

TEXTO PARA DISCUSSÃO Nº 612

# Fiscal Decentralization and Big Cities Financing in Brazil

Fernando Rezende

Brasília, dezembro de 1998



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· Paper presented at the 54<sup>th</sup> IIPF Congress, Cordoba, Argentina, August 1997.

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Tiragem: 105 exemplares

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## ABSTRACT

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Brazilian big cities have high needs but dispose of low means.

This situation leads to a paradox: a higher dependence on the state and federal governments as compared with middle size and smaller cities with respect to the provision of urban and social services. Higher dependence means more submission to political alliances and less room for an effective social control on public spending. This paper explores some aspects of this particular situation, its main causes, and possible solutions.

## INTRODUCTION

The concept of a world city refers to a group of cities that play a special role in the international economy. They combine conditions such as: major financial centers, headquarters or high ranking decision center for multinational, transnational and large national corporations, rapid growth of modern business services, important manufacturing pole, major transportation and communication node and population size. In Brazil, only São Paulo and Rio de Janeiro are included by Friedman (1986) in the select group of world cities, Rio in a secondary position.

In this paper, the case of Rio de Janeiro will be used to explore the particular question of how do world cities in Brazil, and for that matter other big cities, stand in matters of financing. The problem of assigning fiscal capability to local governments is well developed in the literature on fiscal federalism but no special attention is given to the case in point. Generally speaking, local governments are treated as a uniform bunch regardless of the size of the city or the functions they perform. This leads to a situation like the one we observe in Brazil, of a growing incapability for big cities to match revenue and expenditure needs.

The starting point of the argument to be developed in the paper is that world cities have high needs but dispose of low means. This leads to a paradox: a higher dependence on the state and federal governments as compared with middle size and smaller cities with respect to the provision of urban and social services. In turn, higher dependence means more submission to political alliances and less room for an effective social control on public spending. These aspects of the problem are commented in the following sections preceded by a brief summary of the main features of the Brazilian fiscal federalism. By way of concluding we raise some issues for further discussion.

## 2 SPECIAL FEATURES OF THE BRAZILIAN FISCAL FEDERALISM RELATED TO LOCAL FINANCE

Four important aspects have been singled out in the analysis of fiscal relations in the Brazilian federation after the modifications introduced by the 1998 Constitution: the unbalanced distribution of revenue and expenditure needs; the horizontal inequalities on fiscal revenue of state and local governments; the incentives for the creation of new municipalities; and the widening gap between demands and resources at the local level. A brief summary of these questions is provided below as a background for the argument to be developed further in the paper.

### **2.1 The unbalanced distribution of revenue and expenditure needs**

The 1988 Brazilian Constitution has been frequently blamed for promoting a strong decentralization of fiscal resources not followed by a correspondent transfer of responsibilities to state and local governments. On the one hand, the federal government was left with less resources but more responsibilities, mainly in the social

security field. On the other hand, state and local governments that gained resources would not have taken more responsibilities. The outcome of this mismatch between resources and responsibilities would have been a deterioration in public services and an increase in the federal deficit.

In truth, this criticism deserves qualification. Fiscal resources at the disposal of the federal government were negatively affected by the 1988 tax reform but a large part of the losses was recovered afterwards as transfers to states and municipalities did not grow as expected due to the sluggish economic activity of the early nineties and to a rise in federal collected compulsory contributions earmarked for social programs. Thus, the share of the federal government in total public sector revenues that went down to 55% in 1991 began to climb again, reaching the level of 59% as early as 1994. Over the same period, the states were not able to sustain the 30% share they had achieved initially, retreating to the position they held before the reform (around 25%). Only the local governments could preserve substantial relative gains.

As transfers did not fulfill the initial expectations for economic reasons and for other measures adopted to reduce the federal deficit, which implied a reduction on their basis, the net gains of the municipalities and the stabilization of the states quota on the historical level could only be achieved by means of their enlarged ability to tax. In other words, a higher fiscal effort was made by the state and local authorities to keep on with the decentralization process, a feature that has not been emphasized in some analysis but of great importance for a better appraisal of the 1988 tax reform.

Regarding responsibilities, the real story is also different from the common wisdom. With the federal money arriving in smaller quantities and lesser regularity, states and municipalities, the latter mainly, were forced to divert their resources to more sensitive areas from the viewpoint of their constituencies such as health and education. This “forced decentralization” does not preclude the need for a more organized process for transferring federal responsibilities to state and local governments as it leads to distortions regarding the proper care of people’s basic social needs<sup>1</sup>.

The outcome of the constitutional changes and the reactions to them caused a deterioration in the quality of the Brazilian tax system provoked by an increase in turnover type taxes conducted by the federal government to finance the newer social obligations created at the same time. As mentioned, the partial recovery of the federal government share in total revenues was related to the financing of social security related benefits. With less federal money available for other social programs, the local governments moved in to partially fill the gap, a movement that the states could not make with the same scope since they could not sustain their revenue gains. In a way, these movements point to a still very blurred sketch of a new pattern of intergovernmental relations in the Brazilian federation, in which the federal government becomes more involved with the social risks related to unemployment, old age and disability, turning the states and the municipalities more responsible for actions aimed at given equal opportunities for social mobility

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<sup>1</sup> For an analysis of social spending behavior in the post - 1988 Constitution era, see Medici, 1995 and Afonso and Raimundo, 1995.

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through investments in basic education, public health, and other programs focused on the population groups that face the more adverse conditions.

## **2.2 The horizontal inequalities in the distribution of fiscal resources**

The design and implementation of a better balanced proposal for sharing responsibilities in the Brazilian federation is constrained by a disproportional intrastate and intramunicipal distribution of the fiscal resources. Regional concentration of production and the tax basis do not give much room for collecting enough money through local taxes in the overwhelming majority of the five thousand Brazilian municipalities and a great number of the twenty seven states. This leads to an overdue reliance on formula based transfers that are biased in favor of less developed and less populated areas.

Big cities that present huge urban and social problems can not deal with them properly even if they use to the full potential their ability to tax. Smaller cities can not raise enough money through local taxes either but insofar as they are fairly contemplated with transfers, their per capita budgets come out to be much bigger. In 1995, per capital local revenues differed by as much as seven times. As a rule, per capita revenues of the local governments vary inversely to income and population by means of the prominence of transfers in the budgets of medium to small municipalities. The state capital cities are within the less favored group since they get a smaller share of the federal transfers and have been also discriminated on state formulas applied to the distribution of the municipal share subjected to state legislation<sup>2</sup>.

Horizontal inequities in the distribution of fiscal resources poses a difficult problem for the decentralization process. In particular, they do not permit to adopt usual recommendations for assigning responsibilities in a federation for lack of adherence to the actual distribution of financial, human and managerial resources. High levels of urbanization and high indexes of population density require complex technological solutions for urban problems that should be in the realm of the local governments. As financial capabilities are not associated with the nature of the demands and the existence of human and managerial resources, achieving efficiency in public spending through decentralization is not possible. To make feasible the implementation of a new model for assigning responsibilities in the Brazilian federations, the problem in question will have to be faced.

## **2.3 The incentive for the creation of new municipalities**

A wave of political emancipation led to an increase in horizontal inequalities in the last decade. Better facilities for the splitting of former municipalities in two or three new politically independent units, coupled with the financial incentive provided by the rules applied to the determination of the quota of each one in federal funds, added one thousand new municipalities to the four thousand that existed before the promulgation of the 1988 Constitution. As a rule, the newly independent municipalities get a more than proportional share relative to its population, in such a way that they turn out to be

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<sup>2</sup> An analysis of these differences and their causes can be found in Rezende, 1995

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among the best endowed municipalities in their respective states with regard to revenues per capita.

In every case, the emancipation leaves the other part of the old municipality worse off. The reason for this particular result can be found in the economic motivations for being emancipated. First, local districts search emancipation when they perceive the financial benefit derived from the localization in their territory of activities that generate a sizable portion of the state tax collected in the area. When this is not the case, they may gain from getting directly a larger amount of the federal transfers relative to the amount that are being invested in their territory. In both cases, the population that remain in the poorer areas of the former municipality are left with less resources to care for their needs.

#### **2.4 The widening gap between resources and responsibilities**

The changing demographic patterns of the Brazilian population has not been properly dealt with in analysis of the Brazilian fiscal federalism. Yet this is a very important question. In a certain way, intergovernmental relations and revenue sharing schemes still reflect past interpretations of the regional dynamics, not taking into account important developments such as the metropolization of poverty, the pace of urbanization, the higher share of the big cities in total population and the regional differences in the age distribution of the population and its transformation over time.

This is not the place to enter into a detailed analysis of the changing demographic patterns being observed in Brazil<sup>3</sup> but rather to stress its importance for appraising people's demands for public services and their spatial concentration. As the State should focus on the needs of low income families, the dynamics of urbanization and poverty is one important aspect to be looked at. When these aspects are not contemplated in the design of revenue sharing mechanisms and formula transfers, the mismatch between demands and resources widens leading to a curious situation: a greater dependence of middle size and big cities on direct intervention of the state and federal governments in local problems.

One should also look at regional differences in the age distribution of the Brazilian population. Whereas ageing is already a reality in the more developed South and Southeast regions, the young population living in the North, Northeast and Center West regions still grow at high rates. This uneven pace of change in the age distribution of the population translates into more difficulty for matching resources and demands in the less developed regions as the youngest living in these regions should be the focus of social programs under the responsibility of state and local governments, whereas adult demands for social security benefits and unemployment compensation are mainly in the hands of the federal government. Thus, a better understanding of the demographic implications for fiscal decentralization is essential for redressing the above mentioned unbalances.

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<sup>3</sup> To this end refer to IPEA, 1997

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### 3 BIG CITIES: HIGH NEEDS, LOW MEANS

As a rule, big cities have big problems. Traffic congestion, pollution, criminality, waste collection and disposal, housing and sanitation. When big cities are surrounded by poverty, as is the case in less developed countries, social demands - health and education - coupled with restrictions for relying on user fees to improve urban infrastructure impose a heavier burden on local governments. Not always, however, they have the capability for raising the money needed to meet their responsibilities.

As mentioned before, the Brazilian fiscal federalism does not favor the big cities. Their ability to tax is limited to urban real estate and to the provision of services, transports and telecommunications excepted. Seventy five percent of the state value-added tax collected in their jurisdiction plus a share on federal transfers to municipalities, together with the money they can collect on the local taxes, form the bulk of their revenues. As the criteria for allocating state and federal transfers are biased in favor of the less populated cities, the largest metropolitan areas face an increasing difficulty to match expenditure and revenues.

Rio de Janeiro and São Paulo are two important cases worth looking at. Despite the decentralization of the power to tax and the increase in federal transfers to local governments, adopted in the 1988 Constitution, these two cities lost position in the rank of the per capita revenues of the Brazilian state capital cities since then. In fact, they benefited from a higher fiscal effort that was not enough to offset their small participation in transfers.

On the expenditure side pressures kept growing over time. Accumulated interests on the public debt to fill the gap between investment needs and local savings consume a large portion of the local budgets as macroeconomic policy pushes the interest rate up to attract foreign capital and keep monetary stability. At the same time, personnel expenses do not fall rapidly in real terms, as they did in the past, since inflation rates dropped to international levels in recent years (inflation rate for 1988 is expected to be in the vicinity of 3%). Thus, investment capacity almost disappeared in the last two years after having benefited from the 1988 fiscal reform.

Comparing the big cities with the smaller ones is a way to disclose their disadvantage. For Rio de Janeiro, the numbers show a per capita revenue of 454 reais for the inner city and a meager 80 reais per inhabitant in other important municipalities of the metropolitan area<sup>4</sup>. The numbers for the other municipalities of the same state are also impressive. Several small municipalities have a per capita budget twice higher than the state average of 308 reais.

In broad terms the situation is not very much different in the case of São Paulo regarding intrametropolitan differences in per capita revenues, even though the average for the São Paulo

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<sup>4</sup> The metropolitan area of Rio de Janeiro comprises 17 municipalities inhabited by 13,2 million people. It has a total surface of 6464 square kilometers of which 18% refers to the "município" of Rio de Janeiro, the capital city of the same state. Population density reaches five thousand inhabitants per square kilometer in the capital city and 1.7 thousand in the whole metropolitan area.

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metropolitan area<sup>5</sup> is much higher than the one for the RJMR due to a more developed economic activity in the SPMR.

Even though population size is not the sole determinant of people's demand for urban and social services, the striking differences that we observe in the distribution of local government's resources in Brazil are a matter of concern, particularly when the demographic trend points out to a growing concentration of poverty in big cities and their metropolitan area. The more the process of State reform advances in the direction of emphasizing government's responsibilities with economic efficiency and social inequalities, the greater will be perception of the diseconomies generated by the inability of governments to cope with the problems of big cities.

Contrasting to the North American experience, low income people in the Brazilian big cities are concentrated in the outskirts of the city, most of them outside the jurisdiction of the municipality that has a broad tax basis. In general, poor people live in the periphery but demand jobs and services in the center. As a result, neither is able to face the pressures their population exert upon their governments. The poorer municipalities that surround the capital city house a fairly large part of the total population but lack the means to provide the services demanded. At the same time, the richer ones have higher means but not enough to compensate for the deficiencies of their neighbours.

Data for the distribution of local government's revenues in the Rio de Janeiro metropolitan area provide a good illustration of the fiscal unbalances in question. The heavily populated municipalities that surround the state capital city and house most of the low income families living in the area<sup>6</sup> dispose of a budget that is five times smaller, in per capita terms, compared with the resources managed by the mayor of the city of Rio de Janeiro. That does not mean, however, that the latter is in a much better position. The concentration of urban poverty alongside the shores of the Guanabara bay is one of the main causes of water pollution that does a lot of harm to tourism in the city. Traffic suffers from the commuting of workers living in the suburbs to earn their living in the center. Hospitals and health care centers as well as public schools are crowded as people demand services that are not available in their area of residence. Criminal rates climb in line with the social inequalities.

In fact, most of the responsibilities for dealing with the big problems of the RJMR are supposed to be in the hands of the state government. Police and traffic control, water supply, sanitation and control of the environment are areas in which local governments have little, if any, interference. Even in social services - health and education - the state governments have a dominant position in the metropolitan area with the sole exception of the city of Rio de Janeiro.

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<sup>5</sup> 38 municipalities form the metropolitan area of São Paulo in which 16.5 million people live. The SPMA spreads over a surface of eight thousand square kilometers of which 19% belong to the city itself. Population density reaches six thousand five hundred per square kilometer in the inner city and two thousand per square kilometer in the whole metropolitan area.

<sup>6</sup> The "poverty belt" that surrounds the city of Rio de Janeiro comprises the municipalities of Itaguaí, Nova Iguaçu, Belford Roxo, S. J. de Meriti, Nilópolis, Duque de Caxias, Magé and São Gonçalo.

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Having the responsibility does not mean that they have the means to carry them in a satisfactory way. Most of the money to support public provision of basic education by state and local governments come from federal raised earmarked taxes shared with them or given back through bilateral agreements (“convênios”). Worse still: there is no federal money guaranteed for the big urban problems that generate negative economic externalities - congestion, criminality, pollution and infrastructure deficiencies.

Jurisdictional conflicts add to difficulties for improving the management of the public services in the metropolitan area. As the metropolitan area responds for a sizable portion of the economy, the population and the electorate of the state, political competition is strong among the governor and the mayors, particularly in the case of the capital city. In Rio de Janeiro, the metropolitan area generates 85% of the state PIB, houses 76% of the population and supplies 75% of the votes. A degree of concentration far greater than the case of São Paulo, whose metropolitan area has 53% of the state PIB and 49% of the population and votes.

Whenever the state Governor and the Mayor of the city are not of the same political line, a situation that is not uncommon in Brazil, the coordination of policies in the metropolitan area suffers a setback. When the political spectrum is wide, with a lot of political parties participating in the local elections, the possibilities for conflicts are even greater as local interests tend to predominate over the common problems.

As the federal government controls the access of state and local government's to outside sources of financing, investment decisions are subjected to federal influence. Federal financial institutions manage the funds that can be used for financing infrastructure and social investments but the conditions for giving loans to states and municipalities are subjected to rules approved by the Senate and to ceilings that have been under severe vigilance of the Central Bank. As long as the public sector deficit remains a matter of concern, the access to these funds is restricted.

The difficulties for reconciling the goals of decentralization and integration of public policies at the local level with a high degree of dependence on federal finance can be better exposed with the recourse to three important examples: safety, sanitation and health.

Safety is a case of ill-defined frontiers. It is well recognized that safety problems in big cities are related to causes that are beyond the local boundaries. Organized crime grows in line with the traffic of drugs, weapons smuggling, money laundering and other illegal activities which are in the federal jurisdiction. Nevertheless, the general responsibility for safety in the Brazilian cities are in the hands of the state governments. There is a federal police to look over the federal offenses that do not meddle with local affairs. Only recently, an unarmed municipal police was created by the municipality of Rio de Janeiro with restrict power to act. Neither of them disposes of material and human resources to deal with the organized crime in the city of Rio de Janeiro. Insufficient resources and lack of coordination are behind the inefficient repression of an undesirable high rate of criminality. This is clearly an area in which the central government will have to play a more active role in big cities in strict cooperation with the state and local governments.

Sanitation is a case of forced centralization at the state level. The model developed in the past by the federal government forced the municipalities to hand water supply and sewage services to state governments' public enterprises. The implementation of this model was assured by federal control of the funds available for financing newer investments. Only the state enterprises were entitled to receive loans to finance the expansion of services. A cross subsidization scheme built into the tariff structure should allow for the expansion of services in low income areas and smaller municipalities at the same time that generating enough receipts to cover operational costs and the repayment of debts.

In a few time the flaws of this model became evident. State control of tariffs in periods of high inflation weakened the financial situation of these enterprises eroding investment capacity and reducing the room for expanding services in poorer areas by means of cross subsidization. Higher investment costs postponed expansion in sewage with great harm to the environment in big cities and metropolitan areas as continued migration and illegally occupied lands led to more waste disposal in an improper manner. Centralizing investment decisions on the state level did not secure a more rational distribution of investments in the metropolitan area since political interests interfered, more openly, after the democratization of the middle eighties.

Health is the case of an ambiguous decentralization proposal. The unified decentralized system for public health was conceived to give back to the local governments the main responsibility for providing basic health care to their population. The subsidiary principle was behind the model developed for health, the states being responsible for whichever was beyond the capabilities of the municipalities and both relying on federal financing to fulfill budgetary needs. The main difficulties faced in the area were related to an ambiguous proposal for decentralizing management without reducing the dependence on federal finance. In a context of unsecured and unstable resources neither the municipalities nor the state governments felt they could make a long run commitment with the decentralization of health services.

The higher the dependence of big cities on outside financing, the greater are the difficulties for keeping a stable level of public services provision. Inasmuch as the access to resources depends on negotiations with the other governments tiers, four situations may arise as indicated in the chart below.

#### Intergovernmental Relations Patterns According to Municipal and State Political Relations With the Federal Government<sup>7</sup>

		States Aligned	Not Aligned
Municipalities	Aligned	Very Good	Good
	Not Aligned	Very Bad	Bad

<sup>7</sup> The possible combinations outlined above refer to the political alignment with the federal government, including the coalition that has power in congress over the federal budget.

The interests of the local government will be best served when local power is politically aligned with the state and federal government's at the same time as indicated above. The opposite situation would be faced when the state is aligned with the federal government whereas the municipality is not, since the likelihood of having denied access to state and federal managed funds in this case is great.

Intermediary situations refer to the other two possible combinations. If the local power is aligned with the federal power but the state is not, the situation can be considered good as far as a high dependence on federal funds is the rule. Bad would be the case where the municipal and state governments are hand in hand but both diverge from the line of the federal government, since ties with the center could be severed.

Three types of intergovernmental relations arise from the combinations foreseen. We call them Integrated Cooperation, Political Competition and Joint Discrimination. The first is established when the three government tiers share the same political line. In this case, there are better chances for the local government to get the resources in need to meet the demands of its population as the state and federal governments can act in a complementary way.

If a joint discrimination occurs, a perverse condition will be faced as the possibility to count on help from above to reinforce the local capability to expand public services might be remote. The consequences are more difficult to foresee when there occurs a political competition for greater influence on one particular area. In the short run, the local government can benefit by efforts to bring it to the sphere of influence of the contenders. When the prey is not worth, the lack of coordination will lead to waste and inefficiencies.

Volatile political alignments lead to very unstable patterns of intergovernmental relations and to unfavorable conditions for an efficient management of the public services. This unstable condition, more than fiscal constraint, is an important reason for mistargetting the resources and for the low quality of the public sector rendered services. Bringing stability to intergovernmental relations is one of the most effective ways to improve the efficiency and efficacy of the public policies.

#### 4 TOWARD NEW SOLUTIONS. SHOULD BIG CITIES HAVE A SPECIAL PLACE IN FEDERAL FISCAL REGIMES?

Big cities financing would benefit from three important measures: Less dependence on state and federal transfers; more guaranteed and stable resources; and less fragmented sources of financing.

To reduce dependence on transfers, local financial basis would have to be expanded. In spite of recent efforts to better explore the local tax basis, revenue collected through property taxation in Brazil is still low by international standards<sup>8</sup>. To improve local tax collections without

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<sup>8</sup> Only 5,4% of total tax collection in Brazil refer to municipal taxes.

imposing an unbearable burden on the taxpayer, some redistribution of the burden imposed by the state and federal governments might be considered. Without changing the division of the power to tax, this redistribution could be achieved by allowing the deduction of part of the amount collected through property taxes at the local level from the federal income tax, reducing accordingly the sharing of income tax revenues. This removes part of the political reactions for increasing the taxation of property at the same time that avoids an excessive centralization of tax revenues to be given back to the municipalities through formula based transfers.

Greater reliance on user fees is also recommended. Brazilian tradition recommends user fees for financing divisible services whereas collective services should be financed by taxes. As revenues from local taxes can not match the financing needs of collective services in big cities, attempts have been made to apply a charge on such services as street lightening and cleaning, usually as a supplement to property tax liability. As such initiatives have been ruled out by the Supreme Court on grounds of being forbidden by the Constitution, the question of financing ever growing costs of collective consumed services is still waiting for solution<sup>9</sup>.

Even though dependence on transfers can be reduced it can not be eliminated. As mentioned, big cities have big problems whose solutions are beyond individual action. What we need is to implement properly designed financial cooperating mechanisms in order to give better assurance as to the availability of resources and their stability over time.

Foremost in the search for an effective cooperation is the recognizance that, to reach an acceptable standard of public services in big cities, we need a solid commitment of all federal entities with the joint provision of resources for the achievement of agreed upon targets. When emphasis is put on having guaranteed resources, some form of obligation needs to be established. Special funds formed by fixed contributions from the federal, state and local governments budgets are a common device. Earmarking of taxes has also been extensively used for giving financial assurance to governmental priorities.

Assuring resources is a good start but not enough in our case. Most of the urban problems are intertwined needing integrated policies to be more efficiently addressed. Distinct intergovernmental sector arrangements for dealing with the most important problems of metropolitan areas, as referred to above for Rio de Janeiro, lead to inarticulate decisions and to less than efficient actions.

Achieving integration in urban policies in Brazil is not an easy task. Local autonomy is long established and was reinforced in 1988. The only possibility is in the design of a new model of intergovernmental financial cooperation capable of inducing local governments in a metropolitan area to search jointly for state and federal controlled funds. In this model, municipal metropolitan application to federal administered funds should be given priority only when jointly submitted and linked to a master plan. This does not interfere with local autonomy as the money would be

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<sup>9</sup> For a good analysis of the potential for applying user charges to finance the provision of public services see Bird and Tsiopoulos, 1997.

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distributed on an individual basis. Only the decision concerning the projects to be financed would be submitted to a broader appraisal to force the desired cooperation.

Should big metropolitan cities have a special place in federal fiscal regimes? Even though one might be inclined to give an affirmative answer to this question, it is very unlikely that such a proposition would be politically feasible. Instead of calling for a preferred position with regard to other municipalities, they could develop capabilities for convincing their neighbors of the advantages of working together. Their higher technical capability and political influence should be used to substitute a collective action for individual actions in order to achieve better results for all.

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