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The Costs and Benefits of Fiscal Federalism Program in the State of Ceará

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CONTENTS

Introduction

The introduction of the "Real Plan" and the stabilization of the currency were met by unprepared State Governments. The crisis, however, demanded states to adapt and accommodate changes legislated by the Federal Government.

The changes proposed by the Brazilian Government were more than just profound and far-reaching; they were revolutionary. Inflation fueled the illusions of the State Government that they were acting to resolve structural imbalances in their public accounts. We were duped by high interest on taxes. As well as inflation was responsible for corroding in real terms the value of the currency. Brazilian states hoping that they were solving fiscal problems, were actually using a compulsory tax : inflation.

This means that the nature of the imbalance that existed in Brazilian states, was previously masked by high inflation. Eventually the imbalance started to show up retroactively, as inflation started falling, by 60% in 1995 to 8% in 1997, down to the levels present-day.

Considering the scenario where Brazilian states were forced with large deficits, government officials were forced to create other alternatives. The only real alternative that emerged was the " Real Plan ".

One of these alternatives has been the reception of financial resources through institutions or foreign banks. These resources facilitate the execution of the government plans sustaining the continuity of its objectives through the accomplishment of its goals. As well, these resources have facilitated the economic growth of the states.

State Finance Secretariats direct participation in the economic growth of Brazil by generating revenues through the collection of taxes. However, States have been obliged to implement similar changes at the state level as those being implemented at the national level. The inflation crisis has thus provoked states into reflecting critically on an obsolete structure that hinders competitiveness and encourages fraud.

The "National Fiscal Administration Program for the Brazilian States" – PNAFE proposed within the Ministry of Finance and in partnership with Inter-American Developing Bank – IDB both of which are very important institutions.

Within the administrative structure of the Federal Republic of Brazil, the Ministry of Finance is basically responsible for formulating and executing economic policy.

The IDB was created in response to a longstanding desire on the part of the Latin American nations for a development institution that would focus on the pressing problems of the region. A resolution calling for the creation of such a bank was adopted at the First Inter-American Conference, held in Washington, D.C. in 1890. In 1958 President Juscelino Kubitschek of

Brazil proposed that the countries of the Hemisphere embark upon a bold cooperative effort to promote the economic and social development of Latin America. His proposal received support throughout the Hemisphere and shortly thereafter a special committee of the Organization of American States drafted the Articles of Agreement establishing the Inter-American Development Bank.

In its 36 years of operations, the Bank has become a major catalyst in mobilizing resources for the region. The Bank's Charter states that its principal functions are to: utilize its own capital, funds raised by it in financial markets, and other available resources, for financing the development of borrowing member countries; to supplement private investment when private capital is not available on reasonable terms and conditions; and to provide technical assistance for the preparation, financing, and implementation of development plans and projects.

In carrying out its mission, the Bank has mobilized financing for projects that represent a total investment of $206 billion. The Bank's annual lending has grown dramatically from the $294 million in loans approved in 1961 to $6.7 billion in 1996.

The Bank's operations cover the entire spectrum of economic and social development. In the past, Bank lending emphasized the productive sectors of agriculture and industry, the physical infrastructure sectors of energy and transportation and the social sectors of environmental and public health, education and urban development. Current lending priorities include poverty reduction and social equity, modernization and integration, and the environment.

This work, in general lines, tries to show the costs and benefits of the PNAFE – IDB program for the state of Ceara. An up-to-date cost-benefit analysis will be given with the hope of illustrating ways in which the program can be improved. The Secretariat of Finance sums up what the growth of Ceara hops to get out of the program: " To get maximum revenue and to minimize expenses for the development of the State of Ceara".

1. Fiscal Federalism

After the monarchy was abolished, Brazil's first Constitution under the Republic (1891) established a presidential system and three independent powers: Executive, Legislative, and Judiciary. This structure was retained in Brazil's six subsequent republican constitutions, including the present Constitution, drafted by a specially empowered National Congress elected in 1984, and formally promulgated on October 5,1988. The 1988 Constitution incorporates many new concepts ranging from environmental protection to increased powers for the legislature in its relationship with the Executive.

Brazil is a federative republic composed of 26 States and one Federal District where Brasília, the capital of the country, is situated. Each State has its own government, with a structure that mirrors the federal level, enjoying all the powers (defined in its own Constitution) which are not specifically reserved for the federal government or assigned to the Municipal Councils.

Brazil has three different levels of government. The 1988 Constitution ensures the autonomy of the units making up the federation, which are: the Union – Federal and Central Government; the States – Subnational Governments; the Federal District – Government of the Federal Capital and the Municipalities – Local Governments. The head of the state executive is the Governor, elected by direct popular vote under the Federal Constitution. The one-chamber state legislature is a State Assembly. The state judiciary follows the federal pattern and has its jurisdiction defined to avoid any conflict or superimposition with the federal courts.

The scope and authority of the units of the federation from the legislative, administrative and financial standpoints were established by the Constitution. Legislative authority allows the units of the federation to organize themselves politically and enact their own laws, with the legislative affirming their autonomy.

Each of the levels of government possesses administrative autonomy, which is used for organizing their services in general and managing public business. Their financial autonomy is manifested fundamentally through the drawing up of their budgets, their power to define obligatory taxation and their capacity to carry out public spending.

The decentralized form of organization adopted is made up of 27 (twenty-seven) subnational governments (twenty-six States and one Federal District). At the municipal level there are over 4,400 Municipal Councils that are strictly autonomous local governments linked to the State within whose boundaries they are located. The Municipal Councils operate under the provisions of the Basic Law of Municipalities. It should be noted that the Constitution assigns to the Federal District, on a joint and cumulative basis, the legislative authority deriving from its dual capacity as a State and Municipality.

This federal structure is marked by major socioeconomic, demographic and territorial differences. These differences can be illustrated between States such as Amazonas and Para, which are over 1.3 million square kilometers in size, and others such as Sergipe and Alagoas, which are bigger than 27.000 square kilometers. The variation in population are equally marked, as are those in per capita income, which ranges from U$4.240 for Sao Paulo to U$572 for the State of Piaui. These economic differences result in significant inequalities in terms of the State governments' fiscal capacity.

Besides being based on federalism, the characteristics of fiscal policy also derive from historical reasons of a political, economic and social nature. Fiscal policy is also shaped by these marked regional differences, which influence the planning and execution of public policies also shape fiscal policy, with the federal government having an important coordination role.

The Federal Ministry of Finance is a part of this coordination function. Within the administrative structure of the Federal Republic of Brazil, the Ministry of Finance is responsible for formulating and executing economic policy. Since July 1994, this policy has followed the guidelines of the

Economic Stabilization Program, known as the Real Plan, which has the goal of establishing monetary stability so that the Brazilian economy can maintain sustained growth with a redistribution of income.

Legislation presently in effect - specifically Temporary Decree 1063 of July 27, 1995 – defines the Ministry of Finance responsibilities as follows:

- currency, credit, financial institutions, capitalization, savings accounts, private insurance companies and welfare institutions;
- tax and customs policy, administration, inspection and collection;
- budgetary and financial administration, internal control, public auditing and accounting;
- administration of public and domestic debt;
- property administration;
- economic and financial negotiations with governments, as well as domestic, foreign and international organization;
- prices in general and public service tariffs;
- Inspection and control of foreign trade.

The Federal Ministry of Finance, through its Executive Secretariat, are currently seeking solutions to the problems that affect fiscal policy. They are doing so through the Federal Revenue Secretariat, and at subnational level through the president of the National Financial Policy Council (CONFAZ). CONFAZ is the collegiate body representing all the States, in which the State secretaries of finance are members and where the most important fiscal matters with which the subnational governments have to deal are discussed.

2. 2. National Fiscal System

The national fiscal system is divided in two parts: tax *revenues* and *financial administration*.

Tax revenues are the main source of financing for public spending at the national level. This is the national tax system, which is based on general rules which have been codified since 1966 and in accordance with the most recent breakdown of source of tax revenues laid down in the 1988 Constitution. Each sphere of government has its own field of taxation action, and the main taxes are distributed among the different levels of government as follows:

- *Union*: taxes on the income of persons and enterprises; imports and exports; sales of industrial products; financial transactions (credit, currency exchange and operations with stocks and bearer securities); rural properties; and the social contributions payable on sales by businesses;

- *States*: taxes on goods and transport and communications services - sales tax (ICMS); transfer of property by inheritance or as gifts; and ownership of motor vehicles;

- *Municipalities*: taxes on urban property; transfer of urban property; and services of any nature.

Application of this tax system resulted in a tax burden of some 30.85% of GDP in 1995, where the main source of tax revenue for the States, the ICMS sales tax, represented a tax burden of some 7.74% of GDP. The ICMS accounts for close to 90% of the budget resources of the most developed States and approximately 25% of all tax revenue at the national level, and is also the tax that generates the most revenue in the national system.

A significant part of the revenue collected at the federal level is transferred to subnational governments (States and Municipalities) through the revenue-sharing fund for States and Municipalities (FPEM), based on criteria laid down in a specific law.

The chief beneficiaries of this fiscal decentralization are the Municipalities, whose share of available revenues grew from 2.41% of GDP in 1988 to 5.06% in 1995. On the other hand, the Union has seen its available resources decline by approximately 3% of GDP

Two main legal instruments in Brazil regulate the financial administration: the 1988 Constitution and Law 4320 of March 17, 1964. The Constitution establishes the degrees of autonomy of the echelons of the federation's government and sets out the control mechanisms for accounting, cash management, budget, operations and control federal government revenue and of those of the direct and indirect administrative agencies. The National Treasury was created in 1986 and is the central financial planning and control agency. It has responsibility for the integrated financial administration system (SIAFI) of the federal government, which includes the budgetary control and accounting systems.

Law 4320 lays down general rules for the preparation and control of the budgets and general sheets of the Union, the States, the Municipalities and the Federal District. It provides guidelines in certain general cases (on procedures) and in other specific ones (on classifications of expenditure) which regulate the processes of the budget, the definition of the fiscal year and of additional appropriation, the mechanisms for performance of the budget and for the administration of special funds, and control of budget performance and of governmental accounting.

The integrated financial administration system (SIAFI) is used for the federal government as an instrument for administering the public finance. The heart of the SIAFI is a single account integrated with the accounting system so that accounting and budgetary controls can be performed. The system operates on-line, by means of a network of 3.000 terminals, which include all agencies of the federal government, and other agencies linked to the Union's budget. The SIAFI provides an effective and reliable link between budget performance and each management.

The financial administration in the States and municipalities (SIAFEM), based on the SEAFI, is a similar system, which has developed. It shares the basic characteristics of it, mainly integration of financial and accounting management and unity of finances; however, its implementation at the subnational level is minimal. The majority of Brazil's States have financial administrations developed under the general framework of Law 4320 but without any integration oriented or systematic approach.

2.3. Economic and Fiscal Context

In the years before the launch of the current economic stabilization plan, the Real Plan, the Brazilian economy suffered from high and chronic inflation and general indexation as no other country in the world has ever experienced. Contracts were adjusted by a variety of different indexes creating a permanent imbalance in relative prices and creating additional inflationary pressures, or "inertial inflation".

In May 1993, Fernando Henrique Cardoso became President Itamar Franco's fourth Minister of Finance in a period of six months, and immediately implemented an economic program known as the Real Plan.

The first stage of the plan was to substitute the many different indexes used in the Brazilian economy by a single index linked to the U.S. dollar (the URV). On July 1, 1994, this index substituted the Brazilian currency and the Real came into existence. With the Real, inflation dropped immediately from 48% per month in June 1994 to the current 1-2% level. To understand the plan's drastic effects on inflation, it is useful to compare inflation rates before and after the plan. Inflation measured 760% in the first half of 1994, 18% in the second half of 1994, 31% on the first anniversary of the Plan, 19% in 1995 (the lowest level in the last 20 years), and 9.4% in 1996 (the lowest level in the last 40 years). In July 1997, the third anniversary of the Plan was celebrated with the annual inflation around 8%.

The real value of the basic consumption basket has remained stable since June 1994, while real salaries (especially the minimum wage) have risen. Per capita income grew 4.3% in 1994, 2.7% in 1995 and 1.8% in 1996. Since the implementation of the Plan, food consumption has increased at all product levels. The government has continued to restrain the money and credit supply to prevent excessive growth of aggregate demand and to keep domestic consumption compatible with price stability and balance of payments.

Annual Inflation Rates:

1989 - 1450%

1990 - 1700%

1991 - 458%

1992 - 1175%

1993 - 2568%

1994 - 1247%

1995 - 19%

1996 - 9.4%

1997 – 8%

Notwithstanding these results, price stability is still not assured, and neither is sustained economic growth in the medium term, because the public accounts have not yet been brought into balance at the federal level in the majority of the subnational governments.

Overall fiscal performance by the States has deteriorated markedly over the past few years, despite the substantial increase in the fiscal revenue of the States as a result of provisions for revenue sharing established under the 1988 Constitution. The provisions require the federal government to transfer an increase portion of fiscal revenue to the States. However, this increase in revenue did not result in a better fiscal situation for the States because their spending rose even higher, mainly on account of salaries and pensions for civil servants. At year-end 1995, payroll for most of the States averaged from 70% to 80% of net income (total revenue less transfers to municipalities), and in some cases exceeded 90%.

As a resulted of these trends, by the late 1980s, many States were already experiencing a shortfall in revenue, which was covered by short-term debt and the issuance of bonds. However, resorting to bonds became an increasingly less attractive option after July 1994, because the increase in real interest rates prompted by implementation of the Real Plan led to major increases in the service of domestic debt and forced many States to capitalize their interest and principle obligations. This capitalization of unpaid obligations in turn led to much faster growth of the States outstanding debt. Consequently, by the end of 1995, the heavy indebtedness of the States, compounded by growing debt service on such obligations and limited progress in containing salaries had left a large number of States in extremely difficult financial circumstances, in some cases bordering on bankruptcy.

Available data indicate that the fiscal situation of the States and Municipalities has continued to decline, with the balance of domestic debt representing 17.8% of GDP in September 1996, compared with 12.4% in December 1995. It should be noted that four States (Sao Paulo, Minas Gerais, Rio Grande do Sul and Rio de Janeiro) accounted for 90.7% of the total, and of those four, Sao Paulo had slightly over half.

2.4. Tax and Financial Administrative Problems of the States

Tax and financial problems already noted are connected with service of the States’ debt and the rigidity of public expenditures. The various factors that contribute in no small measure to aggravating the problem of the States' finances, are as follows:

- Regarding expenditure, the lack of control and the deficiencies in the financial administration systems tend to prevent efficient management of public expenditure;

- Budget preparation is not integrated into the financial cycle followed by the finance secretariats, to the extent that the codes of the items used in budget preparation are not always consistent with the codes used in budget performance;

- The flow of information between the various executing units is generally very slow and rudimentary and frequently causes delays and inconsistencies in budget execution;

- The lack of integration between the system used for budget preparation and that used for budget execution and the lack of a unified account make it impossible to ensure total transparency and effectiveness in public spending by the States.

The investment in tax administrations has declined because many States have serious problems with revenue collected. The old infrastructure and structure of the secretariats of finance or planning need to be modernized. The currency situation is described as follows:

- Their staff does not have the necessary training to effectively audit tax evasion by taxpayers;

- The degree of automation is extremely low, which makes it impossible to institute the crosschecks necessary to support effective taxpayer inspection and audits;

- The programs for collecting the tax credits used by the fiscal administrations are not very efficient, mainly owing to the absence of an adequate structure for these administrations, the lack of appropriate technological resources and the fact that the legal procedures establish a variety of bodies to which delinquent taxpayers can resort. This may explain why many dilatory or evasive taxpayers do not make their payments through the normal channels but prefer instead to file time-consuming appeals in the knowledge that legal proceedings will almost certainly move very slowly.

- The poor degree of control and effectiveness of collection and inspection measures by the fiscal administrations are an incentive for taxpayers not to comply as they will be not promptly identified or ever punished.

- The lack of studies on tax evasion at the State level, coupled with the fact that the tax administrations are not in a position to conduct such studies, impedes a more precise estimate of the tax revenues that the States fail to collect through administrative inefficiency. However, tax evasion is estimated at over 40% in many States and an average of 33% at the national level for the ICMS.

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3. NATIONAL FISCAL ADMINISTRATION PROGRAM

FOR BRAZILIAN STATES - PNAFE

3.1. General Description of the Program

The National Fiscal Administration Program for Brazilian States – PNAFE is a global program for all States (26) and the Federal District. The Ministry of Finance is the executing agency and the program is coordinated through its Executive Secretariat.

The program has financial support from the Inter-American Development Bank – IDB and local contributions. The 1996-1998 is the period for execution this program, which comprises three priority areas:

1. Support for reform and modernization of the public sector;

2. Support for the process of opening up the economy, including the initiatives to reduce the so-called "Brazil Cost"; and

3. Initiatives to alleviate poverty and inequalities in income distribution.

The PNAFE will act at the subnational level by making technical assistance and resources available to support activities aimed at institutional strengthening of certain areas in the Finance and/or Planning Secretariats. These activities will be carried out through specific projects for each State in tax and financial administration. The program will finance a technical assistance and coordination component and a fiscal administration component.

The technical assistance and coordination component is aimed at strengthening the Federal Ministry of Finance in the process of supervision, integration and coordination of the fiscal area at the national level. To this end, program funds will be used to create the program coordination unit (PCU) and funding will also be provided for technical assistance that the States need in preparing the respective tax and financial for seminars and courses at the national level.

The fiscal administration component is aimed at the States, to finance specific fiscal modernization projects in tax and financial administration like budget, cash management, accounting, audit and internal control.

3.1.1. Objectives

The program's objectives are to increase administrative efficiency, effectiveness, rationality and transparency in the management of the public funds of Brazilian States, through the strengthening of the different agencies responsible for the State governments' fiscal management. To achieve this objective, the implementation of specific fiscal modernization projects are aimed at:

1. Improving the legal, operational technological and management mechanisms of the agencies concerned;

2. Strengthening and integrating financial administration and consolidating audit and internal control;

3. Establishing effective control of taxpayer compliance through implementation of new techniques and methodologies in tax collection and inspection; and

4. Expediting legal action for collection of outstanding tax debts and strengthening integration between the tax administrations and the agencies responsible for judicial collection.

3.1.2. Structure

The borrower, executing agency, beneficiary agencies, financial agent, program coordination unit and state coordination unit comprise the PNAFE's structure.

The borrower of the program is the federal government.

The executing agency is the Federal Ministry of Finances and it is be responsible for the execution of the program through its Executive Secretariat. The Executive Secretariat is responsible for coordinating the program activities with the State governments.

The beneficiary agencies are the 26 States and Federal District through the State finance and/or planning secretariats and that are responsible for the execution of the projects. The State governments were subborrowers under the program.

The financial agent is the Caixa Economica Federal (CEF), a public enterprise forming part the indirect federal administration and linked to the Ministry of Finance. In this program, its role just is that of an agent for onlending the program funds to the respective State governments' finance secretariats. The CEF also acts as a financial agent for repayment of the subloans to the federal government.

The Program Coordination Unit (PCU) includes: one program coordinator, one administrative and financial assistant coordinator, one fiscal specialist (income and expenditure) and other personnel who will work on the program full-time. PCU is responsible for the execution of this program and was establish by the Finance Ministry. Its functions are:

- supporting the preparation of the specific projects of each State;
- certifying the eligibility of projects submitted by the States which meet the eligibility criteria laid down in the program Operating Regulations;
- coordinating the finalization of the contracts between the State and the financial agent;
- supervising the execution and performance of said contracts;
- promoting and coordinating the proposals for integration of the projects and fiscal integration efforts, at the State and national levels;
- promoting the exchange of information and experience between the projects of each State at the national and international level, through seminars and courses, with a view to obtaining economies of scale;
- coordinating and approving the programming of disbursements between the financial agent and each State;
- coordinating with the IDB the procedures for approval and execution of the projects of each State and providing support in the periodic evaluation procedures, as specified in the loan contract.

The State Coordination Unit (SCU) is a local program linked to the PCU. It was set up for each specific project approved by the IDB. SCU's staff must have:

- one coordinator who reports directly to the secretary or director of the area covered by the project;
- two subordinators technical and financial for administrative and financial activity in all projects in the state's program;
- a minimum of eight specialists in the various technical areas of the project;
- three specialists in the areas of information technology, networks, data banks and training programs.

All the specialists are be hired to work on the project on a full-time basis and are funded from local finacing sources.

3.1.3. Dimension

The PNAFE is made up of two main components: technical assistance and coordination and fiscal administration.

The technical assistance and coordination component are designed to provide support for the Executive Secretariat of the Federal Finance Ministry in fiscal supervision, integration and coordination at the national level and for the States in the preparation of the specific fiscal modernization projects that would be financed by the program. For the execution of this component, the Finance Ministry will set up a program coordination unit (PCU)

The fiscal administration component is designed to finance institutional strengthening activities for the States' finance and/or planning secretariats. The activities will be carried out through the specific fiscal modernization projects. This component is divided into two subcomponents: tax administration and financial administration.

The tax administration subcomponent comprises tax projects and the financial administration subcomponent comprises specific financial projects too. State governments will implement both.

The program funds are used to finance mainly:

- Approximately 25% of the program’s investment resources: national and international consulting services, and training programs;

- Approximately 20% of the program’s investment resources: computer equipment and systems;

- Approximately 10% of the program’s investment resources: information and data-processing systems; support equipment for the external tax inspection (transportation, communications, trade balances, etc.) and infrastructure works (facilities and remodeling of offices for taxpayers services, tax posts, State payment units, budget units, etc.)

The responsibilities of the technical assistance and coordination program are based on the definition of the program coordination unit (PCU), as agreed upon by the IDB and the Finance Ministry. This unit will be responsible for the execution of the activities assigned to this component.

The costs of this component were determined by taking into account the cost of consulting services, travel and training programs. The needs for consulting services in the various areas was estimated with the IDB and the estimated figure allowed for PCU technical staff to travel to the States. The figure also included activities connected with training programs at the national level.

These categories of expenditure, which total U$10 million, are financed by means of IDB funds and the Federal Government counterpart funding, on a 50-50 basis.

The responsibilities of the fiscal administration component are based on diagnostic and other studies conducted by IDB. The study identified similar levels of developments in other States. The classification of States is described as follows:

1. Group A is: made up of the States with less self-financing capacity and/or less capacity for making investments. These are also the ones that in general display considerable deficiencies in organizational, technological and operational aspects and in human resources and basic infrastructure. This group includes the States most recently created and incorporated into the Federation, which therefore have less experience in tax and finance. These States are generally located in the less affluent regions of the country which is reflected in lower collection levels. The States have been placed in this group are Roraima, Amapa, Acre, Rondonia, Tocantins, Sergipe, the federal District, Piaui, Alagoas, Mato Grosso do Sul, Rio Grande do Norte, Paraiba and Mato Grosso. This group of 13 states accounts for some 13.5% of all State tax revenues.

2. Group B is: made up of intermediate-level States with finance secretariats that are making efforts at modernization but still displaying structural deficiencies, chiefly in connection with the integration of computerized systems, effectiveness of internal control systems and technical and management training of their personnel. Their finance secretariats are more developed and show signs of growth as a result of incipient initiatives that have placed them on the path to modernization. The States have been placed in this group are Amazonas, Maranhao, Para, Espirito Santo, Goias, Ceara, Pernambuco

and Santa Catarina. This group of 8 States accounts for 21% of all State tax revenues.

3. Group C is: made up of the States with the greatest self-financing capability and which have already started modernization processes in various areas of the public sector, including fiscal matters. In general they are the ones that are best placed in terms of technology bases, training programs, operating procedures and infrastructure. This group consists of the States with the most experience in tax and financial administration. They are generally located in the most developed regions of the country and possess significant economic and revenue-generating potential. The States have been placed in this group are Parana, Bahia, Rio Grande do Sul, Rio de Janeiro, Minas Gerais and Sao Paulo. This group of 6 States accounts for 65.5% of all State revenues.

IDB proposed to implement this operation in two stages:

1. The calculation of the amounts necessary for each State was based on the assumption that under normal operating conditions it is acceptable that the operating costs of a tax and financial administration amount to approximately 2% of the revenue collected. These programs generally last between four and eight years. The amount needed for the execution of a comprehensive program for the modernization of the State fiscal administrations would be US$2.807 billion, a figure obtained from calculating 4% of the tax revenues which were US$70 billion. The figure of 4% was derived from the assumption that the states would need on average an additional 0.5% for a period of eight years.

2. This stage consisted in IDB determining that US$2,807 billion would be technically acceptable for a global process of modernization of the finance secretariats, but that in light of the IDB's experience in this area, it was advisable to carry out

this process in two stages and by means of two four-year projects.

These two basic guidelines confirmed the idea of executing the program in an initial project extending over just four years and paid special attention to the differences observed in income levels and degree of development of the different States.

The aspects of the program were compared with the figures resulting from the results achieved by each State, as shown in the requests submitted to IDB.

IDB’s estimate that approximately 80% of this component’s resources would be used for strengthening the tax administrations and the remaining 20% would be used to finance the financial administration projects was confirmed by a number of projects requested by the states and reviewed by the IDB.

3.2. Expected Results

The results expected by IDB and the Brazilian Government from PNAFE in global terms, are a modernization of the public sector, specifically the secretaries of finance or planning of all 26 States and the District Federal with adequate structure, human resources training, and appropriate technological resources. All of these objectives are also aimed at decreasing tax evasion rates.

In specific terms, upon completion of the program, IDB and the Brazilian Government expect that the following results will be achieved, among others:

- implementation in the States of a total of 27 tax administration modernization projects and 10 financial administration modernization projects;

- effective integration of the tax systems of the states and of the federal government, through implementation of the

State fiscal information systems;

- integration of taxpayer lists at the State and federal levels;
- implementation of mechanisms and procedures for the exchange of information among the state tax systems, thereby allowing for effective control of tax compliance by the major taxpayers in each of the States, estimated at some 300.000, who currently account for over 80% of all commercial transactions recorded in each of the States;
- establishment of benchmarks for State fiscal performance and regional tax evasion rates for the country's main sectors of economic activity;
- greater balance in the States' fiscal position, as a result of the increases in tax collection and in the effectiveness of legal action for collection, and better control and transparency of public spending.

3.3. Costs and Financing

The total cost of the program was estimated at US$1 billion. The Bank's contribution would be US$500 million and the local counterpart would be US$500 million, to be jointly financed by the federal government and the beneficiary States.

The table below shows the division of financial resources provided by IDB and local sources in five different categories:

US$ millions

CATEGORY	IDB	LOCAL	TOTAL	%
1. Administration		105	105	10.5
1. PCU (Federal)		3	3	

2. SCU (State)		102	102	
2. Component I 2.1 Consulting services and training 2.2 General support	<u>5</u> 4.9 0.1	<u>5</u> 3.5 1.5	<u>10</u> 8.4 1.6	1.0
3. Component II 3.1 State tax administration 3.2 State financial administration	<u>452</u> 362 90	<u>302</u> 241 61	<u>754</u> 603 151	75.4
4. Unallocated 4.1 Contingencies (Component I) 4.2 Contingencies (Component II)	<u>38</u> 1 37	<u>23</u> 1 22	<u>61</u> 2 59	6.1
5. Finance Charges 5.1 Inspection and supervision 5.2 Bank interest 5.3 Credit fee	<u>5</u> 5 - -	<u>65</u> - 60 5	<u>70</u> 5 60 5	7.0
TOTAL	**500**	**500**	**1.000**	**100**

The financing of component II was calculated so that the local counterpart funding required from each State would be variable. This was a reflection of the IDB’s aim of selectively supporting those States that benefit from the program on a priority basis because of their economic situation and relatively lower level of development.

Regarding administrative costs, the cost of staffing PCU is covered by the Federal Government while the cost of SCU is provided by the State.

Regarding the unallocated costs, a contingency item has been established (component II) that would be used to assist the States that demonstrate the best performance with their projects and need additional funding to complete the modernization process already under way.

A consolidated table of representative sample projects, by expenditure category, is presented below. Based on these data, it is estimated that the remaining program funds will be in similar proportions as shown in this table:

US$ millions

REPRESENTATIVE SAMPLE – COST TABLE					
Expenditure Category	**Group A**	**Group B**	**Group C**	**Total**	**%**
1. Administration	4.2	5.3	11.7	21.2	7.0
2. Consulting Services	16.0	19.1	53.7	88.8	29.5
3. Training	12.6	14.8	22.5	49.9	16.6
	16.5	20.0	47.4	83.9	27.9

4. Equipment (computers and support for inspection)	5.5	7.2	16.9	29.6	9.8
5. Infrastructure works	5.2	6.6	15.8	27.6	9.2
6. Finance charges					
TOTAL	**60.0**	**73.0**	**168.0**	**301.0**	**100.0**

The limit set for the amount to be financed by IDB for each State, was based on the prior results of each State program. The limit observed the classification adopted by IDB and was designed by allocating minimum percentages of local counterpart funding to each of the three groups of States, previously described. IDB guidelines required that:

- the program as a whole must present a global financing matrix of approximately 50%-50%;
- the counterpart provided by the States must consist of the costs of investment, finance charges and administrative expenses;
- The States with the greatest needs, both technical and financial, will be favored in the financing, but without overburdening the more developed States.

To respect the above items, and in order to avoid making the less affluent States contribute counterpart funding beyond their financial capacity, the program was adjusted. This allowed for IDB to recognize as part of the local counterpart funding, predetermined amounts incurred for activities intrinsically linked to the final results of the program.

The IDB may thus recognize as part of the counterpart funding for investment expenses (estimated at approximately 40%), for the equivalent of up to 25% for the Group A States and up to 15% for the Group B States, in accordance with the following criteria:

- costs of tax auditors performing activities connected with the new inspection and collection programs implemented under the program;
- operating costs of the new fiscal intelligence units set up under the program;
- additional costs of the processing data from the new system instituted under the program;
- fiscal specialists hired to perform program activities.

The IDB based the financial execution schedule for the representative sample and the execution schedule for the projects on the following disbursement schedule:

US$ millions

SCHEDULE OF ANNUAL DISBURSEMENTS						
Source	**1997**	**1998**	**1999**	**2000**	**Total**	**%**
Bank	114	160	149	77	500	50
Counterpart	90	158	146	106	500	50
Total	204	318	295	183	1000	100

% of TOTAL	**20.4**	**31.8**	**29.5**	**18.3**	**100**	

3.4. Justification of the Program

The program is an important element of the efforts that the Brazilian government is making to modernize its public sector and, in particular, to strengthen the fiscal federalism called for under the country's Constitution. The objectives set are responsive to explicit demand on the part of two levels of the federation – the Union and the States – which are seeking to accomplish complementary goals by means of the program:

- Integration and conceptual consistency of the subnational fiscal reforms;
- Strengthening of the fiscal administrations that will enable collection and utilization of tax revenues in a manner consistent with the States' development objectives.

The aim of that program is to achieve many of the same organizational, methodological and information-technology goals that are proposed in the proposed fiscal program for the States.

Despite the fact that the institutional-strengthening nature of the program complicates a strict study of its financial feasibility, it has been determined that the States included in the representative sample will derive significant economic benefits that will amply offset the program's costs, in both areas of activity.

In tax administration, the program's impact is expected to be significant, with collection increasing between 5% for a State such as Sao Paulo, which has a more sophisticated administration, and some 15% to 20% for a small States such as Rio Grande do Norte and Piaui. In Financial administration, annual savings are expected from human resources optimization, organizational reform, and implementation of the unified account and savings in consumables.

However, the program is key for the sustainability of the county's macroeconomic equilibrium through its direct impact on the States' public finances. The efforts that the governments are making to adjust their levels of expenditure and lower their indebtedness are complicated by the lack of financial administration systems that would enable efficient allocation of resources and proper application of legal and policy guidelines in the public budgets. As for revenue, the high level of evasion, estimated at 40% by some scholars, suggests those administrative efforts in inspection and information would generate significant increases in tax collections. Taken together, the tax and financial measures will contribute to laying the foundations for sustainable rehabilitation of the States' public finances.

4.THE PROGRAM IN THE SECRETARY OF FINANCE

IN STATE OF CEARA

4.1. Context of the State of Ceará

The State of Ceará is situated on the northern coast of the Brazilian Atlantic plateau, covering an area of approximately 146,817 km² or 9.4% of the Brazil's northeastern region (1,7% of Brazil's total area). The state's capital is Fortaleza, and Ceará has 184 municipalities.

The population is concentrated in the State's Capital – Fortaleza. It holds more than 1/3 of the state's population while covering only 2.4% of its territory. According to the latest Demographic Census conducted by IBGE, the population of the State of Ceará was 6,809,290 in 1996. In the last several decades the population growth rate has steadily declined, due, in part, to strong urban migration and the subsequent drop in fertility rates.

Ceará’s economic performance is was in previous years above the national average. However, the increase in income was not able to produce similar advances in the social area. Indeed, an examination of the principal social indicators reveals that levels are worse today than in more developed regions of the country.

The State has distinguished itself from other state economies by improvements in public accounts, increases in state investment and vigorous growth in the private sector in urban areas. The State has experienced fiscal equilibrium and a perceptual saving as well as an investment rate at around 16%. The increase in the government investments and the private initiative was the result of its vigorous economic growth, in the industry and service sector. The positive results are numerous. Ceara GDP growth was 32.6% between 1989 and 1995, and the growth of taxes, between 1988 and 1995, was in on average three times higher than anywhere else in the country. Between 1990 and 1995, exports grew 65%, and between 1990 and 1996, the state attracted 367 new industries, that represented approximatly US$ 4,7 billion in investments.

Ceará is a state that has some limitations on its economic autonomy, as depends heavy upon support from the Federal Government.

Among the most vulnerable aspects of the State are its external dependency on food and energy. Due to the scarcity of water resources and archaic agricultural technology, the state is forced to import nearly 60% of the state’s consumption of food. As a result, the State is required to deplete its own income and the State’s rural sector is unable to generate sufficient labor to stem the tide of urban migration.

Though Ceará is a self-sufficient producer of petroleum, it is a net importer of secondary sources of energy, such as, petroleum derivatives (gasoline and diesel fuel) and electricity, that represent, respectively, 24% and 33% of final energy consumption in the State. In the case of petroleum, the lack of a refinery means that the State loses the potential value added of the refining process that currently remains in regions where refineries are located. With regard to electricity, the State has to import more than 98% of the total electric energy that it consumes.

In addition to imported sources of food and energy products, Ceará is an economy profoundly integrated in the national commercial circuit but relatively restricted in the international circuit. From 1990-93, about 88.8% of all external trade were domestic, with less than 12% in the international market. Of imports, 93.2% were of domestic origin and only 6.8% of international origin.

Recent measures and proposed steps on behalf of the Federal Government towards opening the Brazilian market is breaking the virtual economic isolation of Ceará in relation to the rest of the world. As such, Ceara is preparing for the possibility of becoming an important export and import platform, for the country and the world. By increasing the State will be less dependent upon the federal Government. This is also true for states of the mid-south. Despite the respectable image that State now enjoys among the international community, there is a need to further improve the external economic relations and in order to secure more external economic relations in order to secure more external resources and in particular attract additional external investment.

4.1.1. Fiscal Situation

The fiscal situation of the State is characterized by fiscal deficiencies as current public finances have suffered from global crisis and from Brazil's equilibrium plan. The lack of control of public spending and the low level of efficiency and effectiveness in the tax administrations are factors impeding the sustainability of the adjustment achieved in the short term through debt renegotiation, reduction of personnel expenditures and the current legal and constitutional reforms.

The fiscal situation is linked with fiscal administrations. Indeed this will be a crucial factor in the success of the measures adopted and, especially those aimed at lowering public expenditures and increasing tax revenues.

The Secretary of Finance despite having had a real increase in the collection of taxes in relation to previous years doesn't show a proportional growth as reflected in the current economy. However, the Secretary of Finance does offer fiscal incentives and other actions designed to attract investors' interest in the State of Ceara.

4.2. The Program's Projects

The PNAFE in Ceará is composed of 66 projects within the category of administration, consulting services, training, equipment (computers and support for inspection), infrastructure works and finances charges. These projects are divided in following areas as shown below:

Areas	Number of Projects
• Collection, Administrative Court and Taxation	9
• Organization, Administration and Attendance	23
• Inspection	9
• Information Technology	9
• Roster and Integration	1
• Financial Control	5
• Audit and Internal Control	10

4.3 Costs and Benefits

The total of the program for the State of Ceará is U$ 29.000,00. The IDB contribution would be 50% and the local counterpart would be another 50%.

PNAFE’s costs are variable and accessible, as conditions of financing demanded by the IDB. The costs are also compatible with the actual situation.

The following is a table that demonstrates the compromises made with the IDB:

INTEREST RATE	VARIABLE
• Credit fee	0.75%
• Inspection and supervision	1%
• Amortization period	20 years
Disbursement period	4 years
Grace period	4 years
Commitment period for funds from financing	3 years

However we cannot forget that the schedule of physical execution of the projects should be reconciled with financial payment. The statements receiving financial resources would be required to pay credit fee and inspection and supervision rates on unused funds.

The impact of the benefits can be classified as global or direct. The global benefits expected upon total implementation of the program for State of Ceara are:

- Better expectations of sustainable fiscal equilibrium in Ceara as a result of lower tax evasion and hence higher tax collections and also better programming and control of public expenditure, which in turn lead to a more solid financial situation at the national level;

- Increased capacity of Ceara for implementing economic and social development programs, as a result of the availability of more effective and efficient budget management;

- Substantial saving for Ceara resulting from the integration of the tax systems and lower operating costs for inspection stations, especially those located at the border, through the implementation of unified systems;

- Reduction or elimination of tax distortions that adversely impact industry and domestic trade, through reduction of the marked differences in inspection efforts, with a resultant lowering of the level of inequity of the national tax system;

- Strengthening of the mechanisms for dialogue between the federal government and Ceara government in fiscal matters.

The direct impact of the benefits with the implementation of the same projects, are:

- The beginnings of the implementation of an integrated tax and financial administration system;
- The modernization of fiscal processes and procedures;
- The modernization of information systems;
- The strengthening of human resources;
- The establishment of an effective control mechanism to ensure taxpayer compliance with tax obligations.

CONCLUSION

As it has been shown in this work, Brazil has suffered from a wide variety of changes originating from the implementation of "Real Plan" in 1994. The stabilization of the currency with inflationary control, influenced the behavior of States as they were obliged to re-assess their macroeconomic management.

The maintenance of high administrative interest rates for the Federal Government has provoked the growth of linked responsibilities with the Federal and State Government, this situation has depressed the capacity of saving and has disabled States in increasing fixed capital in these areas.

The state of Ceará, in spite of the real increase in tributary revenue, decreased its gains in financial applications. Increased tax revenue has not been enough to compensate an increase in financial responsibilities and of administrative expenses. Consequently the state has required more loans and other financial resources.

In this context the opportunity of integration of the State Finance Secretariats appeared within the plan of the Inter-American Developed Bank - IDB. It facilitates external resource financing while assuring continuity of the process of state development.

Those resources are also assisting the Finance Secretariat of Ceara to continue its modernization process with the hope of supplying the new demands of a global economy in the effects of the technological progress demand government action.

To invest in plans of collection, to have a realistic vision of a prosperous future, and to attempt to acquire resources, has generated wealth for the development of the State of Ceará.

In general terms, PNAFE's program helps the Finance Secretariat of Ceará to develop projects of fundamental importance for administrative and tributary modernization, which will in turn generate efficiency in the collection of taxes.

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