating and develop appropriate borrowing arrangements and instruments, which are designed to encourage and reward each borrowing entity's improvements in accountability and transparency. These efforts, in tandem, move the municipality towards a sense of market discipline. If the government were interested in transferring risk to the borrower and away from federal coffers, the next policy recommendation would be to design a credit system such that the price paid is commensurate with borrower risk.

<u>Automatic, earmarked transfers to local governments should be avoided</u>

Regarding de Mello's final recommendation and based on the institutions explored here, only the implementation of the constitution refers to transfers. They are automatic. As discussed, the amounts are largely formula driven based on economic factors, as opposed to being earmarked for a particular function.

Conclusions

The institutions presented here are interconnected and can be used to leverage one another to advance financial health and debt management. For the institutions to work well together, their intentions and directions ought to be aligned. From this review, the borrowing arrangements seem out of line with the efforts of the other institutions. Rather than advance financial responsibility and independence, they maintain a controlled system. As acknowledged earlier, the national government, which is ultimately held responsible for subnational disturbances in the market, has a vested interest in creating the conditions for responsible borrowing, and penalties for violations of it.

Markets, in theory, reward good fiscal and financial management. Under the logic of the LRF, enhanced fiscal responsibility would be favored by the markets in the form of reduced interest rates. The federal government has put a lot of force into developing municipal fiscal capacity, and programs at BNDES and Caixa Econômica Federal were designed in part to eventually enhance creditworthiness and use the measures as a means of distributing and pricing credit (Martell 2000). Yet, the markets are still characterized as administered.

There are limitations to this discussion and the affects of the aforementioned institutions. For example, the Brazilian municipalities are not homogenous and their responses to the institutional arrangements warrant further attention. While the growth of local revenue sources is attributed more toward an increase in local own-source revenues than to transfers (Afonso and Ramundo 1998; Villela 1998), most of the increase in own-source revenue generation is concentrated in the state capitals and there remains great disparity in financing patterns among municipalities.

At the time the Law of Fiscal Responsibility was implemented, gross differences existed in the capacity of municipalities to comply.[10] Those that had no debt were clearly in a position to meet the debt requirement. However, that alone does not speak to fiscal responsibility. Needed is an analysis of all levels of municipalities to understand which municipalities are complying with which measures, and what keeps them from attaining the other measures.

The transition to accountable, decentralized arrangements requires time to develop capacity and there is no doubt that challenges remain. As municipalities develop their capacity, it is likely that they will assume a greater role in services provision. As such, they will need to explore financing mechanisms for long-term investments. Municipal capital markets are undeveloped in most developing countries and few local governments are deemed creditworthy (Martell 2000, Petersen 1998, Petersen and Hammam 1997, Smoke 1999). One day there may be an international municipal capital market, and the municipalities that have demonstrated financial creditworthiness and accountability will be well positioned to take advantage of financing opportunities. The more solid and secure local finances are, the greater the chance that central government controls will allow municipalities to access the financial market. Accountability is seen consistently by municipal officials as a necessary first step to expanding credit opportunities. "[Brazil is] first concentrating efforts within the country to increase fiscal responsibility and accountability to create conditions necessary to enter the market" (Viega 1999) "The current period reflects a culture that is new and growing" (de Bustamente Monteiro 1999).

Adherence to the Law of Fiscal Responsibility and fair, consistent enforcement is advised. In addition, efforts to develop systems, such as a credit rating system, that reduce

[10] A study by Nazareth and Porto (2002) shows great diversity among the municipalities in the state of Rio de Janeiro in terms of their fiscal capacity and dependence on transfers. They also illustrate the potential for many municipalities to increase their tax collection rates.

information asymmetries and provide reliable, transparent data should be encouraged. Ultimately, the efforts should encourage modern financial institutions such as primary and secondary markets and commitment to allocation and pricing by risk. These policy steps would further encourage municipal financial health, such as adherence with hard budget constraints and stronger accountability structures.

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