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Brazil: The Challenge of Municipal Sector Development in the 1990s

(In Two Volumes) Volume I: Policy Summary and Reform Proposals

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LIST OF ABBREVIATIONS AND ACRONYMS

ABRASF	Brazilian Association of Municipal Capitals
EPAs	Environment Protection Agencies
FMIS	Municipal Financial Management Information System
FPE	State Participation Fund
FPM	Municipal Participation Fund
GDP	Gross Domestic Product
IBAM	Brazilian Institute for Municipal Administration
IBAMA	Brazilian Institute of the Environment and Renewable Natural Resources
IBGE	Brazilian Institute for Geography and Statistics
ICMS	State Value-added Tax
IOF	Tax on Financial Transactions
IPI	Tax on Industrial Products
IPTU	Urban Property Tax
IPVA	Motor Vehicles Registration Tax
IR	Income Tax
ISS	Tax on Services
ITBI	Tax on Property Transfer
ITR	Rural Property Tax
IVVC	Tax on Retail Sales of Fuels Except Diesel
IVVCLG	Fuel Tax
PNAC	National Program for Population Alfabetization
SEPA	State Environmental Protection Agencies
UNDIME	Association of Municipal Secretariats of Education

BRAZIL

THE CHALLENGE OF MUNICIPAL SECTOR DEVELOPMENT IN THE 1990s

VOLUME I

CURRENCY EQUIVALENTS

Currency Unit	=	Cruzeiro (Cr\$)
US\$1	=	705 (November 15, 1991)

BRAZIL

THE CHALLENGE OF MUNICIPAL SECTOR DEVELOPMENT IN THE 1990s

VOLUME I

POLICY SUMMARY AND REFORM PROPOSALS

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Preface

This report is based on a mission to Brazil that visited various municipalities in Ceará, Pará and Paraná in October/November 1990. Emmanuel Mbi, now with AF5CO, designed the task and led the mission. Antonio Estache, now with SASVP, was the Deputy Mission Leader. The principal author of the report is Antonio Estache. Contributions to the report were provided by Tim Campbell (LATIE) and Teresa Lobo (consultant) for the institutional chapter, José Roberto Afonso (consultant), Helena Cordeiro (LA1CO), Jim Hicks (LATIE), and Renato Villela (consultant) for the financial management and macroeconomic chapters, Barbara Bruns (LA1HR) for the primary education case study, Salahuddin Ahmad for Research Assistance and Antonio Estache for the urban pollution case study. Mary Sheehan's contribution at headquarters ensured the link in Volume I between the conceptual framework and the Bank's experience with Municipal Development projects in Brazil. The Ministry of Social Action provided Annexes II and III describing general characteristics of the states and municipalities visited. Administrative support was provided by Elizabete de Lima, Allison Turner and Sallie Rush Wright

The report was discussed with the Brazilian government in June 1992 by Mila Freire and Antonio Estache. The Grey Cover Report includes the results of those discussions.

BRAZIL COUNTRY DATA

AREA (sq km)	POPULATION (1989)	DENSITY (1989)				
8,512,000	147 Million	17.3 per square km				
POPULATION CHARACTERISTICS (most recent estimate)		HEALTH (most recent estimate)				
Crude Birth Rate (per 1,000)	27.4	Population per physician	1,080			
Crude Death Rate (per 1,000)	7.6	Population per hospital bed	200			
INCOME DISTRIBUTION (1973)		DISTRIBUTION OF LAND OWNERSHIP				
Percentage of private income, highest quintile	63.0	Percentage owned by top 10% of owners	45.0			
Percentage of private income, lowest quintile	2.0	Percentage owned by smallest 10% of owners	1.5			
ACCESS TO SAFE WATER (1988)		ACCESS TO ELECTRICITY (most recent estimate)				
Percentage of population	84.0	Percentage of population - total	67.0			
		Percentage of population - rural	21.0			
NUTRITION (most recent estimate)		EDUCATION				
Calorie intake as percentage of requirements	122.9	Adult literacy rate % (1985)	78.0			
Per capita protein intake (grams/day)	63.0	Primary school enrollment % (ages 7-14)	103.0			
GNP PER CAPITA IN 1989: US\$2,540						
GROSS DOMESTIC PRODUCT IN 1989 (1987 prices)			ANNUAL RATE OF GROWTH (% constant prices)			
	Cr\$ Billion	%	1987	1988	1989	
GNP at Market Prices	12,209	100.0	3.8	-0.3	3.5	
Gross Domestic Investment	2,197	18.0	-3.1	-23.8	9.1	
Gross National Saving	2,236	18.3	-4.3	-18.0	5.4	
Current Account Balance	51	0.4	
Exports of GNPs	1,325	10.9	5.3	17.2	5	
Imports of GNPs	798	6.5	-2.6	-0.8	15.8	
OUTPUT EMPLOYMENT AND PRODUCTIVITY IN 1984						
NET DOMESTIC PRODUCT			EMPLOYMENT		NDP PER WORKER	
	US\$ Million	%	Million	%	US\$ Million	%
Agriculture	44,181	12.7	15.0	29.9	2,945	25.4
Non-Agriculture	303,702	87.3	35.2	70.1	8,628	74.6
Total/Average	347,883	100.0	50.2	100.0	11,573	100.0
GOVERNMENT FINANCE						
	GENERAL GOVERNMENT ^{a/}					
	(Cr\$ Million)		PERCENTAGE OF GDP			
	1988		1986	1988		
	Total Receipts	44,126	30.4	48.0		
Total Expenditures	59,022	44.7	64.2			
Overall Balance	(14,896)	(14.3)	(16.2)			
Government Fixed Investment	2,936	4.1	3.2			

^{a/} Includes the consolidated accounts of the Central Government, states, and municipalities, as well as decentralized agencies of the Central Government and of the states.

(cont'd)

(cont'd)

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MONEY, CREDIT AND PRICES (Cz\$ Mill)		1986	1987	1988	1989	1990*
Money Supply (M1)		455	1,036	6,958	103,100	2,143,920
Bank Credit to Private Sector		1,259	4,855	55,290	737,686	...
Money (M1) as % of GDP		12.3	8.7	7.5	7.5	7.8
General Price Index (3/88 = 100)		101	325	2,549	36,193	1,028,033
ANNUAL PERCENTAGE CHANGES IN:						
General Price Index (Dec.-Dec.)		85.0	416.0	1037.0	1782.9	1476.8
Bank Credit to Private Sector		109.4	285.6	1038.7	1234.2	...
BALANCE OF PAYMENTS (US\$ Millions)				MERCHANDISE EXPORTS (AVERAGE 1986-1990)		
	1988	1989	1990p		US\$ Mill.	%
Exports of GNFS	35880	36446	33111	Coffee (beans and soluble)	2,070	7.2
Imports of GNFS	17589	21511	24777	Soybean products	2,409	8.3
Resource Gap (deficit = -)	18291	14935	8334	Sugar	334	1.2
Interest Payments (net)	-7001	-8643	-9044	Cacao	579	2.0
Other Factor Payments (net) <u>g/</u>	-6774	-4657	-2065	Irons	2,042	7.1
Net transfers	100	245	828	Manufactured Goods	15,820	54.7
Balance on Current Account	4616	1880	-1947	All other commodities	5,846	19.5
Direct Private Foreign Investment (net) <u>g/</u>	2330	647	400	Total	28,898	100.0
Net MLT Borrowing <u>b/</u>	1091	-2071	661	EXTERNAL DEBT		
Other Capital (net) and capital n.e.i.	-6720	431	2114	DECEMBER 31, 1990		
Increase in Reserves (-)	-1317	-887	-1228	Public Debt, incl. guaranteed	92,330	
Gross Reserves (end year) <u>g/</u>	9140	9678	9973	Non-guaranteed Private Debt	6,008	
Petroleum Imports <u>d/</u>	3515	3753	4734	Total Outstanding and Disbursed	114,547	
Petroleum Exports <u>d/</u>	876	1018	1536	DEBT SERVICE RATIOS FOR 1990		
					%	
				Net Debt Service Ratio <u>g/</u>	43.2	
				Public Debt Service Ratio (gross) <u>f/</u>	8.3	
RATE OF EXCHANGE AVERAGE 1989		AVERAGE 1990		IBRD/IDA LENDING (Aug.31, 1991 in US\$ Mill.)		
US\$ 1.00 = NCz\$ 2.84		US\$ 1.00 = NCz\$ 68.30		Outstanding & Disbursed		7,651
NCz\$ 1.00 = US\$ 0.35		NCz\$ 1.00 = US\$ 0.015		Undisbursed		4,962
				Outstanding incl. Undisb.		12,613
				IBRD		...
				IDA		...

g/ Includes reinvested profits/earnings.

b/ Net MLT borrowing for 1989 includes arrears of US\$ 3.75 billion.

g/ Change in level of reserves differs from reserve change in balance of payments by valuation adjustment.

d/ Crude and derivatives.

g/ Debt Service on both public and private external debt net of interest earned on foreign exchange reserves as a percentage of Exports of Goods and Non-Factor Services.

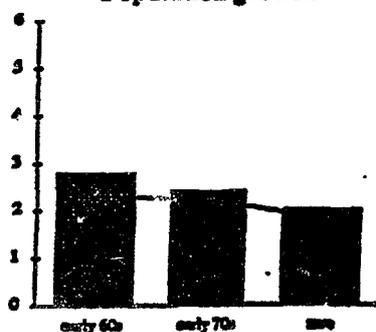
f/ Includes World Bank, official export credits, concessional and non-concessional other.

BRAZIL

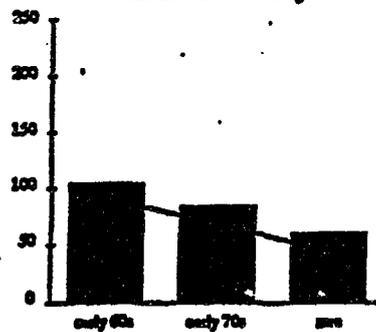
SOCIAL INDICATORS OF DEVELOPMENT, 1990

Unit of measure	25-30 years ago	15-20 years ago	Most recent estimate (mre)	Same region / income group		Next higher income group	
				Latin America, Caribbean	Upper-middle-income		
HUMAN RESOURCES							
Size, growth, structure of population							
Total population (mre = 1989)	thousands	84,292	108,032	147,294	422,417	422,994	788,506
14 and under	% of pop.	43.8	40.1	35.5	36.5	31.6	20.3
15-64		53.0	56.2	60.0	58.9	60.8	66.8
Age dependency ratio	unit	0.89	0.78	0.67	0.70	0.64	0.49
Percentage in urban areas	% of pop.	50.4	61.8	76.1	73.6	68.2	78.6
Females per 100 males							
Urban	number	..	..	103	104	..	..
Rural		..	..	93	..	..	..
Population growth rate							
Urban	annual %	2.8	2.4	2.0	2.0	1.8	0.6
Urban/rural growth differential	differences	5.0	4.3	3.1	2.9	2.9	0.7
Projected population: 2000	thousands	4.4	5.1	4.5	3.0	3.1	0.8
Stationary population		..	..	177,932	514,043	510,348	834,177
		..	..	303,204	..	..	..
Determinants of population growth							
Fertility							
Crude birth rate	per thou. pop.	38.7	32.7	27.4	27.9	25.5	13.7
Total fertility rate	births per woman	5.65	4.41	3.31	3.45	3.27	1.78
Contraceptive prevalence	% of women 15-49	..	..	66.0	..	..	..
Child (0-4) / woman (15-49) ratios							
Urban	per 100 women	..	..	45	..	..	..
Rural		..	..	72	..	..	..
Mortality							
Crude death rate	per thou. pop.	11.4	9.2	7.6	7.1	8.0	8.9
Infant mortality rate	per thou. live births	103.6	83.8	59.9	51.7	45.2	8.9
Under 5 mortality rate		..	..	66.5	61.6	54.4	17.8
Life expectancy at birth: overall	years	57.1	61.0	65.6	67.0	67.4	76.3
female		59.1	63.4	68.6	70.0	69.9	79.6
Labor force (15-64)							
Total labor force	thousands	27,039	37,492	53,349	148,480	159,186	368,427
Agriculture	% of labor force	48.5	37.9	..	..	..	..
Industry		20.2	24.3	..	..	..	..
Female		19.6	24.4	27.4	26.6	30.7	37.8
Females per 100 males							
Urban	number	..	..	104	106	..	..
Rural		..	..	90	88	..	..
Participation rate: overall	% of labor force	32.1	34.7	36.6	35.1	38.7	47.3
female		12.6	16.9	20.0	18.3	23.5	35.1
Educational attainment of labor force							
School years completed: overall	years	..	..	..	..	..	..
male		..	..	..	..	..	..
NATURAL RESOURCES							
Area	thou. sq. km	8,512	8,512	8,512	20,308	16,264	33,808
Density	pop. per sq. km	10	13	17	20	25	23
Agricultural land	% of land area	21.1	25.4	28.8	36.5	31.9	37.1
Agricultural density	pop. per sq. km	47	50	58	55	79	62
Forests and woodland	thou. sq. km	6,007	5,872	5,604	9,703	6,887	8,544
Deforestation rate (net)	annual %	-0.2	-0.2	-0.4	-0.5	-0.4	0.0
Access to safe water							
Urban	% of pop.	..	87.0	84.0	73.2	79.7	..
Rural		..	..	89.0	83.6	90.4	..
		..	..	71.0	52.6	63.2	..

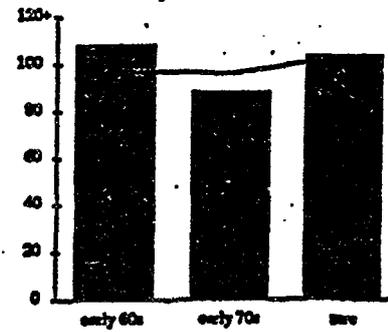
Population growth



Infant mortality



Primary school enrollment



	Unit of measure	25-30 years ago	15-20 years ago	Most recent estimate (mre)	Same region / income group		Next higher income group
					Latin America, Caribbean	Upper-middle-income	
INCOME AND POVERTY							
Income							
GNP per capita (mre = 1989)	US\$	270	1,070	2,540	1,950	3,810	18,840
Total household income							
Share to top 10% of households	% of income	..	..	46	..	..	..
Share to top 20% of households	"	..	62	63	..	..	..
Share to bottom 40% of households	"	..	9	8	..	..	..
Share to bottom 20% of households	"	..	3	2	..	..	..
Poverty							
Absolute poverty income: urban	US\$ per person	..	..	..	..	..	..
rural	"	..	..	..	..	..	..
Pop. in absolute poverty: urban	% of pop.	..	..	..	..	..	..
rural	"	..	..	..	..	..	..
Prevalence of malnutrition (under 5)	% of age group	..	..	12.7	..	..	..
EXPENDITURE							
Food	% of GDP	..	24.2	..	..	..	..
Staples	"	..	6.0	..	..	..	..
Meat, fish, milk, cheese, eggs	"	..	9.9	..	..	..	..
Cereal imports	thou. metric tonnes	1,956	2,244	3,871	17,357	36,788	70,401
Food aid in cereals	"	..	3	21	..	..	..
Food production per capita	1979-81=100	86.6	95.0	117.0	103.8	102.9	101.7
Share of agriculture in GDP	% of GDP	18.7	12.1	8.7	10.1	13.1	2.7
Daily calorie supply	calories per person	2,415	2,496	2,709	2,728	2,980	3,389
Daily protein supply	grams per person	61	61	63	69	77	102
Housing	% of GDP	..	7.6	..	..	..	..
Average household size	persons per household	..	..	..	..	..	..
Urban	"	..	..	..	..	..	..
Fixed investment: housing	% of GDP	..	2.6	..	..	..	..
Fuel and power	% of GDP	..	2.8	..	..	..	..
Energy consumption per capita	kg of oil equivalent	285.8	611.2	825.3	967.1	1,537.7	4,884.4
Households with electricity	% of households	..	..	..	..	..	..
Urban	"	..	..	..	..	..	..
Rural	"	..	..	..	..	..	..
Transport and communication	% of GDP	..	7.7	..	..	..	..
Population per passenger car	persons	74	22	14	17	15	3
Fixed investment: transport equipment	% of GDP	..	2.6	..	..	..	..
Total road length	thou. km	..	..	1,316	..	..	..
Population per telephone	persons	..	35	11	12	8	2
INVESTMENT IN HUMAN CAPITAL							
Medical care	% of GDP	..	3.8	..	..	..	..
Population per: physician	persons	2,500	1,600	1,080	938	1,020	530
nurse	"	..	2,322	1,205	879	601	168
hospital bed	"	..	200	..	..	..	..
Access to health care	% of pop.	..	..	..	..	..	..
Immunized (under 12 months): measles	% of age group	..	..	80.0	52.7	..	..
DPT	"	..	..	67.0	62.4	..	82.4
Oral Rehydration Therapy use (under 5)	% of cases	..	..	40.0	33.6	..	..
Education	% of GDP	..	2.6	..	..	..	..
Gross enrollment ratios							
Primary: total	% of school-age group	108.0	81.0	103.0	106.8	102.6	102.1
female	"	108.0	87.0	99.0	105.4	99.7	102.6
Secondary: total	"	16.0	24.0	38.9	47.9	35.9	92.8
female	"	16.0	21.0	44.9	51.3	36.5	95.7
Tertiary: science/engineering	% of tertiary students	18.6	16.4	17.8	..	..	..
Pupil-teacher ratio: primary	pupils per teacher	28	22	24	24	23	18
secondary	"	17	..	..	..	..	..
Pupils reaching grade 4	% of cohort	..	51.9	59.1	69.3	75.4	96.1
Repeater rate: primary	% of total enrollment	..	15.2	19.7	19.6	19.5	..
Illiteracy rate: overall	% of pop. (age 15+)	..	..	22.3	16.7	22.3	..
female	% of females (age 15+)	..	..	23.5	19.0	25.8	..
Newspaper circulation	per thou. pop.	31.8	39.3	57.3	81.7	83.0	315.5

EXECUTIVE SUMMARY

1. **Issues.** The 1988 Constitutional reforms have enhanced the relative importance of municipalities in Brazil's federal system. Municipalities now have greater expenditure responsibilities and more own and transferred revenue. The need to assess their ability to manage their new responsibilities and their new resources stems from three main observations:

(i) For many sectors which require a municipal role in service delivery such as pollution control or health, the municipalities' experience is limited. What institutional environment is required to assist municipalities in assuming these new responsibilities?

(ii) Some traditional municipal services such as primary education and solid waste management, were deteriorating prior to the increase in municipal responsibilities; under these circumstances, is it realistic to assume that municipalities will be able to increase municipal services delivery without cutting quality?

(iii) Imbalances between revenue sources and expenditure responsibilities could lead to a fiscal crisis in some municipalities; this concern is fueled by the existence of a growing number of municipalities relying on suppliers' credit to finance expenditure while violating the Constitutional limits on municipal indebtedness.

2. **Objectives.** This report has two main purposes. The *first* is to define an analytical normative framework within which Bank dialogue with Brazil on municipal policy issues can occur. This framework will support the design of policy conditions to be built in municipal development projects. The *second* is to propose reforms that address the issues--identified by relying on the normative framework--raised by the design of: (a) the institutional arrangements and policy framework for municipal development, (b) the state of municipal financial management, and (c) the impact of institutional and financial management deficiencies on municipal finances and service delivery performance. The practical relevance of the conceptual analysis is illustrated for the cases of urban pollution control and for primary education.

3. **A Vision for the Emerging Role of Municipalities.** The proposed reforms aim at institutions and policies that place greater emphasis on the efficiency and financial strength of municipalities. Brazil's decentralized approach sees municipalities as quasi-autonomous managers of certain expenditure categories. This does not mean that they have to provide all services themselves because they may rely on private sector delivery for many services. Municipalities will also impact Brazil's macroeconomic performance through: (i) efficient management of their new responsibilities for the delivery of services that are intermediate goods in the production of private services and (ii) fiscal discipline. They should focus on maximizing their financial independence and health by maximizing the revenue they can raise from their own sources of revenue. Local tax burden, reflecting the local tax levels but also local user fees and pricing of services, should be determined by the demand for services and reflect the ability to pay.

4. **An Analytical Framework to Assess Municipal Policy-Making.** The analytical framework supporting the discussion of the issues raised by the current design of municipal policies

is based on a set of five criteria. They are used to assess the institutional and financial aspects of the role of municipalities in intergovernmental arrangements adopted in the process of decentralization. They also allow for classification of the issues raised by the current implementation of urban pollution management and by the municipal role in primary education. They will be used in upcoming Bank projects to assess the design of municipal development projects. More specifically, municipal policy making should be assessed on the basis of:

(i) **Accountability of the Decision-Makers:** Municipalities should be accountable to their electorate but also to the federal and state governments when they act on their behalf. Accountability also improves equity and efficiency in the provision of municipal services. It can require audits, performance indicators, transparent budgetary processes and intergovernmental transfers, approved as part of budgets, and predictable revenue. Off-budget transfers should only appear in exceptional circumstances, i.e., disasters.

(ii) **Production Efficiency:** Municipal services should be provided at the least cost. Good indicators are the evolution in the level of employment for the service provided and the extent to which the private sector is relied upon to provide goods and services that are not necessarily public goods. Another indicator is the existence of competition in service delivery.

(iii) **Demand/Allocation Efficiency:** Provision of municipal services should meet the taxpayers' demand for goods and services and the willingness to pay for those services received. An indicator is provided to the extent by which the price of goods and services reflect their economic costs. This implies that those who benefit from a service should pay the economically correct price (the benefit principle). This price may be in the form of fees, user charges, improvement taxes and/or contributions. Other indicators include the degree of popular participation in investment choices and perhaps more important, the extent of cost recovery.

(iv) **Equity Goals:** Equity measures how well the institutional arrangements deal with Brazil's two main redistributive needs: inter-personal and inter-regional. The poor should be entitled to a minimum level of targeted support provided that the fiscal stability of the local government is not threatened. This entails a key role for the federal government through transfers. For interregional equity, fiscal transfers should be responsive to the effective demand for public infrastructure and services, allocating more resources to areas with increasing employment and population, particularly of poor out-migrants from areas that are losing employment, i.e., *national fiscal flows should support and complement market forces.*

(v) **Sustainability.** Sustainability relates to the impact of municipal policies on the fiscal deficits. If municipal expenditure responsibilities are larger than potential revenue sources, two scenarios can arise: (a) an increasing deficit problem, turning into a municipal debt crisis; (b) a deterioration in the quantity and quality of municipal services. To ensure a sustainable balance between assignment, in general, it is preferable to have revenue authority rest with the same level of government that has expenditure responsibility. When transfers are justified, responsibility should rest with the level of government that has the greatest comparative advantage. These transfers should be limited (sustainability and transparency) and based on revenues that are reasonably predictable. Hence, the predominant share of transfers of fiscal resources should be *legally mandated and formula-driven.* In other words, it should not give room for negotiation.

5. Recommendation. These criteria have been used to assess the main institutional and financial aspects of municipal policy making. The Federal Government, in conjunction with states and municipalities, should consider three major types of reforms:

- (a) in the responsibilities of each government level and in the coordination of policies across government levels;
- (b) in the design of transfers to municipalities;
- (c) in expenditure and revenue management.

Reforms in Responsibilities by Level of Government and in Overall Policy Coordination

6. The Need for a Federal Leadership. The Federal Government is to a large extent responsible for the current institutional vacuum observed across most aspects of municipal policy making. The primary responsibility in municipal development policy is to ensure that limited, national objectives are achieved, including access for all Brazilians to a minimum level of basic services, primarily education and health. The most immediate need is, in consultation with subnational governments, to prepare the implementing regulations for the position of the Constitution governing responsibilities in the municipal sector. It should also present simple, realistic guidelines whenever their absence has become a source of delay for the implementation of the municipal policies and develop proper financial management procedures--auditing, performance management.

7. In Urban Pollution Management for instance, these reforms imply that the federal government needs to take the lead in simplifying environmental law and making the law enforceable. Realistic and relevant standards are needed for the whole country. Defining them and to some extent ensuring their implementation when human or technical resources are insufficient is also a federal responsibility. Another federal responsibility to ensure that pollution control policies are coordinated across government levels. The best way to start this coordination effort is to ensure coordination across federal ministries. Lack of coordination across federal agencies and lack of federal initiative to ensure collaboration across states and municipalities are key factors in the poor performance of urban pollution management in Brazil. A notable exception that demonstrates the federal capacity to assume this role is the involvement of the Sanitation Secretariat in assisting municipalities in creating "consortios" to address water pollution issues common to several municipalities.

8. The Need for Strong States. In the longer run, the state governments will have to take over from the federal government. They need to get ready to assume the basic responsibility for equity across municipalities through setting the rate for the ICMS and its allocation between the state and municipalities. Sharing of the ICMS will have to be formula-driven and not negotiated on a case by case basis, with the sharing formula based on the effective demand for infrastructure and services. Municipalities would be primarily responsible for the provision of local services and infrastructure.

9. In the area of Primary Education, there is a need for federal leadership and for state initiative. The federal government needs to define the respective responsibilities of the three government levels. Direct administration of primary schools should gradually be devolved to municipalities. States should develop complementary roles for: (i) the oversight of municipal education systems and quality control; and (ii) core support functions, such as teacher training. The

federal government should focus on monitoring the states' progress in improving quality and access. Direct federal links to municipalities should be limited to automatic tax transfers.

Reform the Design of Transfers to Municipalities

10. **Reform Conditional Grants from States to Municipalities.** Unlike the current practice, only few programs with explicit objectives (to ensure minimum standards in education or in the environment for instance) are needed and their design should clearly reflect their objectives. If objectives for the thousands existing programs cannot be clarified and then endorsed by the policy makers, they should be eliminated. This should improve state cost-effectiveness in resource allocation without distortions of local priorities. In practice, recent developments in water pollution control projects demonstrate how this works. In some of the Brazilian regions, *consortios*, groups consisting of the various municipalities affected by one specific problem, are being set up and are jointly taking charge of projects to deal with water pollution problems affecting their region. The federal government is assisting by co-financing the project. The grants are conditional on some policy actions—such as better enforcement of laws and better implementation of the polluter payer principle to recover costs.

11. **Replace Negotiated Grants by Formula Driven Transfers.** Negotiated grants have high transaction costs and should be evaluated in comparison with relevant alternatives. For example, if the FPE and FPM could be expanded and allocated on a formula-driven basis, negotiated grants could be eliminated. As an option, negotiated grants could be pooled into just one grant, covering all sectors of local concern. The federal government would then provide integrated support to local governments thereby enhancing its capacity to ensure that national interests that cross governmental jurisdictions are dealt with. Yet another alternative to numerous negotiated grants is to critically evaluate the current ICMS policy. The ICMS allocation between the state and municipalities should be formula-driven and not negotiated. The formula should be more consistent with each level of government's comparative advantage in service delivery financing and operation.

12. **Built in Performance Incentives in the Distribution of Resources for Education.** In order to finance municipal education, the federal and state governments must assure that adequate revenues and incentives exist. States should equalize resources across municipalities so that all municipalities can meet the minimum standards. However, resource transfers should be linked to municipalities' progress of increasing revenues from their own tax and budget efforts, including their Constitutional mandate to spend 25% of their total revenues on education. Finally, a municipal model of primary education should imply reduced direct expenditure needs at the state level, but 25% of revenues devoted to education at the municipal level will not suffice. Hence, the federal government should ensure that the transfer of the responsibility for state schools from the states to the municipalities is accompanied by the appropriate transfer of state resources to municipalities.

Reform Expenditure and Revenue Management

13. **Strengthen Municipal Taxation Capacity and Incentive.** Many municipalities have the potential to increase own-source revenues. Improvements in this area will pay-off considerably for both municipal and overall public sector performance. Both federal and state governments should be

involved in monitoring municipal tax (own) revenues and use some performance and fiscal effort indicators as criteria to guide intergovernmental transfers.

14. **Improve Cost Recovery in Pricing.** Municipalities could improve cost recovery by relying on user fees rather than on taxes to finance their activities. One way to achieve this is to allow actual, private or public, providers to collect their revenue from consumers directly as is the case for water and electricity. Ideally, recovery of full economic costs, including for example, environmental damage or any other type externality should be the goal. In the context of pollution, this implies **reform pricing policies to improve pollution control.** A proper pricing of water, sewerage and waste management services would stimulate the internalization of costs by polluters and reduce implicit subsidies to polluters. Immediate improvements would include the introduction of pollution taxes or natural resources user fees. Reforms should also include **expansion of the instruments relied upon to control pollution.** The federal or states governments could, for instance, impose an insurance policy on all polluters for environmental damage risks. This way, the cost of monitoring the risks is left to the insurance company. The government could also intervene by taxing more polluting inputs, thereby increasing revenue.

15. **Reform Municipal Expenditure Management.** The deterioration of expenditure performance is due to wages and personnel expenditures, and debt management. Improvements in budget elaboration and implementation observed in those municipalities that have implemented cost centers with clear management responsibility for service delivery should be generalized. The existence of a double set of books, one for budgetary expenditures and one for extra budgetary expenditures, impedes any analysis of the relative balance of the allocation of resources. A single account book should be an immediate priority. The identification of additional, more specific needs for reform would also require a more detailed assessment of budgetary practices. To promote these changes, the federal government could link financial assistance to local governments to expenditure reform programs. This could be done in the context of financial relations (e.g., *convênios*, grants).

16. In the area of **Primary Education** for instance, this would include setting quality standards for municipal services. The federal government, along with the states, should establish "minimum standards" for primary schools. States should supervise and assist municipalities in achieving those standards. The federal government should expand its national education assessment system to develop a national capacity for evaluating school system effectiveness, at both the state and municipal level. They should also expand their research on educational effectiveness as a basis for giving technical assistance to states when educational innovations are being introduced.

17. **Increase the Private Sector Role.** This will require identifying the municipal activities that can be fully privatized. Many municipal functions are performed in a non-competitive environment. This often results in poor production or even demand efficiency. Private sector involvement in the provision of municipal services should be considered in order to reduce rationing in some services and improve overall quality. The potential of the private sector is larger in the provision of "publicly provided private goods", that is, services which are excludable in the sense that they are provided to consumers who pay for them. This includes many municipal services such as parking, public transportation, toll roads and solid waste collection.

18. **Solid Waste Management** provides a clear illustration of the potential role of the private sector in delivering municipal services. In many municipalities, private companies are

responsible for a significant share of waste collection. But this sector also illustrates another issue raised by the reliance on the private sector. These private providers charge the municipalities. Unfortunately, municipalities hardly recover anything from the beneficiaries of the services. While subsidies may be justified for the poor or when health risks are unbearable, cost recovery should be an objective because it (i) contributes to improvement of the financial situation of the municipality, and (ii) it makes the beneficiaries aware of the costs of services they enjoy, which may lead them to alter their "polluting" behavior.

19. **Quickly Improve the Information Available.** Many of the issues raised above cannot adequately deal with the current data base. In fact, the most urgent agenda item is possibly the design and implementation of a Municipal Financial Management Information System (FMIS). It should cover all municipal accounts, budgetary and extra budgetary, for both direct and indirect administration. It has three objectives: (1) to monitor the implementation of macroeconomic policy; (ii) to improve transparency in intergovernmental financial transactions; (iii) to form an analytical base on which to improve intergovernmental fiscal transfers, assess tax reforms (e.g., consolidation of taxes with overlapping jurisdictional bases, decentralization of tax authority as an alternative to transfers) and to draw closer revenue authority with expenditure responsibility at each level of government.

20. This need for information does not apply only to financial management, it also applies to all types of service delivery. In the case of pollution management for instance, it is also crucial to create a pollution data base. Any solution to the regulator's limited capacity to enforce the law should start with the development of a uniform and systematically updated database. This database should provide policy makers with information on the social costs of pollution, facilitate the ranking of local and national environmental problems and allow for a better allocation of scarce resources.

MATRIX OF POLICY RECOMMENDATIONS

Reform Area	Objectives	Practical Importance for Pollution Management and for Primary Education Policies
Responsibilities by Level of Government and in Policy Coordination		
<p>1. The Federal Government needs to take the lead in filling the institutional vacuum observed across most aspects of municipal policy making; this implies, in consultation with subnational governments, the preparation of simple and clear regulation formalizing the Constitutional responsibilities of the municipal sector. It should also take the lead in ensuring coordination across government levels and across federal ministries</p>	<p>Improve production efficiency by eliminating the bottlenecks currently delaying municipal service delivery; many municipalities are still waiting to act on their new Constitutional Responsibilities in order to avoid wasting resources or out of mere inexperience in their new functions</p>	<p>Pollution Management: Simplification of the environmental law and coordination between government levels could lead to a much more cost effective law enforcement. For example, in states with understaffed environmental agencies, municipal enforcement of the law could dramatically reduce pollution control costs. The initiative for this redesign in assignments of responsibilities should be state or federal; such coordination efforts are beginning through the creation of "consortios" of municipalities to deal with water pollution issues</p>
<p>2. In the long-run, the States will have to assume most of the municipal development functions and will be responsible for equity across municipalities. This would be achieved by the reform in the formula for allocation of its transfers to municipalities; it also stresses the pressing character of the need to reform transfers</p>	<p>Maintain production efficiency and ensure sustainability and equity by taking over in the long run the federal initiative and providing technical assistance</p>	<p>Primary Education: The federal government should clearly define the role of each level of government. Once administrative capacity has been strengthened, direct administration should gradually be transferred from the states to the municipalities. States should monitor and provide technical assistance or training. The federal role is to monitor states' performance and to set minimum quality standards</p>
Transfers to Municipalities		
<p>3. Immediately reduce conditional grants to a few programs with explicit objectives (e.g. spillover compensation or ensuring minimum standards)</p>	<p>Improve accountability, efficiency and equity by increasing the transparency of the system achieved by formula driven transfers as well as a reduction in transaction costs and in discretionary allocation of resources</p>	<p>Pollution Management: Federal or state subsidies to assist municipalities in implementing specific responsibilities vis-a-vis the protection of the environment would be an example of a conditional grant intended to address a specific objective. The grant should be conditional for those municipalities setting prices for "environmental services" (i.e., waste management) to ensure that polluters or beneficiaries of improvements in the environment contribute their fair share to the costs of managing pollution. This condition would provide for both program efficiency and financial sustainability</p>
<p>4. Phase out negotiated grants as soon as possible; in the transition, and if necessary, merge them into a single grant cutting across sectors of local concern. Then if it is necessary, replace them by a formula driven expansion of the FPE and FPM or by non-matching grants</p>	<p>Improve production efficiency, equity and sustainability by providing incentives to municipalities to deliver on their legal obligations and by forcing them to maximize the revenue from their own sources (user fees and property taxes) and by increasing the weight given in the distribution formula for transfers to factors more consistent with the fiscal needs of individual municipalities</p>	<p>Primary Education: Federal, technical and financial assistance to states and municipalities in education should be conditional on states taking charge of their overall responsibility for coordinating municipal and state systems, and also on states and municipalities meeting federal minimum standards for students' cognitive achievements in primary schools throughout Brazil. States, however, should equalize resources across municipalities to the extent necessary to ensure that all municipalities have the capacity to meet these minimum standards. This should be achieved through the revenue distribution formula to ensure transparency and equity</p>
<p>5. Review the formula driving the distribution of state transfers revenue across municipalities so as to include minimum quality and access to service standards. The incentive to meet standards requires that indicators of fiscal effort and delivery performance be part of the formula. Municipalities failing to maximize the use of local revenue or to meet constitutional obligations on service delivery would be penalized</p>		

Expenditure and Revenue Management

6. Reinforce Municipal Taxation and Pricing Capacity: While the reforms in the design of transfers should improve the incentive to increase tax and pricing efforts, the federal government should take the lead or cooperate with states in putting together a technical assistance program to update property surveys and pricing of municipal services and in establishing the institutional apparatus that will allow the stronger incentive to increase actual revenue

7. Reform Expenditure Management: This will require improving Personnel and Procurement procedures as well as budget elaboration and implementation (this in turn would provide inputs to the information system discussed below (FMIS))

8. Increase the Role of the Private Sector: This will require the identification of municipal activities that can be fully or partially privatized

9. Design and implement a Municipal Financial Management Information System (FMIS): it would provide a consistent financial reporting system for all levels of government and form an analytical base on which to improve intergovernmental fiscal transfers and to tighten the linkage between revenue authority with expenditure responsibility at each level of government. This will also require a standardization and simplification of financial reporting procedures to minimize the distortions created by inflation in executed budget data and actual financial flows and hence on effective transfers

Improve demand efficiency, equity and sustainability by ensuring that prices reflect the municipal production costs, that the beneficiaries of this service are not subsidized when they have the ability to pay and that resources are available to maintain and improve upon service delivery

Improve efficiency and sustainability by ensuring that services meet desirable performance standards both in terms of quantity and quality and that the expenditure levels are cost effective and are consistent with revenue achieved

Improve efficiency by relying more actively on service providers who can benefit from economies of scale that individual municipalities cannot rely upon, or those with strong incentives to perform, (e.g. the private sector)

Increase efficiency by easing adjustments in resources allocation across municipalities to ensure that service delivery is improved when needed

Increase equity by ensuring that the municipalities with the greatest needs and the performances closest to their potential will benefit the performance based transfers

Ensure sustainability by easing adjustments in resource allocation to ensure that municipal revenues adequately match expenditure responsibilities

Increase Accountability by improving the transparency of resource sources and allocation

Pollution Management: The core pollution problem in Brazil is a pricing problem. Pollution management is generally subsidized and when revenues are insufficient, expenditures fail to meet the needs. For instance, pricing water, sewerage, drainage at levels that forces consumers to recognize the costs, they impose on society or the benefits that they enjoy from publicly provided services such as recreational parks: (i) reduces pollution and waste; (ii) eliminates the delays in investing in basic sanitation, which is a critical problem in Brazil given extremely limited treatment of waste water which takes place and its huge effect on water pollution

Primary Education: Minimum standards are needed for primary schools throughout Brazil. They should include minimum requirements for student cognitive achievements as well as spending per student, adequacy of physical facilities, material and teacher quality. These are requirements for achieving cost-effectiveness in education expenditure

Pollution Management: Solid waste management in Brazil clearly demonstrates that municipal services can be taken over by the private sector; but delegating the provision of services to private firms is not sufficient: recovering from the taxpayer's costs charged by these private firms is as important if the consumers of these services are to be aware of the costs they impose and if the provision of these services is not to be rationed because of budget constraints

Pollution Management: The limited capacity of enforcing pollution laws in Brazil is a product of both the complexity of the law and the very limited information available to the environmental agencies. In Minas Gerais, for instance, water has not been monitored in almost 5 years now. Simultaneously, the Rio das Velhas is dying. Until sources of pollution are clearly identified little can be done to design policies to control them

Primary Education: The federal government needs to expand its national education assessment system into a strong capacity for evaluating school system effectiveness and provide feedback to states and municipalities. Without the creation of a database, the efficiency objectives are unlikely to be met any time soon

BRAZIL

**THE CHALLENGE OF MUNICIPAL SECTOR DEVELOPMENT
IN THE 1990s**

VOLUME I
POLICY SUMMARY AND REFORM PROPOSALS

A. INTRODUCTION

1. **Motivation.** The 1988 Constitutional reforms have enhanced the relative importance of municipalities in Brazil's federal system. Municipalities now have more expenditure responsibilities as well as more income from all sources--own and transferred. However, in many sectors that require a larger local role in service delivery such as water, pollution or health, the municipalities' experience is limited. Furthermore, some traditional municipal services such as primary education and solid waste management, are deteriorating at a time when municipal resources are increasing. These facts alone point to the need to assess whether the municipalities are capable of assuming their new responsibilities and managing their new resources efficiently.

2. There is also a macroeconomic aspect. While the full effect of the new transfer system will not be felt until 1993, there is already growing concern over the national fiscal impact of the larger municipal role. The revenue effect of the changes can reasonably be approximated, but the magnitude of the larger expenditure requirements is still unknown. Imbalances between revenue sources and expenditure responsibilities could lead to a fiscal crisis in some municipalities. This is illustrated by the fact that a growing number of municipalities are relying on suppliers' credit to finance expenditure while violating the constitutional limits on municipal indebtedness. Investment rationing in infrastructure, in sanitation and municipal transport for instance, is another sign of potential trouble.

3. **Objectives.** This report has two main purposes. The *first* is to define an analytical framework to structure the Bank dialogue with Brazil on municipal policy issues. This framework supports the design of policy conditions to be built in municipal development projects. The *second* is to propose reforms to address the issues raised by: (i) the institutional arrangements and policy framework for municipal development; (ii) the state of municipal financial management; and (iii) the impact of institutional and financial management deficiencies on municipal finances and service delivery performance. The practical relevance of the conceptual analysis is illustrated for the cases of urban pollution and for primary education.

4. **The Analytical Framework.** The analysis of the role and management of municipalities is based on four criteria derived from the theory of fiscal federalism and from public choice and principal-agent theory. More specifically, municipal policy making should be based on: (i) the accountability of the decision makers; (ii) fiscal sustainability; (iii) efficiency; and (iv) equity in resource use and expenditure choices. These criteria, which are defined below, support a normative vision of municipal policy making. The reform needs of the sector are indicated where deviations from this vision can be observed.

5. **The Report.** The report is composed of two volumes. Volume I is a policy oriented summary. It integrates the main findings of a mission that visited Brazil in October 1990. Volume II provides the detailed analysis that supports these findings. In particular, volume II provides a more detailed discussion of the policy reforms proposed.

6. **Volume I.** The rest of this volume is organized into six parts:

Section B provides an overview of the structure and importance of Brazil's municipal sector;

Section C describes the criteria used to assess the institutional and financial arrangements;¹

Section D reviews and assesses the institutional background of municipal policy making;

Section E focuses on weaknesses in municipal financial management;

Section F summarizes a set of reform proposals. It provides some guidance on the actual design of reforms to improve municipal services along the lines recommended by the normative framework.

B. AN OVERVIEW OF BRAZIL'S MUNICIPAL SECTOR

1. A Description of the Municipal Sector

7. **The Institutional Importance of Municipalities.** Brazil has 4,493 municipalities. Over 4,000 have a population of less than 50,000, about 290 have a population between 50,000 and 200,000 and only 25 have more than 500,000 residents. About two thirds of these municipalities are in the Northeast and Southeast. The decision to create new municipalities lies within the authority of the states. However, the 1988 Constitution reinforced the federative nature of Brazil's government system by making municipalities co-equal and independent partners; in most other federations, municipalities are usually the handmaidens of state governments. Municipalities now have more resources at the expense of the federal and state governments, but they also have more responsibilities for expenditures.

8. **Indirect vs. Direct Administration.** Brazil also relies on a large "parallel" administration known as "indirect or decentralized administration." This consists of governmental entities outside the central federal, state or municipal direct administration to which many functions are delegated. There are about 300 such entities at the municipal level. They have various names and legal forms. They include autonomous entities carrying out typical government functions (*autarquias*), mixed economy enterprises that combine private (usually very little) and public capital (*sociedade de economia mista*),

¹ For a detailed discussion of some of these criteria, see T. Campbell (1991), Decentralization to Local Government in LAC: National Strategies and Local Response in Planning, Spending and Management, The World Bank, LAT Regional Studies Program, Regional Report No. 5, July and J. Hicks (1991), Local Government Financial Management During Adjustment, LATIE Dissemination Note, January.

public enterprises, and foundations (*fundações*) that carry out functions that need not legally be implemented by the public sector. These indirect administration bodies are particularly important (in terms of expenditures in public utilities; such as electricity, water and sanitation), road construction and maintenance, housing, transport, social security and data processing.

9. **On the Limitation of Municipal Data.** The importance of the municipal sector in Brazil is impossible to assess in absolute terms. All sources of data with national coverage ignore indirect administration and exclude extra-budgetary operations. These can be important as shown below. In spite of these limitations, national accounts provide enough disaggregation on the final disposition and composition of revenue to indicate the relative importance of the three levels of direct administration. The most recent national account data are analyzed hereafter.

2. The Relative Importance of Municipalities in Brazil's Federation

10. **Municipal Disposable Revenue.** National Accounts data for 1990, summarized in Table 1, illustrate the significant increase in the relative importance of the municipal sector. Municipal resources in 1990 were estimated at 5.2% of GDP, over twice the 1985 level. Most stem from transfers, since own revenue only reaches around 1% of GDP. In relative terms, this means that the municipal share in the final disposition of total revenue has increased from around 10-12% for the last two decades to almost 17% in 1990. This is still during the transition before 1993 when municipalities will get the full increase in shared revenue granted by the new Constitution--about 23% of total revenue if the current tax system is maintained.

11. **Municipal Expenditures.** Municipal expenditures in 1990 were estimated at 4.3% of GDP, 1.6% points more than in 1985. In relative terms this means that the municipal share has increased by almost 3% since 1985 to reach almost 14% of the total in 1990. The composition of the relative contribution of the direct administration of municipalities to public services also illustrates their increasing macroeconomic importance. This increased role can be observed in the labor market, in public investments, and in the social sectors.

12. **Labor Market.** Municipalities are acquiring a larger relative importance in the labor market through expenditures on wages and salaries--1.8% of GDP in 1990 or 17.5% of the total direct administration wage bill. There is only partial evidence on their total employment levels. The two largest municipalities in Brazil, Rio de Janeiro and São Paulo, have about 150,000 employees each. Medium-sized municipalities vary from 1,000 to 4,000 employees (e.g. Campo Largo--1,400; Ananindeua--4,000; Sobral--2,600). Small municipalities tend to employ about 200-300 people (Bocaiúva do Sul--200).

13. **Public Investment.** Municipalities have significant potential to influence the overall performance of the economy. Their investment reached almost 1% of GDP in 1990, nearly twice the federal performance. Most of it is infrastructure investment aimed, in principle, at complementing and enhancing the productivity of private sector investment.²

² Even accounting for the exclusion of indirect administration investment, it is rather unusual for a country to have municipal investment that is twice as large as federal investment.

TABLE I-1
INDICATORS OF THE EVOLUTION OF THE SIZE OF THE THREE
GOVERNMENT LEVELS IN BRAZIL
(% of GDP)

	1970	1980	1985	1989	1990
Revenue	27.1	33.7	31.7	26.1	31.0
Central	14.8	15.5	12.7	14.5	16.3
State	9.6	5.8	6.5	7.8	9.5
Municipal	2.7	2.4	2.5	3.8	5.2
(Municipal Share as % of total)	10.0	9.9	11.4	14.5	16.8
(Municipal Share per capita in 1990 US\$)	50.0	78.7	78.1	126.5	163.4
Expenditure	25.4	29.8	24.4	32.7	31.0
Central	14.5	15.7	14.3	20.9	16.5
State	8.3	5.6	7.1	8.1	10.2
Municipal	2.6	2.5	2.7	3.7	4.3
(Municipal Share as % of total)	10.2	10.5	11.1	11.3	13.0
(Municipal Share per capita in 1990 US\$)	47.6	83.6	86.5	122.7	135.1
Of which:					
Wages & Salaries	8.3	7.1	6.9	9.7	10.5
Central	3.5	3.0	2.5	4.1	3.6
State	3.9	3.3	3.4	4.0	5.0
Municipal	0.8	0.8	1.1	1.6	1.8
(Municipal Share as % of total)	10.1	15.7	15.4	16.6	17.5
(Municipal Share per cap. in 1990 US\$)	16.0	33.0	34.0	55.0	59.0
Social Transfers	9.0	11.5	11.5	9.4	10.0
Central	7.5	10.4	7.4	7.7	8.0
State	1.3	0.9	1.7	1.2	1.5
Municipal	0.2	0.8	0.3	0.5	0.5
(Municipal Share as % of total)	2.2	1.5	2.7	5.1	5.0
(Municipal Share per cap. in 1990 US\$)	4.0	4.0	7.0	13.0	13.0
Gross Investment	4.4	2.4	2.3	2.9	3.5
Central	1.6	0.7	0.5	0.9	0.5
State	1.9	0.9	1.2	1.4	2.1
Municipal	1.0	0.7	0.6	0.7	0.9
(Municipal Share as % of total)	22.2	30.8	26.3	22.9	24.3
(Municipal Share per cap. in 1990 US\$)	18.0	24.0	19.0	22.0	27.0

Sources: National Accounts/FGV/IBRE/CEF (up to 1987) and FIBGE/DECNA (1988/1989); PIB - FIBGE (jan/91)

Notes: 1. The figures cover direct administration, including social security, FGTS and PIE/PASEP but exclude the Central Bank and public enterprises.

2. Data for 1990 is preliminary.

3. Revenue includes net own tax and non-tax revenue as well as intergovernmental transfers

4. Social Transfers are composed of social security and subsidies.

14. **Poverty Alleviation.** Finally, municipalities have a social role to play. They now spend about \$16 per capita on social transfers in 1990. While this is still well below the federal government's level of \$251 and the states' level of \$47, redistribution is generally considered to be a federal responsibility so the contribution of the municipalities is seen as a bonus. This is the case given that the 1990 figure spent on municipal social transfers is twice as much as in 1985.

3. Composition of Municipal Services

15. Only partial evidence exists on the Functional Allocation of Expenditures. What little there is can be found in an 1985 IBGE survey of Municipalities of Capitals and in an informal 1989 World Bank survey summarized in Table 2. The sample for the Bank survey is small--only 6 municipalities. It was picked randomly but an attempt was made to cover municipalities in both poor states such as Pará or Ceará, and richer states, such as Paraná and Minas Gerais. The sample also covers large municipalities, such as Belém, Curitiba and Fortaleza, and much smaller ones, such as Sobral, Caucaia and Campo Largo.³

TABLE I-2

EXPENDITURE PER FUNCTION IN A SAMPLE OF MUNICIPALITIES (1989)

	Belém	Fortaleza	Sobral	Caucaia	Curitiba	Campo Largo	Average
FUNCTION	100.0	100.0	100.0	100.0	100.0	100.0	
Legislative	11.7	4.2	6.0	4.4	3.8	1.5	5.3
Planning	23.2	13.0	16.7	17.5	17.8	32.0	20.0
Education & Culture	15.9	16.5	24.4	23.1	21.9	25.5	21.2
Housing & Urbanization	1.8	24.0	35.7	13.3	17.0	15.8	17.9
Health & Sanitation	23.9	19.2	8.8	9.4	13.5	2.9	13.0
Social Assistance	11.1	12.3	4.6	9.8	14.2	10.6	10.4
Transports	9.4	9.9	1.2	14.9	8.9	10.7	9.2
Other	3.0	0.9	2.7	7.6	2.9	1.0	3.0

Source: Data collected during mission field trip.

16. Both surveys lead to similar conclusions with respect to the composition of municipal services in Brazil. In particular, they show that:

- (a) although there are large variations between municipalities, by far the largest proportion of municipal expenditures, about 40% of the total, goes on administrative expenditures, such as; planning, housing and urbanization and legislation. These categories are labor intensive. Public job creation is still perceived by many in Brazil as a means to alleviate poverty. A large, but unknown, share of the wages paid in these categories could be added to the average of about 10% of expenditures allocated to Social Assistance--both for the 1985 and the 1989 samples;

³ More details on these municipalities are provided in the Appendix to Volume II.

- (b) Education and Culture represent the largest category on average--21.2% of total expenditures. In general, it has accounted for a larger share in smaller municipalities than in larger ones; and
- (c) the importance of Transport varies a lot across municipalities--between 1.2% and 14.9% in the 1989 sample. It depends on how much reliance is placed on the private sector to provide that service.

4. Municipal Service Provision: Two Case Studies.

17. To illustrate the discussion, the report provides examples of the practical importance of the conceptual issues raised by the design of the institutional and financial management environment of municipal policy making in Brazil. These examples are drawn from two case studies: *the municipal management of urban pollution* and *municipally-run education systems*. This section provides an overview of the importance of these two services in the context of municipal policy making.

4.1. The Urban Pollution Problem

18. **The Physical Sources of Pollution.** The pollution threat to Brazil's cities stems from the increase in gas, liquid, heat, noise and residuals or byproducts of the production and consumption activities arising from population growth which is over 3% per year. Environmental problems of concern to urban municipalities include: (i) improper collection, treatment and disposal of solid waste; (ii) insufficient and deficient sewer systems; (iii) insufficient and improper design of urban transport. All lead to a combination of land, water and air pollution that is becoming unsustainable in some parts of the country. The most dramatic effect is on public health.

19. **The Role of Local Governments.** The role of local governments is fundamental in addressing these problems. Theory suggests that, for pollutants that do not raise any inter-jurisdictional issues, the optimal level of environmental quality should vary among municipalities according to local circumstances. In each municipality, marginal gains should be matched against marginal costs. Intuitively, this seems plausible. First, many of the sources of urban pollution problems are local by nature. The municipal governments are often the appropriate level at which to identify environmental problems like increased demand or need for sewerage services or the health effects of transport related air pollution. Sometimes, however, economies of scale are important in the provision of services, so that actions to control the environmental problems detected locally are best taken at the state or federal level.

20. Second, many state and local administrations have a Constitutional mandate to enforce some of the federal decisions on environmental matters and will have to adjust to the federal agenda. In fact, the tendency is to move responsibility for the provision of some services, such as sewerage and even water supply, from the state to the municipalities whenever possible. This should be reinforced by suppressing an old legal provision that prevented municipalities from borrowing finance for sewerage and water supply facilities. Currently, water suppliers, whether state or municipal, have to borrow directly from the federal government.

21. **The Policy Failures.** To address the risks imposed by pollution, the three levels of Brazil's government are supposed to jointly design policies to ensure the internalization of the costs imposed by the market failures. In this context, the 1988 reforms at all levels of government have tempted to delegate more responsibilities to municipalities. The overall design of policies raises to be highlighted throughout the discussion of this report.

4.2. Issues in Municipally-Run Education Systems

22. **The Municipal Experience.** Municipally-run education systems currently serve about 33% of all preschool students, 30% of primary students, 4% of secondary students and 5% of higher education students in Brazil. In addition, municipalities are the major source of public day care. Municipal-level education services have expanded steadily over the past few decades: in 1960, municipalities accounted for 8% of total public spending on education; by 1983, they accounted for close to 16%. Education represents a significant item in most municipalities' budgets, about 15%-20% of total spending, and it is mandated to increase still further. The 1988 Constitution requires municipalities to allocate at least 25% of their total revenues (including transfers from other levels of government) to education.

23. **The Constitutional Requirements.** The 1988 Constitution also established the "right" of all children aged 0-6 to attend day care or preschool. It also instructed municipalities to spend their education resources "on a priority basis" on primary education in pursuit of the national objectives of universal primary education and universal literacy within a decade. This legal framework is one stimulus on municipalities to increase spending on education, but the greatest source of pressure is probably community demand. There is tremendous pressure on municipalities to expand day care and preschool services; less than 10% of children currently attend day care, and even at the preschool level coverage is only about 30% of the 4-6 age group. Municipalities also face pressures to expand primary education enrollments, to improve primary education quality and, increasingly, to take on support functions (principally maintenance and construction) for school systems run by the states.

24. **Policy Failures.** What are the prospects for the municipalization of primary education over the next decade? Several things are clear. However strong the theoretical efficiency advantages of municipal primary education, they cannot be captured without major institutional changes at all three levels of government. Nor can they be captured overnight. No official policy regarding municipalization of primary education exists today, and there are several major issues to be resolved before a policy like this could be successfully implemented as will be discussed in the report.

C. CRITERIA TO ASSESS MUNICIPAL POLICY MAKING

25. This section defines a set of criteria that can be used to assess the institutional and financial aspects of the role of municipalities in the intergovernmental arrangements adopted in the process of decentralization. Jointly, they define a normative approach to the assessment of municipal policy making. They provide the characteristics required from the design of municipal policy making that allow municipalities to assume the new role they have been assigned by the new Constitution.

26. **A Vision of the Emerging Role of Municipalities.** In the medium term, municipal institutions and policies should aim at transforming their current state of disarray, to one that places much greater emphasis on the efficiency and financial strength of municipalities. In Brazil's decentralized government structure, municipalities act as quasi-autonomous managers of expenditures on services such as health, education, water supply, waste collection, drainage, paving and public transport. Municipalities, in theory, have a comparative advantage in the provision of these services because local governments are more knowledgeable about local needs and are better at responding rapidly to changes in these needs. This does not mean that municipalities have to provide all services by themselves. For many of these activities, municipalities will be able to rely on the private sector through concessions or contracting. This should expand the scope of service delivery. Since many of these services are intermediate goods in the production of private services, the municipal performance in managing these expenditures will also contribute to the determination of Brazil's macroeconomic performance. Municipalities should also contribute to a return to sustainable macroeconomic growth through their own fiscal efforts. They should ensure their financial independence and health by maximizing the revenue they can raise from their own sources of revenue. The local tax burden, including local tax levels, local user fees and the pricing of local services should be determined by the level of demand for services.

27. **The Criteria.** If municipalities are to be responsible for expenditure on many types of public goods and services, reforms in their roles, functions and financial management must be designed as a coherent package. This report proposes a set of criteria that can be used to assess the current design of municipal policy making. They can also be used to identify coherent reforms. These criteria are:

- (a) accountability;
- (b) production efficiency;
- (c) demand efficiency;
- (d) equity in resource mobilization and allocation; and
- (e) sustainability.

28. **Accountability.** Municipalities should first be accountable to their electorate as well as to the federal and state governments when they act on their behalf. Both financial and managerial accountability are required to ensure overall accountability to a higher level of government. Accountability improves equity and efficiency in the provision of municipal services. Instruments commonly relied upon to ensure accountability include audits and performance indicators to identify, if public production is provided at the best price available. An implication of these requirements is that all government levels should have transparent budgetary processes. Revenue sources should be predictable from the perspective both of national fiscal agencies and municipalities as inputs to the budgeting and planning process. Intergovernmental transfers should be transparent. They should be approved as part of federal, state and municipal budgets. Off-budget transfers should only appear in exceptional circumstances--i.e. disasters.

29. **Production Efficiency.** Municipal services should be produced efficiently. Production efficiency measures the costs at which specific municipal goods and services of a given quality are provided. It requires that these goods and services be provided at minimum costs. Production efficiency may depend on the possibilities of economies of scales in the provision of municipal services that may require coordination. Strong indicators of efficiency are: (i) the room for reducing participation of the private sectors in the level of employment for a given level of service, (ii) an increase in the provision by the of goods and services that are not public goods, and (iii) the existence of competition for service delivery.

30. **Demand/Allocation Efficiency.** The provision of municipal services should meet the taxpayers' demand for goods and services and their willingness to pay for the services received. Demand efficiency measures how well municipal services match consumer preferences and budget constraints. It is measured by the extent to which the price of goods and services reflect their economic costs, for example, consumers should pay for the cost of supplying water as well as for the cost of collecting and treating "used" water. This implies that those who benefit from a service should pay for it, i.e. the benefit principle. They should pay the economically correct price for what they receive, including the economic costs of pollution for instance, whether in the form of fees, user charges, improvement taxes or contributions. Key indicators include the extent to which willingness to pay is demonstrated, the degree of popular participation in the municipal investment choices and perhaps most important, the extent to which costs are recovered.

31. **The Equity Goals.** Equity measures how well the institutional arrangements meet Brazil's two main redistributive needs. These needs stem from two sources: interpersonal and interregional. The deterioration of the macroeconomic situation during the 1980s has increased the number of people living in poverty in Brazil.⁴ The poor should be entitled to a minimum level of targeted support while the macroeconomic adjustment is taking place. Greater efficiency and better financial management will be necessary to achieve this. However, new and more effective means of addressing long-standing equity problems must also be found. But this should be a federal initiative as redistribution should remain fundamentally a national problem. Municipal redistributive policies tend to attract those who would benefit from these policies and repel those who would have to finance them, thereby threatening the fiscal stability of the local government.

32. Similarly, equity can also be assessed by looking at the extent to which interregional differences in municipal income could be reduced without, at the same time, reducing the incentive of the poorest municipalities to maximize revenue from their own sources. In general, it is recommended that the efficiency and equity criteria for transfers of national fiscal resources be guided by the following. First, the distribution of national fiscal transfers should be responsive to the effective demand for public infrastructure and services. This means that more resources should be allocated to areas with increasing employment and population, particularly for poor migrants from areas that are losing employment. In other words, *national fiscal flows should support and complement market forces*. Second, national fiscal resources should be targeted at such services as education and health care, which are necessary if citizens are to have effective access to the labor market. In any case, the federal government has a duty to provide at least a minimum level of public services, but this approach is also consistent with the goal of interpersonal equity. Because the labor force is mobile, which leads to benefit spillovers across

⁴ For a quantitative analysis, see Bonelli, R. and G.L. Sedlacek (1990), "A Evolução da Distribuição de Renda Entre 1983 e 1988", IPEA, Texto Para Discussão No. 199, Outubro.

municipalities, the services should be provided across the board, irrespective of where each citizen resides when receiving the service.

BOX N° 1: EFFICIENCY AND EQUITY

- In practice, there is no need to have a trade-off between demand efficiency (cost recovery) and equity or poverty alleviation. In fact, the trade-off will arise when prices (or tariffs) are used to alleviate poverty, as happens frequently in Brazil. Manipulating user fees to achieve social objectives is seldom an effective way to deal with poverty alleviation. Experience has shown that user fees below the cost-recovery level have two negative effects: (i) they benefit more those people who have the ability to pay (higher income groups) rather than the lower income ones; and (ii) they weaken the financial capacity of government to expand the provision of services, (with the eventual consequence that the low income groups are those who suffer the most).
- More effective ways to tackle distributional issues at the local level include expenditure policies and targeted subsidies. Cross-subsidization can also be an approach to compatibilize equity and efficiency concerns.
- Two recent water sector projects illustrate how the benefit principle and ability to pay principle can be reconciled in Brazil. One is the Campinas project on low-cost technologies for water supply to low-income municipalities; the second is the São Paulo component of the recently negotiated water pollution project. In both cases, the tariff structure includes some progressivity to ensure that the poorest are covered by a minimum service provision. In the case of the São Paulo Project, the rate of cost recovery and the level of service were adjusted to take into account: (i) the willingness of the poorest to pay (measured by a direct survey organized by the water utility); and (ii) their ability to pay up to the level of consumption that is consistent with the standard needs of the local population.

33. **Sustainability.** Sustainability deals with two aspects in the design of the municipal role that can contribute to national fiscal deficits. The first stems from an imbalance between municipal expenditure responsibilities and revenue sources. If municipal expenditure responsibilities are larger than potential revenue sources, two scenarios can arise: (a) an increasing deficit problem, turning into a municipal debt crisis; and/or (b) a deterioration in the quantity and quality of municipal services. A deterioration on both counts can be interpreted as evidence of unsustainability built into the design of municipal policies. To ensure a balance between revenue and expenditures assignment, in general, it is preferable to have revenue authority rest with the same level of government as expenditure responsibility. When transfers are justified, revenue authority and expenditure responsibility should rest with the level of government that has the greatest comparative advantage.

34. A second potential contribution to an unsustainable national fiscal deficit stems from the design of transfers.⁵ Transfers to municipalities should be limited (sustainability and transparency) and based on revenues that are reasonably buoyant (predictability). It follows that the predominant share of transfers of fiscal resources should be *legally mandated and formula-driven*, with only a small "reserve" of national fiscal transfers available for discretionary transfers based on emergencies such as natural disasters. Without these restrictions on national transfers, incentives for increased autonomy and accountability of municipalities are undermined, and national fiscal discipline may be compromised.

35. Correction of mismatches between local government revenues and expenditure responsibilities should not be done through negotiated transfers because, very often, they become dominated by political considerations. Negotiated transfers blur accountability for the delivery and

⁵ An extensive analysis of intergovernmental transfers, of their design and of their macroeconomic importance is currently underway at the Bank. The last Appendix of Volume II provides a summary of the issues involved.

financing of infrastructure and services, the fiscal requirements for municipalities become unpredictable. The results contribute to macroeconomic destabilization in which all lose, particularly the poor.

36. **Application to Urban Management.**⁶ To meet the specific financial management requirements of the urban sector, infrastructure and services should be financed and delivered by the lowest level of government at which efficiency and equity objectives may be achieved. The role of the National Government would be to provide the national regulatory and normative framework applicable to all States and Municipalities, as well as to promote national efficiency and equity objectives. The role of the States would be to provide state-level regulations and norms, and to promote state efficiency and equity objectives. This implies a coordination role or a co-provision/co-regulator responsibility for many municipal activities. In this normative framework for reforming municipalities, most of the responsibilities for financing and delivering urban infrastructure and services would rest with municipalities. This is where effective demand is most easily identified and measured, and where urban citizens may best hold elected officials accountable for their performance.

D. INSTITUTIONAL ISSUES IN THE MUNICIPAL SECTOR

37. This section focuses on the institutional component of municipal policy making which consists of the legal, regulatory and administrative framework required to implement federal, state and municipal policy decisions. This framework is crucial in determining the ability of municipalities to deliver services and provide sound financial management. The section begins with a description of the municipal structure and institutional environment, and goes on to describe some aspects of the current approach to municipal service delivery. It concludes with an inventory of deviations from the normative criteria.

1. The Municipalities' Structure and their Institutional Environment

38. **The Institutional Environment of Brazil's Municipal Policymaking.** The institutional environment of Brazil's policy makers dealing with municipalities is defined by four main factors: (i) the new Constitution, (ii) the Federal government, (iii) the States, and (iv) the Metropolitan areas. In doing so, it also provides an initial assessment of the current state of the new institutional arrangements.

39. **Instruments of Decentralization.** The new Constitution is the major instrument relied upon to decentralize. Three instruments are used:

- (a) *A change in the mix of expenditure authority among government levels:* Municipal responsibilities for service delivery are summarized as follows: legislation on matters of *local interest* to supplement state and federal legislation; and delivering of public services including collective transportation, basic education and health, planning and

⁶ Most of the discussion in this report applies both to urban and rural municipalities. The focus of this analysis is on municipalities, because municipalities represent the unit of the federation directly empowered with resources and decision making authority. While urban and rural municipalities have to deal with different problems, their institutional framework is the same in this federation. Urban municipalities are just one type of municipality with specific problems--in particular coordination needs as cities are often a collection of municipalities.

control of land use and occupation. These are generally consistent with the decentralization objectives;

- (b) *More own revenue sources:* Municipal taxes were considerably expanded by the 1988 Constitution. Until then, municipalities had relied on only two taxes, a property tax and a service tax. Now there are four: an *urban property tax (IPTU)*; a *value-added tax on services* in a number of tertiary activities; a *tax on property sales (ITBI)*; and a *fuel tax (IVVCLG)*. Additional local revenue could be generated by charging *user fees* and adequate *public tariffs*. The broad principles underlying the optimal tax assignment are needed for equity (consistency of revenue means with expenditure needs) and efficiency (minimizing resource cost). Current tax assignment in Brazil is broadly consistent with these recommendations;
- (c) *More transferred revenue:* Municipalities have benefitted from more transfer revenue from the states and from the federal government since the new Constitution came into effect. Tax Transfers or "Constitutional transfers" are based on federal or state tax revenues and are prescribed by law or by the Constitution. The allocation criterion is usually the amount collected in the receiving state or municipality, although in some cases other criteria, such as population or income, are used. The various sources are as follows. The Municipal Participation Fund allocates the proceeds of the federal income (IR) and the industrial products taxes (IPI). It will gradually be increased from 17% in 1988 to 22.5% in 1993. From the 10% of IPI transferred to states by the Federal government as an Export Compensation Fund, municipalities receive one quarter. Municipalities received 60% of the proceeds from the federal financial transactions tax (IOF) on gold, and 50% of the federal rural property tax (ITR), compared to 100% prior the 1988 Constitution. The municipal share of the state value-added tax (ICMS which has a wider tax base), went from 20 to 25%. Half of the proceeds from the state motor vehicles registration tax (IPVA) is shared with municipalities.

40. There are also nontax transfers. These are not associated with specific taxes. They are negotiated on a case by case basis between the federal government and municipalities, and between states and municipalities. These transfers take the form of agreements (*convênios*) that stipulate the amount of the transfer and the use to which it will be put. They are poorly documented, and their negotiation lacks transparency.

41. **The Potentially Larger Role of the States.** The new scheme of intergovernmental relations in Brazil creates the potential for a larger and more important role for states than ever. But this potential may well remain unrealized until complementary legislation and national policy are made explicit. The failure of the states to achieve their potential role will undoubtedly alter the chances of municipalities to reach their own potential. To assess the municipal risks, it is necessary to understand what role the states could play in Brazil's federal structure. The potential strength of the states' new role lies in three facts. *First*, they have more resources than ever in the last twenty years. *Second*, their constitutional mandate grants them: (i) legal and policy prerogatives, many of which are new and still undefined, for urban, municipal and regional development, including infrastructure; and (ii) a predominant role in supra-municipal affairs--urban agglomerations and metropolitan areas. They have the freedom to make urban policy, including regional development, provided it fits in with federal

guidelines and policy. Also, responsibilities not assigned by the Constitution explicitly accrue to the states, by default. And *third*, for a given need, they generally have more staff, who are as qualified as the federal staff to provide the required technical assistance to municipalities, as illustrated by their share of wages and salaries in Table 1.

42. **The Leadership and Coordinating Role of the Federal Government.** The Ministry of Social Action (via the Secretariats of Regional Development and liaising with the Office of the President) and the Ministry of Transport are the key federal agent in the overall design of municipal policies. The former has adopted a portfolio of social programs that includes social welfare, housing, economic development and water and sanitation. The Ministry of Transportation handles inter- and intra-city transit. By agreement, the Ministry of Social Action will eventually take over responsibility for urban transportation once urban transit systems have been nursed back to financial health. The Ministry of Social Action has stated its intention to establish inter-ministerial coordination and ministries responsible for health, education, economic development and social welfare.

43. **A Role for Metropolitan Regions.** Beginning in 1967, the government established metropolitan authorities in nine cities to address common problems shared by more than one municipality. Eventually, the number of these authorities rose to 13 and they were given power over the planning and coordination of growth. The most efficient among these metropolitan entities (for instance, Belo Horizonte) organized and set up area-wide transportation authorities, coordinated transportation systems, instituted land use planning and offered technical assistance in cadastral information systems to constituent municipalities in São Paulo.

2. Aspects of Municipal Services Delivery

44. **The Two Roles of Municipalities.** Municipalities can have two major roles in a decentralized system. First, they can be *autonomous suppliers* of public services. They can then work towards their own objectives within their budget constraints. Second, municipalities can also be *sub-contractors or agents* for the federal or state governments. As such, they contribute to achieving the objectives of higher government levels. The sub-contracting of responsibilities to municipalities requires built-in incentives to ensure the channelling of local initiative. It also requires proper guidelines from the mandating government level. Lack of leadership can create an institutional vacuum and prevent programs and policies to be implemented.

45. **The Tools for the Municipal Mandate.** Tools such as budgets, investment plans and negotiated arrangements with the state and federal governments have a potentially important role to play. But they were largely overlooked in the reforms complementing the 1988 Constitution. They have not been used to their fullest extent. The way municipalities have responded to the lack of definition in the Constitution has shown them both at their best and their worst. Strong, self-starting municipalities have shown initiative and vigor, as is the case of Sobral, increasing their own source revenues or, in the case of Curitiba, showing budgetary surpluses. Others, many of them smaller towns, can continue to be a tool of local clientelism, especially during election years.

46. **Popular Participation.** Popular participation in municipal affairs was recommended in the Constitution and is practiced among the most active of the municipalities. Popular participation in the formulation of municipal development policy is guaranteed by two legal provisions: (i) representative

associations may take part in municipal planning; and (ii) a process of electoral initiative which allows ordinary citizens to propose local legislation, provided 5% of the electorate shows an interest in it. Perhaps the most common example of participation is advisory councils formed by mayors to tap into local sentiment and resources. The fact that there has already been one mayoral impeachment case illustrates the local demand for accountability.

47. **The Municipal Capacity Problem.** The need to strengthen the capacity of municipal administrations has already been recognized by the Government of Brazil and by the Bank as an important priority in the urban sector.⁷ Although the chief municipal strengthening institution in Latin America, IBAM, in Rio de Janeiro, reports an upsurge in requests for training and assistance in the years since decentralization, capacity strengthening is largely dependent on the motivation of individual municipalities, which is often in turn dependent on their financial position. At present, no other systematic programs are available to municipalities to help them strengthen their capacity to deal with the new financial and managerial responsibilities that they have been given.

48. Capacity strengthening involves a number of separate issues and considerations. The first area is the composition of the municipal civil services, i.e. municipal employment. Presently, each municipality may design and adopt its own service, a rule that works against the creation of a nationwide pool of technical municipal officers with similar expertise, training, salary and longevity. A second area of concern is administration and management, broadly understood to include resource mobilization, decision making, cost controls and accountability. Municipal revenue patterns are typically better documented than spending practices and efficiency in Brazil. Other areas that need to be considered include project and environmental evaluation and the strengthening of political, financial and economic control mechanisms to restrain spending and maintain efficiency checks on local government.

3. The Potential for an Institutional Crisis

49. The 1988 reforms have brought significant changes that require specific institutional arrangements, federal and state leadership, coordination across government levels and within each government level, among agencies or ministries. The Constitution provides a framework for decentralization. But this framework requires a complementary blueprint to assist all government levels to adjust to the new mix of responsibilities, given the realities encountered at all levels of the federation. While it is not within the scope of this report to provide such a blueprint, the following set of issues could be viewed as a detailed outline of what it should address. The analysis is based on interviews conducted during the mission as there is no hard data allowing a more quantitative evaluation. Specific illustrations for the analysis are provided in the two case studies discussed in the last part of the report. The current attempts to implement decentralization have led to deviations from the accountability, demand efficiency, production efficiency and equity objectives. They should all be addressed by any institutional reform.

⁷ The Bank has financed several state-wide municipal development projects (Santa Catarina, Paraná and Rio Grande do Sul) establishing state municipal development funds to strengthen the municipal capacity to manage their increased responsibilities and revenue. Table I-3 shows how reforms brought about by these projects performed according to the criteria just defined.

**MUNICIPAL DEVELOPMENT PROJECTS IN BRAZIL
(1984-1990)**

Project Title	Project Objectives	Accountability	Production Efficiency	Demand Efficiency	Equity	Sustainability	Comments
Paraná Market Towns (2434-BR) Effective: 3/15/1984	Finance infrastructure, public services & social facilities in small towns in the State.	O: NC I: high	O: NC I: NC	O: med I: med	O: med I: med	O:high I: high	Financial & institutional capacity of municipalities not addressed in objectives; project successful largely due to high degree of political accountability developed independent of project design at local levels.
Santa Catarina Small Towns (2623-BR) Effective: 9/24/1986	Finance infrastructure, public services & social facilities while strengthening managerial & financial capabilities of municipalities & improving resource allocation.	O: low I: low	O: NC I: NC	O: med I: low	O: NC I: NC	O:high I: low	While increased awareness of fin. & inst. weaknesses in project design, implementation suffered due to reliance primarily on traditional criteria of demand efficiency (cost-recovery) and sustainability.
Salvador Metropolitan Development (2681-BR) Effective: 5/18/1987	Finance infrastructure, public services & social facilities while supporting increased economic activity in Salvador Metro region & strengthening financial capacity of municipalities through technical assistance.	O: low I: very low	O: med I: low	O: med I: low	O: med I: low	O:high I: low	Project design begins to address other criteria, however, project implementation dramatically affected by very low accountability at all government levels.
Municipal Development in Paraná (3100-BR) Effective: 1/19/1990	Finance infrastructure, public services & social facilities while improving financial & institutional capacity of municipalities to: appropriately utilize fiscal resources, improve planning, cost recovery performance & policy, environmental protection & poverty alleviation.	high	med	high	med	high	Newer generation of projects attempts to address these criteria more explicitly in project design.
Municipal Development in R. Grande do Sul (3129-BR) Effective: 6/25/1990	Finance infrastructure, public services & social facilities while improving financial & institutional capacity of municipalities to: appropriately utilize fiscal resources, improve planning, cost recovery performance & policy, environmental protection & poverty alleviation.	high	med	high	med	high	Newer generation of projects attempts to address these criteria explicitly in project design.

Notes: a/ O and I have been used to distinguish between the extent to which projects at an advanced stage of implementation (the first three shown) addressed the criteria of accountability, efficiency, equity and sustainability in both their OBJECTIVE—or initial design stage—and their IMPLEMENTATION. The remaining two projects are so recent that the only assessment made is of the extent to which the criteria were met by the projects' objectives.

b/ NC signifies "Not Considered."

Deviation from Accountability: The Lack of Transparency, of Clarity in the Inter- and Intra-governmental Division of Responsibilities and Coordination

50. **The Need For Transparency.** Perhaps the most striking feature of the current institutional arrangements is that there has been little demand for transparency from any of the three levels of governments. The lack of transparency impedes accountability and appears mainly due to a lack of incentives to provide information. Better information structures make it possible for decision makers to minimize costs and to meet demand effectively. Accountability is also improved as municipalities are able to generate their own resources. With this in mind, reinforcing the municipal tax administration capacity should be a priority as weakness in this area is the main difficulty encountered by municipalities in their attempt to gain revenue independence. As discussed in the next section, municipalities have long relied mostly on transferred revenue.

51. **The Ambiguity of Environmental Law.** A clear example of the costs of a lack of transparency is provided by the complexity of the current environmental law. It leads to very high compliance costs and monitoring costs. Also, it makes unrealistic demands on the administration. Combined with a very poor data base on the sources and levels of pollution in most of Brazil, this lack of accountability is bound to be extremely damaging for an efficient and successful management of pollution. For instance, the *lei orgânica* of Rio prohibits anything to be thrown into rivers without cleaning it first and it requires municipalities to enforce this. Most do not have the resources or the skills and have to rely on states' assistance. To offset the effects of a complex law, many state agencies have to invest time and money in understanding the law, and their interpretation of the law does not always prevail in court. Private sector lawyers know this and use it to minimize compliance requirements.

52. **The Unclear Division of Actual Responsibilities for Policy Implementation.** In defense of municipal governments, it should be emphasized that accountability requires a reference structure which is not yet fully in place. Federal and to some extent State guidelines that are needed to place municipal responsibilities in context, and are still not prepared two years after the adoption of the Constitution. The federal government needs to clarify the division of actual responsibilities among levels of the government and to develop a more coherent policy framework than previously. In general, the federal role should be limited to setting standards and creating incentives for sub-national levels of government to improve their performance. If the financial and managerial capacities of municipalities were strengthened, this would increasingly permit them to raise more local revenue for more efficient discretionary spending. It would also enable them to provide infrastructure and services more efficiently, whether directly, as in the case of most local public services such as water, waste, paving and drainage, or by contracting out to private providers where appropriate. Other nongovernment organizations and local voluntary groups should also begin to play a more visible role in providing local services.

53. **Primary Education as a Victim of Weak Municipal Administrative Capacity.** Few municipal systems do an adequate job of running their current school systems. Those that do are ill-prepared to manage a significantly larger number of schools. Most municipal systems possess no trained staff in the areas of physical planning, budgeting or other non-teaching functions. They also rely on higher levels of government for some important functions that could conceivably be handled more efficiently at the municipal (or state) level, such as textbook procurement and the provision of school lunches. Rationalizing education functions among the three levels of government will require stronger municipal school administrations and should imply considerable shrinking of the federal and state apparatus. This will take time, particularly in rural municipalities. It will also require technical assistance. At present, however, neither state nor federal education agencies have the capacity to provide such assistance. State plans for the municipalization of primary education must be gradual and allow for implementation to proceed at different paces in different municipalities in light of their varying administrative capacity.

54. **The Need for Better Coordination.** Coordination fails if everybody wants to coordinate but nobody wants to be coordinated. Inter-sectoral coordination, particularly in housing and urban transport, should be managed in ways that are strategically different from past approaches. Coordination of housing and urban transport are influenced by two factors. First, policies on cost recovery and managerial efficiency should be substantially harmonious across subsectors. Second, and more difficult, broad developmental objectives in housing, transportation and municipal strengthening should be guided by the potential economic advantages inherent in the physical and spatial linkages among the subsectors. To some extent, this means that land use management and planning, particularly in the largest and fastest growing cities, should be more fully understood through sector work and explored in a few experimental cases.

55. **Coordination Failures in Pollution Management.** In the area of pollution management, poor coordination stems from a failure to assign responsibilities among government levels clearly or efficiently. If nobody is clearly responsible, or the required capacity does not exist, accountability is impossible. At present, policies are not always well coordinated and distributed between the various levels of government. For instance, production efficiency would improve if municipalities performed the enforcement function. Instead, this role is generally assigned to state environmental protection agencies (SEPA), who do not have enough resources and are hence slow to react.

56. Policies are often not well coordinated across municipalities/states. The effects of this failure are most obvious when pollution spillovers occur across jurisdictions. The unwillingness to negotiate the cost sharing of clean up costs with the victims is common. Also, competition for investment and jobs between municipalities and states reduces the incentive of the governments to alter their environmental laws or their implementation.

57. Finally, policies are generally not well coordinated across various ministries or secretariats, such as health, industry, transport and environment, that cover the various aspects of the municipal pollution issue. This has had an important impact on urban pollution. In only a few cases is there a conscious effort to design a transport policy that will alleviate pollution. At the local level, Curitiba may be the only major city in which the choice of transport equipment is made with that objective in mind.

58. **Coordination Failures in Primary Education.** The 1988 Constitution left overlapping responsibilities for primary education between states and municipalities. It recognized municipalities as "autonomous" actors in the provision of education and stipulated that municipalities should allocate their education resources "prioritarily" to primary education and preschool. It shied away from suggesting that municipalities should have exclusive or even principal responsibility for the delivery of primary education. Instead it called for a *regime de colaboração* in which the federal government would provide technical and financial assistance to states and municipalities, which would share responsibilities for education delivery. Thus, it implied the continued co-existence of ill-coordinated state and municipal primary education networks and set out no clear guidelines for the division of responsibilities.

59. The Constitution specifies that states have overall responsibility for education policy, implying the coordination of municipal and state systems. To date, however, this function has been underdeveloped at the state level, and state school administrations have been preoccupied with running their own schools. In the vast majority of states, no mechanisms yet exist for the coordination of state and municipal school systems. Investment programs are developed independently, for example, and the pattern throughout Brazil continues to be that some areas are served by duplicate and under utilized state and municipal schools in close proximity, while other areas suffer from severely overcrowded schools or none at all.

60. The institutional framework is further complicated by the fact that the federal government refuses to relinquish its traditional role in providing direct funding to municipalities, despite the fact that it is not in a position to evaluate the needs of over 4,000 municipal school systems nor to monitor school system performance. Continued federal funding of municipal education via negotiated transfer programs (*convênios*) poses two dangers. First, because meaningful technical criteria cannot be analyzed or monitored by the federal government at the municipal level, many federal transfers for education essentially become political. An example of this is the federal government's new US\$500 million Programa Nacional da Alfabetização da Cidadania (PNAC). The PNAC has begun transferring significant amounts to states and municipalities before establishing any technical criteria for allocations. Second, if municipalities continue to receive significant resources from the federal government with little or no accountability for results, it will undermine any state efforts to coordinate municipal and state education systems and to increase the quality of schools.

Deviation from Production Efficiency: The Need to Rely More on the Private Sector

61. Current institutional arrangements do not provide any guarantee or incentives for public service provision at minimum cost. At the conceptual level, the current structure of information does not allow higher levels of governments or the electors to check if production is at minimum cost. A clear indicator of the lack of production efficiency stems from the rather minor role granted to the private sector in the direct provision of municipal services. The potential role of the private sector in the efficient provision of local public goods should not be underestimated. In solid waste management for instance, Brazil's municipalities frequently grant concessions to private companies who recover their private costs. This form of service delivery should be considered for many other services such as transport, street cleaning and data processing, though that will not necessarily ensure demand efficiency.

Deviation from Demand Efficiency: Pricing According to the Benefit Principle

62. The demand for services will be excessive as long as municipalities fail to price them properly and continue to subsidize consumers by financing the gap between the price paid to suppliers and the price recovered from beneficiaries. The municipalities do not aim at cost recovery through proper pricing or taxation. Ideally, for goods and services with the characteristics of private goods, user fees should be charged to ensure that both the efficiency and the benefit objectives are met. When a service has public good features, such as the protection of the environment or the creation of a municipal park, and if its consumption by one person does not affect the consumption by others, the benefit principle requires user fees to be personalized. This, however, is too costly to implement. Demand efficiency may then be approximated by requiring residents to pay the same share of the marginal social costs as they get in total marginal benefits. This will generally violate the benefit principle. This rule is very seldom applied in Brazil. There is no clear principle underlying municipal pricing policies in Brazil. Prices are adjusted as revenue needs arise. Efficiency is seldom a concern and this cannot be explained by a preference for equity over efficiency as the poor do not benefit from inefficiencies.

63. **The Current Pricing of Use of the Environment Implies a Subsidy to Polluters.** The protection of the environment is entirely subsidized by general revenue at all government levels. The provision of services aimed at protecting the environment is seldom viewed as a service that needs to be paid for by beneficiaries. For instance, municipal waste collection services are basically free in most places. In São Paulo, the municipality with the best pricing policy in this sector, financial costs for providing waste related services is \$1/month/habitant, but the municipality recovers only 25% of it. Revenue mobilized through user fees and tariffs is not sufficient to match the costs of the services they

are supposed to finance. This is very obvious in solid waste management where the best performers recover at best 25% of the financial costs--not even the economic costs. This implies that municipal services are not priced to ensure demand efficiency. The implicit subsidies built into the current pricing policies promote over consumption and distorts the overall allocation of very scarce resources across municipal services. This is a generalized problem, even if larger municipalities are doing better than the smaller ones where, in general, no use is made of this source of revenue.

The Equity Payoffs of Efficiency and Accountability Improvements

64. Improvements in accountability within and across government levels may have strong equity payoffs. A fairer distribution of resources and a minimization of the interpersonal and interregional distortions introduced by rent-seeking activities will be among the payoffs of improved accountability. First, disfavored municipalities or individuals should be able to rely on a more accurate data to demonstrate their claims. Second, as efficiency improves, services costs tend to decline. Providing lower-cost services also contributes to poverty alleviation. This increases the resources available with which to expand the coverage and quality of services in the long run. In the short run, it makes it easier to target assistance to the poorest.

65. Subsidies may be justified if they are well targeted and designed to achieve poverty alleviation. But in general, rather than achieving redistributive objectives, they simply promote demand for services over and above what residents would have consumed if they had been charged the proper price or user fee. When the relative prices of goods and services provided are distorted by subsidies, demand is unlikely to be efficient. Redistributive objectives are seldom achieved and rationing of services becomes the norm set by the budget constraint. Most commonly, the poorest are the first to be the victims of rationing.

E. MUNICIPAL FINANCIAL MANAGEMENT ISSUES

66. This section focuses on the effect of the design of the financing sources and expenditures of municipalities on their current fiscal situation and prospects. It compares the balance between: (i) the costs of their larger expenditure responsibilities; and (ii) the magnitude of the larger share of revenue granted to them by the new Constitution. It reviews Brazil's traditional municipal expenditure patterns, and goes on to provide an overview of the various sources of municipal revenue. Preliminary evidence on the financial impact of the reform is also reviewed. The last section applies the normative framework to the main issues.

1. The Financial Performance of Municipalities

67. This subsection provides some information on how municipalities actually tend to spend their money on. It then provides a detailed discussion of the various sources of financing of these expenditures, with some emphasis on the 1988 reforms.

Municipal Expenditure

68. **How Much Have Expenditure Requirements Increased?** According to the National Accounts, municipal expenditures increased by almost 16% between 1988 and 1990. This percentage also represents the increase in the wage bill of a sample of capital municipalities. However, current practice has not yet caught up with the constitutional guidelines and the variance of increase in the sample of municipalities is rather high. In some areas, such as education, health, urban transportation, recreation and culture, child care, care of the elderly, and social assistance, there is overlapping or duplication of services, apparently because of a carryover of traditional patterns of service delivery that conflict with the new delegation of responsibility. An orderly transition to the new institutional arrangements is needed. Steps are being taken in a few areas to design a gradual approach to the devolution of expenditure responsibility. For example, the central government recently announced a medium-term plan (*Plano de Reconstrução Nacional*) that details state and municipal responsibilities for recovering, maintaining and building segments of the federal road network. This suggests that it is somewhat early to provide assessment of the effect of the changes on the municipalities' expenditure requirements. It is, however, useful to provide some perspective on the traditional municipal expenditure pattern.

69. **Municipal Expenditures per Categories.** Two surveys of capital municipalities, one carried out in 1985 and one in 1990, provide some insights into the composition of municipal expenditures, (for details, see Volume II, Chapter 2). They show that most municipalities spend 50-60% of their resources on consumption activities, wages and salaries and purchases of goods and services. This may be an underestimate because many municipalities such as Belo Horizonte, rely on a very labor-intensive indirect administration. In 1985, the average share of wages and salaries was about 34%. Purchases of goods and services averaged about 17%. The shares were comparable in the 1990 sample. The major difference between the two surveys is physical investment, which in the 1990 survey only represented 13% of total expenditure, against 18% in 1985. Most of this difference was offset by increased expenditure on goods and services. This decline is somewhat surprising because demand for municipal infrastructure increases with population growth. This suggests that municipal expenditures have been rationed.

70. **The Unevenness of Municipal Services Provided.** The uneven pattern of service delivery by municipalities, particularly in health, social assistance and other more traditional services such as solid waste, markets and slaughterhouses, is another result of confusing signals from the center and from the states. Many municipalities have foundered in the absence of clear guidance on which services they are responsible for delivering and to what standard. However, some have begun to take interesting initiatives in health, education, social assistance and infrastructure. For instance, the largest cities, notably Rio and São Paulo, have begun to move towards integrated health planning, while many others have taken initiatives in nutrition, primary education, housing and solid waste. Rio, São Paulo and Curitiba have all developed innovative programs that may be appropriate to extend to other municipalities. These include contracting out municipal day-care centers to private in-home providers, contracting out solid waste disposal services to the private sector, rewarding residents in *favelas* for recovering solid waste by giving them city bus tokens and encouraging private developers to provide public facilities.

71. At the same time, however, basic services, such as health and education, are uneven at best and often inadequate. For example, some large but financially weak municipalities in the Northeast have high quality technical people in charge of city health, but budgetary constraints prohibit them from expanding primary health care to those areas recently turned over by the state. As a consequence, a large percentage of the low income population is severely underserved. Other cities have sacrificed public works in favor of real increases in primary health care (from 9-14% of one city budget). These differences reflect a disadvantage that can arise from municipal autonomy, i.e., the uneven provision of

basic services. They also explain why there is a residual role for state or federal intervention in ensuring service delivery to the poor.

Municipal Disposable Revenue

72. **Composition of Municipal Resources.** The 1990 survey provides some detailed information for 11 capital municipalities. The results are illustrated in Figure 1. This information is somewhat biased as capitals benefit from a somewhat higher level of transfers, but it does not necessarily alter the major conclusions that can be derived from this survey. The major characteristics are that tax revenue and user fees represent only an average of 30% of municipal resources. The average own tax revenue in that sample is \$50 per capita, about 20% of federal or state own tax revenue. The ISS yields almost three times what the IPTU yields. Actually, it yields almost four times more because ISS is collected in all municipalities while IPTU is only levied in urban municipalities. For 1988, own revenue was 0.58% of GDP, 0.19% was due to the ISS in the capital municipalities, 0.05% was from the IPTU. User fees are hardly used at all with an average share of 3.7%. The two new taxes ITBI and IVVC are off to a slow start as together they do not even yield as much as the ISS.

73. Transfers represent over 50% of municipal revenue. By far the largest component, on average, is the ICMS share. It yields as much as all sources of own revenue. The FPM, the second largest source of transfer revenue with 17.5%, yields more than the ISS, the largest source of own revenue. The budget figures do not indicate a major municipal debt problem as, according to these figures, credit operations are only 3.4% of the revenue sources; in this sample also, only São Paulo borrows abroad. However, borrowing is potentially a more serious problem than it appears to be from an analysis of budgets. Extra-budgetary sources of revenue, a parallel set of accounts held by most municipalities to account for all revenue and expenditures not itemized in the budget, double the size of budget.

74. **Potential Revenue Effects of Better Local Tax Collection.** The data analyzed so far reveals the low intensity of the local fiscal effort. The main obstacle is the traditional political unwillingness to tax at local levels. One exception is Florianópolis which adjusted its cadastre value two years in a row. It has the highest IPTU revenue per capita of all, \$44. Most other municipalities have an IPTU revenue below \$10 per capita. Florianópolis cannot necessarily be emulated by other municipalities as it has a specific attraction for tourists that many others do not have, but it provides some idea of what is possible. Cuiabá has made tremendous efforts also over the last two years, increasing real collections by almost 1000% between 1989 and 1990, but still only manages to collect a third of what Florianópolis does. Property values are clearly not comparable, but even poorer municipalities should be able to obtain more. Cuiabá is collecting five times more IPTU than Rio Branco is collecting, four times more than João Pessoa and three times more than Aracajú. None of these cities have increased their revenue as much as they could have.

75. **Municipal Resources in 1993.** In view of the high degree of macroeconomic uncertainty, variability of inflation, tax reforms, and trade liberalization, it is impossible to ascertain the likely final revenue impact of the 1988 reforms on the municipal sector. But the preliminary data for 1990 provides a rather good indication of a lower bound. The net municipal share of the income tax and IPI revenue increased from 39.5% in 1989 to 40.5% in 1990. It will increase by one percentage point until it reaches 44% in 1993, almost 10% more than in 1990. In actual revenue terms, this means that transferred revenue was 22.9% higher in 1989 and 31% in 1990 over what it would have been without the reforms. The impact of the macroeconomic measures that led to a reduction in inflation, cuts in Tanzi effects, and increases in exports plus the impact of reducing effective transfer lags, further improved performance. In real terms, transferred revenue was almost 40% higher in 1990 than it would have been

had the 1988 conditions prevailed. Assuming that the sources of transferred revenue represent about 50%, a conservative estimate, means that effective municipal revenue could increase by about another 0.5% of GDP.

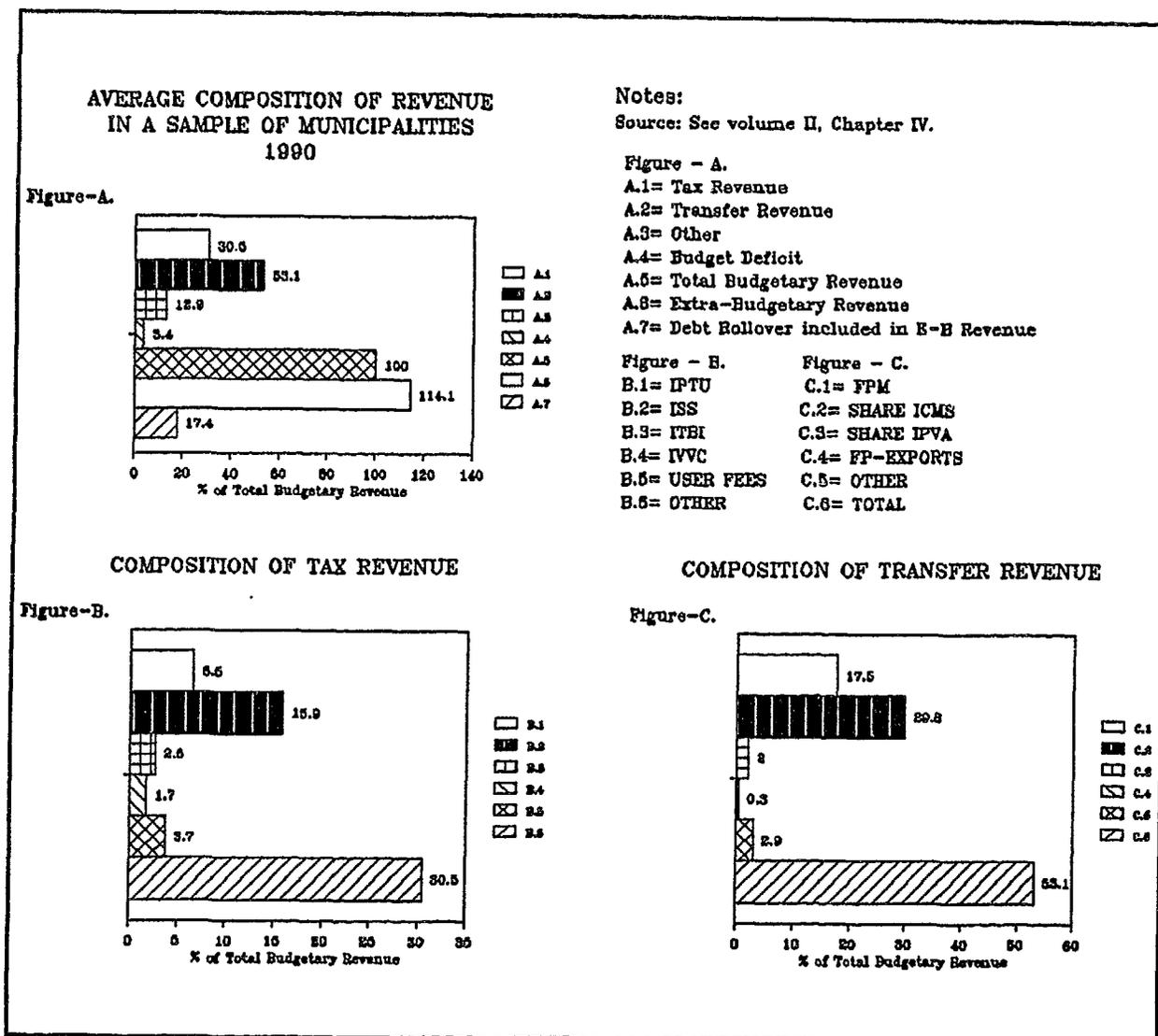


Figure I-1
Average Financial Indicators for a Sample of Municipalities

Is There a Potential Municipal Debt Crisis in Brazil?

76. Own tax revenues, transfers and other receipts (such as user fees and financial earnings) have not provided sufficient resources to finance municipal spending. Local governments can and do borrow. Although subject to limits imposed by the federal government's stabilization policy and by the Senate, which regulates public sector indebtedness, local governments have increasingly used credit; in fact, they have imposed it on suppliers. During the second half of the 1980s, suppliers' credit and arrears have become an important additional source of financing for local as well as higher-levels of government. This is documented by an analysis of extra-budgetary balance sheets.

77. Extra-budgetary balances do not follow a standard pattern. In some municipalities negotiated transfers are included here rather than in the budgetary balance sheets. This is one of the important impediments to a full assessment of municipal financial management. In particular, it blurs the analysis of the potential for a municipal debt crisis. Indeed, a major component of these extra-budgetary accounts is debt rollover. Debt rollover, as used here, has a very wide coverage; it includes any form of non-payment of liabilities. A major component of these is a, sometimes "mandatory", supplier's credit. Figure 1-A illustrates the importance of these extra-budgetary accounts showing revenue and debt rollover as a percentage of budgetary revenue.

78. For five out of ten municipalities in the ABRASF sample of capitals, extra-budgetary revenue represents more than just the budgetary revenue. The average for the sample is 1.1 times the normal budgetary revenue. For many, this simply reflects the fact that negotiated transfers are not built into the regular budget, but are part of extra-budgetary revenue. Debt rollover represents, on average, less than 20% of the budgetary revenue, or about 10% of the sum of extra and regular budget revenue. This presents a clear problem for some cities like: Manaus, Cuiabá, Porto Alegre, Campo Grande and more interestingly Florianópolis. This last municipality is, on the one hand, a top performer in terms of absolute fiscal effort but at the same time relies significantly on suppliers' credit. While no exact information is available for 1991, early indications suggest that debt rollover is spreading across municipalities as a financing instrument.

2. An Assessment of Current Municipal Financial Management

79. This section assesses the current status of municipal financial management, using the normative framework and the information provided earlier. The current design of financial management deviates simultaneously from all the normative criteria.

2.1. Assessing Transfers

Deviation from Accountability, Efficiency and Equity: The Need for Formula Driven Transfers

80. The overall design of municipal funding and in particular the design of transfers in Brazil does not provide incentives to municipalities for maximizing their own revenue or to be accountable for their financial management. This is reflected in the relatively slight use of user fees (*taxas*) and property taxes. Significant improvements in municipal fiscal efforts are unlikely to be successful without reforms in the design of transfers. Own revenue sources, local taxes and fees, are generally politically costly and thus tend to be avoided by local decision makers. Since the current revenue sharing arrangements in Brazil do not penalize municipalities who fail to maximize the use of local revenue, most municipalities have not attempted to develop their tax administration capacity. Few have updated property cadastres, for instance, and the base for the tax on services almost never reflects the current cost of services.

BOX N° 2: EQUALIZATION IN LOCAL FINANCE

- Horizontal fiscal balance has attracted much attention in the literature on fiscal federalism and multi-level finance. Equalization, as it is usually called, has been a controversial policy objective in many countries, because it has many different interpretations. For example, if horizontal fiscal balance is interpreted in the gap-filling sense, this implies a level of transfers sufficient to equalize actual expenditures of each local government. However, filling all gaps between actual outlays and actual own-source revenues for all local governments, like equalizing the actual outlays of local governments in per capita terms, ignores differences in local needs, costs and in own revenue-raising capacity. Moreover, it discourages local revenue raising effort and local expenditure restraint, since under this system those with the highest expenditures and the lowest takes, get the largest transfers.
- For these reasons, in all countries with formal systems of equalization transfers, the aim is either to equalize the capacity of local governments to provide a certain level of public services or to equalize actual service performance by local governments. Transfers are conditioned on both capacity and performance, by requiring the specified package of services to be provided. Alternatively, in a "truly" federal system in which local preferences are assumed to dominate national preferences for local public goods, such transfers should, in principle, be unconditional, even if the result is that local governments reduce their taxes or build municipal palaces rather than pay school teachers, as the national government might prefer.
- The capacity approach aims to provide local governments with sufficient funds (own-source revenues plus transfers) to enable them to deliver a centrally determined level of service. Differentials in the cost of providing services may or may not be taken into account. Unless grants are conditional, transfers based solely on capacity measures do not ensure that the recipient governments will use the funds they receive as the central government wishes.
- The service performance criterion adjusts the transfers received in accordance with the locality's need for the aided service (it may allow for cost differentials) and is in principle more attractive to central governments and those concerned with maintaining service standards in education or social assistance. The level of service to be funded is determined centrally and the transfer can be made conditional on the provision of that level of service. Unfortunately, this approach suffers from the same disincentive effect on the revenue side as equalizing actual outlays, since that government which tries the least, again, gets the most, unless an adjustment is made for differential fiscal capacity.
- How to equalize either approach in practice depends on how the standard of services to be financed is set. Full horizontal fiscal balance (full equalization) will be achieved only if the revenue raising capacity assumed by the grant is set at a level which could be afforded by the richest local government. Otherwise, the disabilities of below-average localities relative to those that are above average will obviously remain. The only exception to this statement is when the positive transfers required to bring those below the average up to the average are financed by negative transfers from those above the average (as in the finanzausgleich of Germany or the Danish local government grant scheme).

81. **The FPM.** Although the new Constitution provides for an increasing proportion of national income and industrial production taxes to be transferred to municipalities on a formula-driven basis through the FPM, this revenue sharing system is not predictable and transparent for many municipalities. Different financial reporting procedures during periods of high inflation may result in dramatically different budget data and actual financial flows. Many municipalities maintain that the FPM system is not transparent and that the federal government has transferred resources irregularly for the purpose of protecting itself from inflationary effects. This perception is widespread, and whether true or not, the integrity and accountability of intergovernmental transfers has been placed in question.

82. **State Transfers.** The distribution of state tax transfers for the most part follows the origin principle and is highly transparent. ICMS revenues are distributed by a formula that allocates at least 75% of such revenues according to where the value-added originated. Following this principle, there are wide divergences in municipal transfers in per capita terms by state; marginal weight is given in the formula to other factors that the individual states may consider relevant in the distribution of ICMS revenues within their jurisdictions. In fact, only 25% of total revenues are intended to be consistent with the fiscal needs of individual municipalities. It is in this area that the formulas used by individual states need to be re-examined. Municipal tax bases and indicators of fiscal effort could

integrate the formula. States could be granted continued flexibility for distributing state tax revenues among municipalities above a certain level of transfer. In any case these transfers should be formula-driven.

83. **Negotiated Transfers/Convênios.** Another serious impediment to local government financial management is the fact that municipalities and states may negotiate grant transfers with national ministries, completely outside the FPM and FPE systems. In addition to the extremely high transaction costs of these negotiated grants, their widespread use undermines all of the guidelines for intergovernmental fiscal transfers recommended earlier. *Convênios* appear to please none and to have no purpose. In general, municipalities downplay the role and amount of *convênios* but simultaneously accuse the federal government of disrupting local programs by ending them. Most *convênios* involve education and urban service programs.

84. Negotiated transfers from the national and state governments further undermines the incentives for municipal governments to mobilize their own resources. With the elimination of these negotiated transfers, there would be a clear incentive to increase local fiscal effort if the municipal political process indicates a demand for increased and improved services and infrastructure.

85. **Transfers and Equalization of Access to Primary Education.** A further concern about the municipal financing of education is that the new tax structure may not adequately ensure horizontal balance; some municipalities, particularly poor, rural ones, simply may not generate sufficient resources either through their own tax effort or through transfers to allow for adequate spending on education. It is clear from the huge variations in municipal spending per student that the tax and transfer structure at present does not equalize resource availability across municipalities with different *per capita* income. The extent to which this will change by 1993 is unclear. Full equalization of resources, of course, is a very ambitious goal, but there is some consensus among education experts in Brazil that the system should at least guarantee all municipalities (contingent upon their own tax effort) adequate resources to achieve "minimum standards" in the provision of basic municipal services.

2.2. Assessing The Expenditure and Revenue Assignment

Deviation from Accountability: The Costs of Weak Financial Data

86. Lack of data impedes an evaluation of the adequacy of: (i) expenditure assignment, (ii) resource authority and (iii) resource sufficiency by level of government. Macroeconomic instability and the lack of a systematic data collection process are the two basic reasons for this lack of adequate evaluation data. Brazil's macroeconomic instability over the past years has resulted in local government financial reporting that does not permit an assessment of current and proposed reforms in local government financial management beyond identifying and making a general analysis of fiscal allocation criteria and trends. Furthermore, there is no municipal information system for government financial management that permits comparison of revenue and expenditure performance between local governments and within municipalities to be evaluated over time. This is a key to the lack of accountability. It is not too soon for the Government to begin building the foundation for sustainable reform of local government financial management, as discussed below as an agenda item for the future.

Deviation from Efficiency: The Need to Improve Enforcement of Pricing Policies

87. **The Failure of Pricing Policies.** Currently, municipal pricing policies depart from the normative criteria in three ways: First, they rarely follow marginal cost pricing rules (or average cost

pricing when economies of scale exist), although a national tariff law exists on paper. Therefore, services have a built-in subsidy to consumers that promotes waste. Even when subsidies are meant to protect the poorest segment of the population, they often alter the incentive structure in a counterproductive way. The poor wind up subsidizing the rich, or the poor are provided with an incentive to waste so as to maximize the benefits from the implicit or explicit subsidy. Second, even when proper pricing is attempted because the provision of these services is sub-contracted to private or semi-private firms, the pricing formula focuses on the private costs rather than the social costs. Third, when services are subcontracted to private suppliers, cartels tend to be organized. In the case of solid waste collection, for instance, only a few corporations function in every state. In São Paulo, for example, there are only 13 firms of which four account for most of the service for this state. These firms rarely compete with each other, which may explain the high costs. A figure of \$10-\$20/ton is often quoted as reasonable for the collection service in Brazil. In Curitiba, the cost is around \$25/ton and it is \$65 in Brasília. In São Paulo, the cost varies between \$15 and \$25, but distances to dumping sites are greater than in most other states.

Deviation from Efficiency and Equity

88. **The Costs of Mismatches.** The mission's field visits indicate that municipal revenues do not adequately match expenditure responsibilities. This possible mismatch is of concern not only because of potential gaps in service delivery, but also because it may dilute institutional accountability in the municipal sector. It may also reflect poor financing choices or instrument selection. Mismatches of revenue and expenditure assignments over time will aggravate deviations from efficiency and equity. For example, the formulae for FPM allocation provide for equal treatment for all, municipalities with populations greater than 156,000. This may result in "overfunding" for municipalities with small populations that are losing people because of low employment potential and, therefore, have less demand for public infrastructure and services. For these municipalities, there is little incentive to control recurrent expenditures and increase local resource mobilization. Thus their investments tend to have a lower economic rate of return and less of an impact on poverty than those of municipalities that are absorbing poor migrants seeking better employment opportunities. These growing municipalities may be "underfunded" because of the increasing demand for infrastructure and services.

89. **The Case of Urban Municipalities.** This appears to be especially critical in municipalities that are at the periphery of metropolitan and other urban agglomerations. For example, there are numerous cases of metropolitan "bedroom" municipalities, such as Riberão das Neves in the Belo Horizonte Metropolitan Region where, because of relatively low land values and good access to the urban labor market, annual population growth rates have exceeded 15%, but industrial and commercial development has lagged far behind population growth. These municipalities have a high demand for infrastructure and services (e.g., education, primary health, transport, drainage) but a limited potential for cost recovery potential from direct beneficiaries (through user charges). They also have a limited local tax base. Therefore, these municipalities are highly dependent upon intergovernmental fiscal transfers. However, they are often "losers" in transfer allocations because of the FPM population cap, and because the ICMS allocations are based on the geographic source of the tax. As discussed below, the issue of underfunding for municipalities with rapidly growing populations may be addressed more effectively at the state rather than at the federal level.

Deviation from Production Efficiency: The Need to Control Expenditure Quality and Quantity

90. **The Need for an Expenditure Control System.** The analysis of the composition of expenditures provides clear evidence of an overloaded administration and insufficient investment levels. For an expenditure management system at a municipal level to operate efficiently (the same is true for

states) an appropriate information system is required. Currently weaknesses in financial management information make it difficult to assess expenditure efficiency. But, informal evidence gathered during the mission as well as survey data summarized in the document, point to a great potential for improvements in municipal expenditure efficiency. The existing expenditure control system is primarily based on cash management, and the tendency towards day-by-day cash control has been exacerbated by the continuing weakness of the formal budgetary process. For example, improvements in personnel policies and procurement practices could substantially increase the level of service provided per unit of expenditure.

91. **Unevenness of Education Quality.** To date, "minimum standards" for education at the municipal level have not been defined. The Ministry of Education has begun working on this. It is clear from the Ministry's recent research on Paraná and Rio Grande do Norte, however, that "minimum education standards" cannot be defined solely in terms of education inputs or spending per student. The real objective of education is student learning and what municipalities must pursue is an education model that reduces student repetition and dropout rates and increases learning. One implication of recent research is that neither state nor municipal systems have a very good idea about what inputs and interventions increase student learning most cost effectively; if they did, one would expect to see much higher increases in average student test scores associated with higher spending per student.

92. The third major issue is the **inadequacy of the financial framework**. Much has been made of the 1988 Constitution's tax reform and the sharp change in the distribution of overall fiscal resources across the three levels of government. It is true that, on average, municipalities are beginning to see higher revenues, and they should experience significant financial improvement after 1993 when the full effects of the reform kick in. However, there are still several problems. The first is the lack of incentives for municipal tax effort. The amount of tax transfers given to municipalities is not dependent upon how much incremental revenue they generate from their own tax bases, notably, property taxes. This means that the incremental transfer revenues may end up substituting for other revenue sources, so that municipalities' total revenues may not increase as much as expected. The potential for the projected levels of revenue will still exist, and municipalities that feel genuine pressure from their communities to expand services may sustain and even increase their own tax effort in addition to the incremental revenues they receive from transfers. But the evidence from other countries suggests: (i) that political pressure for tax reduction can be even more intense than pressure to increase spending and (ii) that decentralized levels of government tend to respond to increased transfers from higher levels of government by reducing their own tax effort. Thus, given the structure of incentives under the new tax system, there is considerable uncertainty about how total municipal revenues will evolve.

Deviation from Accountability and Sustainability

93. **Are Municipalities Using their Resources as Required?** There is uncertainty over the speed and degree of municipalities' compliance with the Constitutional provision that 25% of total municipal revenues should be allocated to education. According to the Association of Municipal Secretaries of Education (UNDIME), by 1990 at least 70% of municipalities had not yet met the Constitutional requirement. Aggregate data regarding the municipal share of total spending allocated to education are not available, but rough estimates suggest that it is still in the range of 18% to 22%. In the sample of municipalities visited by the mission, education spending ranged from 16% to 25% of total municipal spending and averaged 21%.

F. AN AGENDA FOR REFORM

94. This section summarizes the reform proposals, detailed in Volume II, to strengthen Brazil's municipal sector. These proposals in many cases constitute a drastic change from the present situation, as described in previous sections. But the direction, and to some extent the magnitude, of the necessary change is clear. Macroeconomic adjustment and stabilization for Brazil as a whole requires improving efficiency of local government investment and implementation, and instituting reforms in municipal finance.

95. It will take longer to achieve institutional strengthening than to achieve significant increase in the efficiency with which resources are mobilized and allocated than it will take to reform municipal financial management. However, the interaction between institutions and finances can be significant. Strengthening municipalities will allow mobilization more own-source revenues and more efficient provision of services, either directly or by subcontracting and monitoring private providers. Transaction costs will also be cut as rules, regulations and guidelines are simpler, more straight forward and easier to monitor.

96. The proposals are divided into three types: (i) reforms in the assignment of responsibilities by level of government and policy coordination; (ii) reform in the design of transfers, and (iii) reform in Expenditure and Revenue Management. Some proposals are general and cut across government levels--dealing with information as a requirement imposed by the need to reform the overall design of transfers. Other proposals are specific to each government level. They focus mostly on the role of each government level in municipal policymaking.

1. Reforms in Responsibilities by Level of Government and in Policy Coordination

97. **The Federal Government.** The primary responsibility of the federal government in municipal development policy should be to ensure that limited, national objectives are achieved, including access for all Brazilians to a minimum level of basic services, primarily education and health. In the short-run, this means that the federal government has to take the lead in filling the institutional vacuum observed across most aspects of municipal policymaking. The most immediate need is to prepare, in consultation with subnational governments, regulations formalizing the responsibilities of the municipal sector as defined by the new Constitution. It should also ensure the proper coordination with its ministries and across government levels. A first step towards this would be to present simple, realistic guidelines whenever their absence has become a source of delay in implementing municipal policies. The federal government should also take the lead in developing proper financial management procedures, including auditing, program performance management, criteria and technical assistance to implement these strengthening measures at the local level.

98. **The States.** As the economy stabilizes and the Government's policy for reforming and decentralizing the public sector matures, it may be expected that the States will assume most of the municipal development functions that have been exercised by the national government. With a stabilized economy and with resumption of economic growth, the assignment of municipal development functions and responsibilities would appear to be consistent with the Government's decentralization policy.

99. The State Governments would also assume the basic responsibility for equity across municipalities. This would be achieved primarily by setting the rate for the ICMS and allocating it between the state and municipalities. The ICMS would then be shared out according to a formula rather than negotiated on a case-by-case basis, with the sharing formula being based on the effective demand for infrastructure and services. The sharing formula could follow the criteria for intergovernmental fiscal

transfers and hence, there would be no need for negotiated transfers except in unique cases such as natural disasters. States could also promote inter-municipal provision of infrastructure and services, such as transportation and solid waste, in metropolitan areas and other urban agglomerations.

100. **The Municipalities.** Once these institutional arrangements are in place, municipalities would primarily be responsible for providing local services and infrastructure. They would have predictable and transparent shared revenues, complemented by their own-source revenues, and they would have clear responsibility for the quality of services, by being held accountable through the political process.

101. Thus, the level of municipal services and infrastructure, and their sectoral allocation, would be determined by the local political process, and subject to certain National and State objectives in areas such as education and health. The level of municipal taxes would be determined by the demand for services, as manifested through the municipal political process. As shared revenues would be formula-driven, and therefore transparent and predictable, service levels above those permitted by revenues shared with the state would have to be financed by the municipalities' own-source revenues.

102. **The Need for Federal Leadership in Pollution Management.** The actions required to address the issues identified will have to come from all levels of government. The Federal Government will need to provide leadership by devising general and minimum guidelines needed to facilitate coordination at all levels. The states and municipalities will have to adjust to these new guidelines and ensure that they are translated into effective policies at their levels. All three levels will have to work at reducing the political economy obstacles and at widening the choice of instruments. There is no legal impediment to introducing user charges at any level of government to finance environmental policy but the instruments need to be designed and implemented. In the case of water pollution, the Ministry of Social Action is currently demonstrating the required leadership by contributing the design of policymaking in the States of São Paulo, Paraná and Minas Gerais, but this is a rare exception.

103. **Addressing Coordination Needs of Pollution Management.** In some of the Brazilian regions, *consortios*, groups consisting of various municipalities affected by one specific problem, are being set up and are jointly analyzing the issues and identifying possible solutions to their problems. The success of these attempts is, however, still very uncertain. In several cases, political differences usually unrelated to the environmental problems, have hurt initiatives. At the federal level, IBAMA is currently reviewing this aspect of environmental policy and is expected to come up with a reform shortly.

104. **Matching the Complexity of Environmental Law to the Administrative Capacity.** The best solution would be to have a simple law but this is unlikely to be implemented immediately as it requires careful preparation. In the short-run, alternatives must be considered. Fortaleza and Curitiba have invested with some success in an education process at all levels, where they teach children about the environment. They also compile laws in an integrated form to help enterprises understand and thus obey them. Ceará has also included in its constitution a provision which requires the creation of a state court for environmental issues. This specialized court should dramatically reduce transaction costs for all parties involved and introduce some consistency in environmental court decisions as well. This is not the case presently in Brazil as there is no specialized court, only specialized lawyers.

105. **Responsibilities Assignment and Coordination Reforms in Primary Education.** The federal government needs to establish a clear definition of the respective responsibilities of the federal, state and municipal governments in the area of education, plus mechanisms for coordination. Direct administration of all primary schools should gradually be devolved from the states to municipalities as the administrative capacity of the latter is strengthened. States should develop strong complementary roles for: (i) the oversight of municipal education systems and quality control and (ii) core support

functions, such as curriculum research and development and teacher training. The federal government should concentrate on monitoring the progress of the states to improve the quality of and access to education. Direct federal links to municipalities should be eschewed except through automatic tax transfers.

2. Reforms in the Overall Design of Transfers

106. The Federal Government, in conjunction with states and municipalities, should quickly pay particular attention to reforming negotiated grants, which are excessively flexible, and to the ICMS system, which is excessively rigid. In this evaluation, it is recommended that the desirability of decreased financial dependence on higher levels of government be included, based on the principle that increased financial autonomy promotes increased government accountability for its actions.

107. **Reform of Negotiated Grants.** The Government should consider sweeping reforms in its policy of negotiated grants. They have high transaction costs for all levels of government. Therefore, it is recommended that negotiated grants between the national, state and municipal governments be compared with relevant alternatives. For example, if it is determined that municipalities need national resources in addition to the FPE and FPM, then these funds could be expanded and allocated on a formula-driven basis, while negotiated grants could be reduced or eliminated. As an alternative, negotiated grants could be pooled into just one grant, covering all sectors of local concern. In addition to reducing transaction costs, this would enable the government to provide an integrated support system to local governments and enhance its capacity to ensure that national interests which cross governmental jurisdictions (externalities of education and health services, for example) are adequately treated.

108. A second alternative to negotiated transfers is a system of selective (specific purpose) non-matching (block) per capita grants. Such grants would not interfere with the fiscal autonomy of local governments, would encourage innovation by individual governments, and would help bridge the fiscal gap. From the federal viewpoint, these grants would help municipalities achieve minimum standards and improve access to services. They are particularly appropriate for financing health and education. Federal direct participation in municipal projects may be restricted to technical and financial assistance for major projects, such as mass transit systems in large cities or metropolitan areas.

109. Yet another alternative to numerous negotiated grants is to critically evaluate the current ICMS policy. The requirement that ICMS revenues be divided 75% to states and 25% to municipalities prohibits service assignments from being effectively redistributed between the state and municipalities. It is recommended that a more flexible ICMS system be evaluated, (perhaps in conjunction with the phasing out of negotiated grants from the national government to states and from states to municipalities), in which the ICMS allocation between the state and municipalities may be brought in line with each level of government's comparative advantage in service delivery financing and operation.

110. **Reduce The Number of Conditional Grants.** Conditional transfers from states to their municipalities also need restructuring. Only few programs with explicit objectives, e.g., spillover compensation, or ensuring certain minimum standards need to be developed, and their design should clearly reflect their objectives. That would allow higher-level of governments to achieve objectives in a cost-effective manner, without distorting local priorities. Given the almost universal criticism of existing *convênios* in Brazil, these reforms are a high priority for all levels of government and could be implemented in a relatively short time frame.

111. **Built in Performance Incentives In Primary Education.** The federal and state governments must assure that adequate revenues and incentives exist to finance municipal education. States should equalize resources across municipalities to the extent necessary to ensure that all

municipalities have the capacity to meet the minimum standards. However, resource transfers should be linked to municipalities' progress in increasing revenues from their own tax (adjusted for changes in their revenue base) and budget efforts, specifically with respect to the constitutional mandate that they should spend 25% of their total revenues on education. The Federal Government should ensure horizontal balance across states (in other words, states' compliance with this constitutional requirement) as well as vertical balance and incentives at the state level. Finally, it should be explicitly understood that moving towards a municipal model of primary education implies reduced direct expenditure needs at the state level and the possibility that 25% of revenues devoted to education at the municipal level will not suffice. To deal with these issues, the federal government should ensure that the transfer of the administrative responsibilities for state schools from states to municipalities is accompanied by the appropriate transfer of state financial resources to municipalities.

112. Poverty Alleviation. Poverty should be addressed through clear and consistent targeting and eligibility criteria in municipal programs, rather than by regional investment as in the past. But eventually, municipal strengthening programs should be national or statewide in scope, with specific provisions that address regional variations in poverty and administrative strength. These might take the form of matching grants, increased shares of technical assistance and training and variations in counterpart financing requirements among others.

113. Creation of Financial Management Information System. Perhaps the most urgent agenda item is the design and implementation of a Municipal Financial Management Information System (FMIS) that would evolve to cover the entire sub-national government. Without a properly designed data base, many of the policy reforms are likely to be hard to implement. It should cover all municipal accounts, budget and extra-budgetary, for both direct and indirect administration. The Federal Government, in conjunction with states and municipalities, should quickly improve the information available which is necessary to evaluate and improve intergovernmental fiscal relations. Based on this information and evaluation. Its design and implementation of the FMIS should not be a unilateral exercise of the federal government. Instead, states and municipalities should be active participants. This collaborative effort would increase confidence in fiscal transparency; it may also improve the quality of the inputs that local governments make to the FMIS.

114. The FMIS has three primary objectives: (i) to monitor the implementation of macroeconomic policy, (ii) to provide a consistent financial reporting system for all levels of government for cross-section and longitudinal analyses, as well as improved transparency in inter-governmental financial transactions; this means it should cover both budgetary and extra-budgetary data as well as its indirect administration, and (iii) to form an analytical base on which to improve inter-governmental fiscal transfers, recommend tax reforms (e.g., consolidation of taxes with overlapping jurisdictional bases, decentralizing tax authority as an alternative to fiscal transfers) and draw closer revenue authority with expenditure responsibility at each level of government.

115. The Need for A Pollution Database. Just as in the case of financial management, data is crucial to the success of pollution management. Any solution to the regulator's limited capacity to enforce the law should start with the development of a good, uniform and systematically updated database. This database should provide policymakers with adequate information on the social costs of pollution, facilitate the ranking of local and national environmental problems and allow better allocation of the scarce resources available for implementing the law.

3. Reforms in Expenditure and Revenue Management

116. **Strengthening Municipal Taxation Capacity and Incentive.** It is clear that many municipalities have the potential to increase own-source revenues. There is a general perception that tax administration is very weak in most Brazilian municipalities or even non-existent in many cases. Improvements in this area will have considerable pay-off for both municipal and overall public sector performance. The federal government could take the lead or cooperate with the state governments to put together a technical assistance program to update property surveys and to strengthen or establish the institutional apparatus. Both federal and state governments should be involved in monitoring municipal tax (own) revenues and use some indicators of fiscal effort and performance as criteria for granting intergovernmental transfers.

117. In order to help municipalities make economically sound decisions, technical assistance in three high priority areas must be provided: (i) tax administration, (ii) medium- and long-term planning and financial programming, and (iii) project evaluation. Federal and state governments have to be major players in this assistance.

118. **Improving Cost Recovery in Pricing.** Municipalities' pricing and cost recovery should be much improved when they rely on user fees rather than on taxes to finance their activities. Full financial cost recovery should be the aim of pricing policies in the provision of municipal services. One way to achieve this is to allow actual, private or public, providers to collect their revenue directly from consumers as is already the case for water and electricity. Ideally, the aim should be to recover the full economic costs, including, for instance, environmental damage or any other type of externality. In the short run, in the smaller municipalities, it may be unrealistic to aim at anything except for the introduction of a service fees. Over time, however, the same general pricing policies should apply everywhere.

119. **Pricing Reform as A Component of Pollution Management Reform.** The core pollution problem is a pricing problem. A proper pricing strategy for the provision of water, sewerage and waste management services should also help the largest municipalities cope with the pressure of natural population growth and with the effects of rural-urban migration. In addition, the identification of cost minimizing pollution control policies should also ease the financial constraints on all levels of government, but the victims of pollution should be compensated and polluters should pay. Pricing policies should not only recognize the private benefits but also the social costs of pollution. In an extreme interpretation of this principle, it could be argued for instance, that the source of industrial water pollution has as much to do with the firm's choice of technologies as it has to do with the pricing of sewerage services. Similarly, the source of industrial air pollution reflects an imperfect energy pricing policy. As long as the pricing policy of these services does not have a social cost component, industry will be subsidized by the general population. This is, of course, an exaggeration as other instruments are available, but it may be useful as an illustration of the need to reform current policies. Immediate improvements would include the introduction of pollution taxes or natural resources user fees as decided in the context of a water pollution control project in Brazil currently being prepared by the Bank.

120. **Municipal Expenditure Management Reform.** At present, overall spending by municipalities does not fully match their expenditure assignment. The deterioration of expenditure performance appears to result from two specific items: wages and other personnel expenditures, and debt management. Improved personnel policies and procurement procedures may substantially increase the level of service output per unit of expenditure. Existing costs should not be accepted as a base for next year's budget. They should be reassessed until needs are met in terms of quantity and standards. Improving budget elaboration and implementation may significantly improve the efficiency of municipal expenditures. This can be observed currently municipalities which have instituted cost centers with clear

management responsibility for service delivery. Better design and execution of the budget would also provide valuable inputs to the FMIS. Having a double set of books, one for budgetary expenditures and one for extra budgetary expenditures, as many municipalities have at present, impedes any analysis of the allocation of resources. A single account book should be an immediate priority if policy decisions are to be based on relevant information. Identifying additional, more specific reform needs would also require a more detailed assessment of budgetary practices. This is currently being done for the capital municipalities at the initiative of the ABRASF, Association of Brazilian Capital Municipalities, and specific recommendations are likely to result. To promote these changes, the federal government could link financial assistance to local governments to expenditure reform programs. This could be done in the context of financial relations (e.g., *convênios*, grants, authorization for additional borrowing).

121. **Set Quality Standards for Municipal Primary Education.** The federal government, working with the states, should establish "minimum standards" for primary schools throughout Brazil. States should be responsible for providing insight and technical assistance to municipalities to help them achieve them. Minimum standards should include student cognitive achievement as well as other indicators, such as spending per student and the adequacy of physical facilities, materials and teacher quality. The federal government should expand its fledgling national education assessment system into a strong national capacity for evaluating school system effectiveness, with feedback of results to the states. The federal government should also expand its research in the area of education effectiveness as a basis for giving technical assistance to states when educational innovations are being made.

122. **Increasing the Role of the Private Sector.** For the private sector to increase its role, it will be necessary to identify those municipal activities that can be fully privatized. Many municipal functions are performed in a non-competitive environment. This often results in poor production or even demand efficiency. Private sector involvement in the provision of municipal services should be expanded to reduce rationing of some services and improve overall quality of those services. The potential private role is larger in the provision of services for which consumers are excludable when they do not pay for the benefits they receive--private goods and toll goods. This includes many municipal services such as parking, public transportation, roads, solid waste collection.

123. The increase in the private sector role should occur with a fiscal objective in mind. Municipalities should not subsidize consumers, as is currently the case with the concession of trash collection going to private companies. Also, the competitive process should be clearly monitored to avoid the oligopolistic structure leading to price-fixing which has been observed in solid waste management in Brazil as in many other countries.

4. Timing for Implementation of Reforms

124. With the recent constitutional reforms scheduled for evaluation and possible revisions not later than 1993, it is clear that Brazil is in an important transitory period regarding the institutional responsibilities of each level of government. Therefore, the Government may wish to evaluate the reforms suggested above according to the following timetable.

125. In the short-term, the Federal Government should improve its information system regarding the financial relationships between, and the performance of, each level of government. This improvement would support not only macroeconomic policy formulation and implementation, but also policies regarding the primary responsibilities and sources of financing for each level of government. This system also would help identify areas of technical assistance required to formulate and implement further reforms.

126. In the medium-term, the target would be intergovernmental fiscal relations that are transparent and predictable for all levels of government, including review of transfer formulas and tax assignment, with states and municipalities remaining autonomous and accountable for the levels and quality of the services and infrastructure within their jurisdictions, within clear national parameters for services of national interest. This would be achieved with clear "rules of the game" regarding intergovernmental fiscal transfers, and with the elimination of most if not all negotiated grants. New municipal investments would be financed by municipal current account savings and borrowing. The Federal Government should evaluate the roles, relevance and macroeconomic impact of official sources of credit.

127. The Federal Government should evaluate the relationship of local governments to the financial sector. In principle, local governments should not receive preferential treatment through a segmented financial sector with subsidized financing terms and conditions. Rather, local governments should compete with other activities (e.g., agriculture, industry, commerce) for access to credit. If the government's policy is to subsidize certain services for clearly targeted social groups, these subsidies should be provided via a transparent budgetary process consistent with macroeconomic and social objectives, and not via the financial sector.